

How does bankruptcy affect a 401(k) account?

Written by Australian Business

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Debt has become an overwhelming problem for many in recent years due to a variety of reasons. Some have suffered financial troubles stemming from the decline in the economy which resulted in the loss of a job while other reasons include the costs of a divorce and separate households, unanticipated health problems, and difficulties with resolving predatory home loans are only a few of the reasons why someone gets into financial trouble.

What are the solutions to solving the debt problem? Many people, having put away a part of each paycheck for years through employer-sponsored retirement accounts have accumulated substantial funds in their retirement accounts and consider liquidating those retirement funds in order to pay their debt and move forward. However, anyone considering this alternative should think twice and talk with an attorney before liquidating these funds to pay credit card debts or medical bills as there are likely to be a variety of unintended consequences many of which can be avoided by seeking a resolution through bankruptcy.

In most instances, federal laws protect retirement accounts when a person seeks relief from their debt through a [Chapter 7](#) or [Chapter 13](#) bankruptcy filing. A bankruptcy attorney can explain how the filing options can provide a fresh start without negatively affecting the funds in the retirement plan.

Tax implications of an early withdrawal

There can be tax implications for the early withdrawal of money invested in a 401(k) or 403(b) account. Those accounts are funded with pre-tax dollars, which means that there is no income tax paid until the money is taken out. To discourage people from using retirement funds before retiring, the law also imposes an additional ten percent tax on early withdrawals before age 59 1/2 as a penalty for the early withdrawal. Taking money out of retirement accounts to pay credit cards or other unsecured obligations may not be a good idea. The following explanation illustrates the reasons.

Depending on other income earned in a year, the income tax on an early withdrawal could be up to 39.5 percent without even considering the 10 percent penalty. Even a middle of the road income tax rate would mean paying 35 percent (25 percent income tax plus the 10 percent penalty). A withdrawal of \$20,000 would result in a tax bill of approximately \$7,000. At tax time,

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it might be impossible to pay the bill. Installment agreements with the taxing authorities are often possible, but this simply substitutes the nature of the creditor and the treatment which will have to be afforded that creditor. Outstanding tax debts of this nature are difficult to discharge in bankruptcy and may only be discharged in certain limited instances. A bankruptcy attorney can explain how the filing options can provide a fresh start without negatively affecting retirement plans or incurring significant tax liabilities and penalties.

Rebuilding a retirement account after an early withdrawal is a difficult process

Although there is no rule or law against rebuilding a retirement account, depending on the age at which the withdrawal was taken and the employment situation of the individual, it is almost impossible to make up the sums withdrawn from retirement accounts. This often affects not only when an individual can retire, but also the lifestyle that they may be able to afford after retirement may be considerably lessened. Even without an early withdrawal from a retirement account, those over the age of 65 make up the fastest-growing segment of the labor force as the costs of living exceed savings. Cashing out one's retirement accounts may mean needing to work more years in order to be able to afford retirement.

Bankruptcy protections on different types of retirement funds

In general, employer-provided retirement accounts (i.e. pensions, 401(k) and 403(b) accounts) are exempt from the bankruptcy estate. That means these accounts do not need to be liquidated to pay creditors in a bankruptcy and are protected.

Traditional IRAs and Roth IRAs also have protections up to a certain point. Currently, the federal bankruptcy laws allow for the exemption of funds in an IRA or Roth IRA from the claims of creditor but that exemption is limited to \$1,245,475 for combined accounts although rules may vary by state. In addition, there are certain other restrictions having to do with the amounts deposited into the IRA accounts. An attorney should be consulted about the protections available to IRA's under applicable state and federal law.

While IRAs and Roth IRA's are protected as noted above, it is extremely important to keep in mind that once there is a transfer of money from a retirement account to a regular savings or checking account, the funds lose their protected status under the bankruptcy rules and the

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sums may then be available to be distributed to creditors. In addition, be aware that once the money is taken out of the protective IRA status, taxes also may become an issue on the withdrawn funds.

There are many benefits to a strong retirement plan and although deep in debt and worried about a solution, withdrawing funds from retirement accounts is rarely the proper solution when bankruptcy is an option. Before cashing out retirement accounts to pay debts, consult a bankruptcy attorney to discuss options that might save your retirement and at the same time, allow you to obtain a fresh start free of the overwhelming debt burden.

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