Cashing Out a 401(k) Due to COVID-19? Consider These Things First

Under the CARES Act, individuals impacted by coronavirus can access up to $100,000 from their 401(k)s and IRAs with fewer consequences than usual. But is it the right decision?

By Chris Davis May 6, 2020

Typically, the penalty for withdrawing from a 401(k) before the age of 59½ is 10% of the distribution, plus an automatic withholding of at least 20% for taxes. But with the passage of the CARES Act, that all changes in 2020.

The Coronavirus Aid, Relief and Economic Security Act, which allocates $2 trillion toward economic stimulus and relief in the wake of the coronavirus pandemic, includes several provisions that make it easier for those affected by the outbreak to access retirement funds.

The $300 billion earmarked for direct payments is getting considerable attention, but the CARES Act's language on early withdrawals from retirement accounts is remarkable in itself. Here's a broad overview:

- Individuals affected by COVID-19 can withdraw up to $100,000 from employee-sponsored retirement accounts like 401(k)s and 403(b)s, as well as personal retirement accounts, such as traditional individual retirement accounts, or a combination of these.
- The 10% penalty will be waived for distributions made in 2020.
- There are no mandatory withholding requirements.
- The distribution can be taxed as income spread evenly over tax years 2020, 2021 and 2022. However, if you can pay back the amount you took out within three years, you can claim a refund on those taxes.
- 401(k) plan participants can now take out 100% of their vested balance (previous rules limited borrowers to 50%) as a loan up to $100,000, and payments on this loan can be delayed for up to one year.

The CARES Act also waives **required minimum distributions** from retirement accounts in 2020 — a significant update for today's retirees.

Those aged 70½ and older can forgo the distribution and let it grow for another year, which can help prevent retirees from having to sell stock investments at a bad time. This can also allow retirees to reduce their income taxes in 2020 without the distribution.

Who is eligible for coronavirus-related distributions?

If you, your spouse or a dependent have been diagnosed with COVID-19, you qualify for the above benefits. However, eligibility for coronavirus-related distributions extends well beyond those who have been diagnosed, including:

- Any individual who has experienced "adverse financial consequences" because they've been quarantined or furloughed, or because their hours at work were cut.
- Individuals who haven't been able to work because they've had to stay home to take care of their kids.
- Business owners who have had to slash operating hours or shut down due to the outbreak.

If I'm eligible, should I take a distribution from my 401(k) or IRA?

Even with the new rules in place, it's still advisable to exhaust most other resources, such as emergency funds or other easily accessible forms of savings, before tapping into your retirement accounts.

But if you are considering taking a distribution from your IRA or 401(k), think through the following first.

You may be hurting your retirement

Every dollar you take from your 401(k) or IRA today means less you'll have in retirement — much less, thanks to compounding interest.

Let's say you have $50,000 in your 401(k), and you take a $5,000 penalty-free distribution. If you don't pay it back, not only will you forgo the tax refund, you'll miss out on substantial long-term growth.

In this scenario, $50,000 could grow to about $160,400 after 20 years without any additional contributions. Conversely, $45,000 might only grow to about $144,300. So the $5,000 paid the bills in the short term, but cost you about $16,000 in the long term. Use our 401(k) withdrawal calculator to explore your specific situation.

You may have to sell investments at a bad time

Pulling cash out of investment accounts after the market has fallen means you're locking in any losses you've incurred. Even if you reinvest these funds down the road, you'll have missed reaping any gains those investments would have seen in the interim.

In 2020, the S&P 500 had its largest first-quarter decline in history, finishing down 20%. Stats like this can lead to panic selling, or, coupled with the loosened withdrawal rules, may tempt you to dip into retirement accounts to prevent further losses.

But remember: You haven't lost anything until you sell. So if your cash crunch isn't an emergency, you can avoid losses by riding out the storm, and benefit from the rebound whenever it eventually occurs.

You'll still need to be mindful of taxes

You'll still owe income tax on your distribution from any tax-deferred retirement account. However, if you pay the distribution back within three years, you can file for a refund of the taxes you paid on that distribution.

Also worth noting: The income can be claimed all at once in 2020 for tax purposes, or spread evenly over the next three years. In many cases, dividing it evenly over three years may result in a better tax situation, as it's less likely to bump you into a higher tax bracket in any single year.

If your income is expected to be lower in 2020 than the subsequent two years, though, it could make sense to claim all of the income on your 2020 tax return. Not only might this minimize the effective tax rate you pay on this income, but you'll also have two years to pay back the distribution and ultimately get a refund.

Keep in mind that if you have a Roth IRA, it may still be a better choice for withdrawals than your 401(k) or IRA. That's because savers can always withdraw contributions (but not earnings) from their Roth IRA penalty- and tax-free.

401(k) loans versus 401(k) distributions: Which to choose?

With these new rules, the lines between a 401(k) loan and withdrawal can become a bit blurred. Both let you access up to $100,000 of your retirement funds penalty- and tax-free, but there are slight differences.

If you take a withdrawal:

- Repayment isn't required.
- There's no withdrawal penalty.
- It will be taxed as income initially, though you can claim a refund if you pay back the distribution in three years.
- You have tax options.

If you take a loan:

- Repayment is required within a specified time frame, typically five years.
- The loan amount is not taxed initially, and there is no penalty. However, if you can't pay it back in five years, the outstanding balance will be taxed as if it were a withdrawal, and you'll also pay the 10% early withdrawal penalty.
- All loan payments due in 2020 can be delayed for up to one year from the time you take out the loan.
- If you leave your job, you have until mid-October of the following year to pay back the entirety of the loan. If you don't pay it back, you'll be hit with early withdrawal taxes and penalties.

Bottom line. If you're confident you'll stay with your current employer for the next five years, a loan may be a better option than a withdrawal. Workers who stay with their employer will have five years to pay back the funds before facing taxes or penalties, and the interest paid back into the account can help make up for lost returns.

However, if a new job is on the horizon and you need to access retirement funds, a coronavirus-related withdrawal may be more prudent, considering 86% of those who change jobs with outstanding 401(k) loans *fail to pay them back in time*. You'll be taxed on the withdrawal initially, but you'll have the three-year period to pay it back and get a refund on those taxes.

It's important to note that employers must choose to amend their existing policies regarding loans and distributions to accommodate the provisions in the CARES Act. Moreover, not all plan sponsors offer 401(k) loans, and distributions are still at the employer's discretion. Be sure to consult with your employer on plan specifics before considering a loan or withdrawal.

Still considering a coronavirus-related distribution?

Using cash from a retirement account should always be a last resort, but there are a few scenarios when, under the new rules, it could make sense to withdraw early.

To avoid high-interest debt. If you're considering paying for expenses using a high-interest credit card or personal loan, using cash from retirement accounts may be a better option (depending on your credit and interest rate). You'll have three years to pay yourself back, interest-free, compared to paying down high-interest credit card debt or a loan.

To avoid a housing problem. If your bank or landlord hasn't put any rent or mortgage relief plans in place, it could be advantageous to continue paying these with retirement funds if you're at risk of eviction or foreclosure and have no other savings.

To meet other basic needs. If you don't have an emergency fund in a non-retirement savings account, it may make sense to tap into retirement accounts to pay for medical emergencies, prescriptions, essential food and hygiene items for you and your family, or elder care.

If you do decide to withdraw, the key to minimizing the downside is to only take out what's absolutely necessary and pay back the amount within three years — though the sooner you can pay it back, the better.