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Should You Cash Out Your 401(k) or IRA Early?

As investors educate themselves about the financial advice that is accepted as "common wisdom," many begin to realize that 401(k)s might not be the "retirement solution" they were assumed to be. Even Ted Benna, the man who popularized the Internal Revenue Code 401(K) that turned into the 401(k) program, is very critical of what it has become.

But should you cash out your 401(k) or IRA? There are serious disadvantages as well as advantages, and it's often not a simple or clear-cut decision.

The Pros and Cons of Cashing Out Your 401(k)/IRA Early

There are many good reasons to liquidate your 401(k)/IRA for good (or perhaps just put future dollars elsewhere). Here are seven of them:

1. Future taxes: Many fear (for good reason: such as the US Federal deficit) that income taxes may rise and increase the future cost of receiving your money from your 401(k)/IRA.

2. Political uncertainty: There are risks in keeping your money in accounts governed by policymakers and a government in debt. Tax laws change on a regular basis. From 1986 to 1996 there was a 15% penalty (Excise Tax) if you received too much money from your qualified plan…simply because the Government changed the rules. Even today, Congress still often debates all kinds of things they would like to do with qualified plan funds.

3. Rules of Borrowing: Plan participants have restricted access to dollars for limited reasons and cannot use accounts to leverage against. Funds cannot be used to pay for college, start a business, purchase a home, or for other purposes without being subject to taxes and/or penalties. The only option is to take a loan. The maximum you can borrow is 50% of the account value up to $50,000.

4. The inefficiency of 401(k) loans: General Loans from a 401(k) must be repaid over five years which results in high payments during a time that money is tight, hence the reason for the loan. Any dollars borrowed from a 401(k) originally went into the account "tax deferred" but must be replaced with "after tax" dollars only to be taxed AGAIN upon withdrawal. The interest and principle re-paid are after-tax and taxed once again when withdrawn during retirement. That becomes an expensive loan! By the way…loans are prohibited from an IRA.

5. Consumer debt: Many plan participants already have high interest debts that could be paid off if they weren't contributing to their 401(k). It is common for a person to think it is wise to contribute to a 401(k) plan even though they are carrying high interest debt. The truth is, they are not creating wealth. Due to the illiquidity of a 401(k), it is likely a person will end up with increased debt.

6. Costs: Mutual fund management and administrative fees, broker commissions, actuarial and plan administrative fees drain profits and slow growth.

7. Limited choices: Investment choices are limited to the funds offered by the Plan and mostly consist of mutual funds.

In spite of compelling reasons to liquidate a 401(k), there are also important considerations and reasons why cashing out your 401(k) may be a BAD IDEA – or at least, not a good move to make right now.
Before considering pulling your money out of any tax-deferred qualified plan, be well aware of the following considerations:

EMPLOYER MATCHING: It is usually a good idea to fund your 401(k) if your Employer matches 50% or more of your contribution.

TAXES: You must be prepared to pay the taxes and penalties – both financially and mentally! Even when it makes sense numerically, it is often very difficult to pay all of those taxes which are due April 15th.

TIMING: Cashing out your 401(k) also means pulling out of your current investments. Nervous investors tend to pull their money after large losses – which may be exactly the wrong time. It feels counter-intuitive, but the best time to move your money from the market is usually when it has been performing well!

SAVINGS HABIT: Do you have an alternative structure (such as a Whole Life policy) in place to continue your savings habit? As problematic as qualified plans are, too often those who don't save in qualified plans find themselves not saving at all.

WHAT NEXT? Where will you put the money AFTER you liquidate your qualified plan? Do you have a solid next-step strategy? Are you confident it is a BETTER place for you money than your 401(k)?

We agree with Andy Tanner, author of 401(k)aos, liquidating your 401(k) without having a sound strategy for what to do NEXT is not a good plan. In his informative video (https://www.youtube.com/watch?t=15&v=ACUbiI21iro), Tanner explains why liquidating your 401(k) won't necessarily solve the "real" problem of why you were investing in a limiting and inefficient qualified plan to start with. As Andy points out, the reason that many employees are in 401(k)s in the first place is that they don't know how to do better on their own – in other words, **they don't know how to invest.**

Solving the 401(k) Problem

In spite of some limited and rather skewed "investment education" programs from plan administrators, a 401(k) won't solve the problem of teaching people to invest. (Ironically, the plans are designed so that this problem CAN'T be solved, as truly educating employees how to invest would lead them to choose different options than a 401(k)!)

"We will never teach 40 million participants to become highly skilled investors," Ted Benna told MarketWatch.com, after observing that "a 20 percent drop on your account value feels a lot different when your balance is more than $100,000 at age 56 than when you are 29 and have a $10,000 balance."

But the problem goes deeper than teaching people how to get a better rate of return. If anything, chasing high rates of return are actually a symptom. The bigger problem is that qualified plans lead people to INVEST more than they can afford while SAVING too little.

It is imperative that people SAVE MORE. Saving helps you keep control of your money, while too often investing involves giving the control to a manager or broker or someone else. (It is recommended you use 20% as a guideline or goal to keep up with taxes, inflation, planned obsolescence, and technological change).

Most people have far too few liquid assets that can be used for emergencies or opportunities, and too many assets in restricted environments. As a result, they are subject to unreasonable risk and also "raid" their qualified plans when emergencies strike – with costly results. (It is recommended that you have six months of your Gross Income in liquid savings).

Interestingly enough, when Benna tells the history of 401(k) plans, he reveals that they began with a mere 2 options: one for saving, and another for investing. An insurance company would offer a fund at a guaranteed rate, and the other option would be a broad, generally growth-oriented mutual fund, though sometimes it was the company stock plan (which, as we all know now, is a risky proposition.)

As Benna recounts, most participants chose to split their contributions between the two 50/50. Now, that didn't solve the issue of having the employee's savings locked behind the qualified plan wall, but it DID offer them some security and protection against market instabilities.

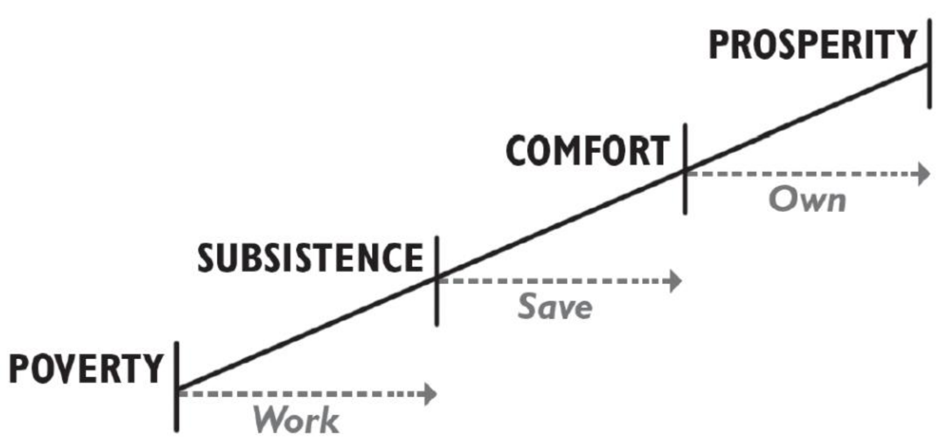
Yet there is another issue with the investment options provided in a typical 401(k). It has to do with the limited way many people have come to define "investments" as too often limited to stocks, bonds, and mutual funds.

Investing – as opposed to *saving* – is commonly thought of as attempting to get a higher rate of return than you could in a guaranteed account or whole life cash value. Unfortunately, that does not take into account the value of liquidity, use, and control.

Earning an attractive rate of return can be very important in cash flow investments, but when it comes to growth, assets and businesses that the investor can OWN or CONTROL or BUILD EQUITY in are equally important.

Real estate fits this definition. Business, ownerships, and partnerships can fit this definition. Cash value accounts within Whole Life policies fit the definition as well, although they are not technically classified as "investments."

In the Prosperity Ladder, (a concept described further in Kim Butler's book, *Busting the Financial Planning Lies*), WORK is what lifts people from poverty to subsistence, SAVING is what takes people from subsistence to comfort, and OWNERSHIP is what helps people climb the rest of the way up the mountain to PROSPERITY.



Get the Facts, Explore Your Options

Give me a call to discuss the pros and cons and options – if appropriate – to cash out your 401(k), IRA or Profit Sharing Plan early or perhaps free your money from a qualified plan gradually. Even if you don't wish to liquidate your 401(k) now, it may be high time you created other investment or savings vehicles for new dollars.

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