EGPS
ECONOMIC GROUP
PENSION SERVICES, INC.

401(k) AND COVID

Is withdrawing from your 401(k) Plan during COVID the right choice?

Workers who have been terminated or furloughed without pay during the COVID-19 crisis may have difficulty making ends meet. The most apparent source of relief for many is their 401(k) account. The government is helping people access their 401(k) accounts by providing legislation to make hardships and loans more accessible during this economic downturn. However, assuming the economy will eventually recover, and workers will want to retire, is this the best decision?

The tale of Sally and Bob

Sally and Bob are both age 39 in 2020. They each had $100,000 in their 401(k) accounts at the beginning of the year. Sally and Bob were laid off during the COVID-19 crisis. In order to make ends meet, Bob took a $30,000 hardship distribution from his 401(k) account (of which $6,000 he had to pay back in taxes at the end of the year). Sally sold a car and borrowed money from her parents but did not touch her 401(k) account.

Looking into the future:

- The market fully recovers in 24 months
- The target-date funds in which Sally and Bob are invested earn an average return of seven percent until their retirement at age 65

	401(k) Balance April 1, 2020	Amount distributed	401(k) Balance after dist./loan	401(k) Balance after recovery	401(k) Balance at age 65	Retirement income (monthly)	Decrease from COVID-19
Sally	$75,000	$0	$75,000	$100,000	$507,237	$3,074	0.00%
Bob	$75,000	$30,000	$45,000	$60,000	$304,342	$1,844	40.01%

Sally has $202,895 more in her 401(k) account at age 65 and can retire with income of $3,074 per month. Bob only has income of $1,844 per month. Bob's reduction of 40 percent of his retirement income is due to the $30,000 distribution Bob took some 26 years prior (which only netted him $24,000 at the time).

An alternative for Bob is to take the $30,000 as a loan from his account, rather than a distribution. This would result in a slightly better outcome, assuming it is actually paid back.

	401(k) Balance April 1, 2020	Amount loaned	401(k) Balance after dist./loan	401(k) Balance after recovery	401(k) Balance at age 65	Retirement income (monthly)	Decrease from COVID-19
Sally	$75,000	$0	$75,000	$100,000	$507,237	$3,074	0.00%
Bob	$75,000	$30,000	$45,000	$67,506	$449,169	$2,722	11.45%

***Includes 12 months of loan payments and 20% assumed growth during last 12 months of recovery**

This table above assumes that Bob went back to work with his current employer and paid back the loan over five years, following a one-year "grace period." However, the biweekly loan payments would be about $265, or approximately 20 percent of Bob's net paycheck assuming he is making $45,000 per year. If the loan is not repaid, the balance will be reported as a taxable distribution to Bob (plus he will incur a 10 percent early distribution penalty tax), and it will put the loss to his retirement income back in line with the 40 percent reduction under the hardship distribution scenario.

Be aware that both scenarios above assume no further contributions are made to the 401(k) account. It is possible for Bob and Sally to both improve their retirement income to the extent they make contributions after returning to work, and Bob could even catch up to Sally if he is willing to make larger contributions than her in future years.

Are there other options?

Workers impacted by COVID-19 should first and foremost consult their financial advisors. Other than that, a simple internet search can yield some good ideas—borrow from family, cut-back on spending, sell items from around the house, get a temporary job online, etc.

Employers may also consider supporting furloughed employees with temporary programs like IRC Sec. 139 plans, which allow a business to provide "disaster relief" payments to employees that are excluded from most taxes.

In summary, using 401(k) or other retirement plan assets now may have long lasting implications. It is recommended that plan participants consult with a financial professional before deciding to distribute or borrow from their retirement account.