Hitting the 401K

There is sometimes a sense of panic that sets in when you see your credit card bills begin to spiral out of control. When you are fairly new to that sense of being trapped by credit, you may turn to a second mortgage. But then if the credit card bills continue to grow and grow, as they are designed to do, you suddenly realize you have put your home on the line and it might now be in danger if you default on those bills.

This is when that mountain of debt can begin to knock on the door of your last remaining resources to try to fight back and you have to make some important decisions. And one is whether it would be a good idea to cash in your retirement money or borrow on your 401K to get enough money to try to bring down your debt levels. So deciding whether this is a good idea is a huge gamble because if you win, you could eliminate debt entirely. But if you lose, there goes your protection for your senior years and maybe the little nest egg you wanted to pass along to the kids as an inheritance.

Hitting the 401K to pay off your credit card debt is a bad idea for a lot of reasons. The most obvious reason is that your retirement money is tax deferred so when you put it into that account, you didn’t pay any taxes on it. You don’t have to pay taxes on it until you take it out. On top of that, the money is intended to stay in reserve until you hit retirement age so in a lot of cases, if you take it out early, there is a big penalty you have to pay.

So right away if you cash out your retirement funds to pay down or pay off your credit card debt, you are losing a lot of money to those penalties and taxes. You might want to calculate how much that penalty is going to be compared to the interest you might save because it’s a big pay off just to get to those funds.

The prevailing logic of hitting the 401k is that in theory you will save more money from the interest than you would make from the investment. But there is some solid logic for leaving those retirement funds right where hey are. For one thing, debt will come and go but retirement funds have a tendency to going away and never coming back. Once you cash out those retirement funds and give the money over to credit card debt, your retirement is gone. But if you find ways to take care of that credit card debt and leave your retirement alone, it is there for you and you have that sense of ownership that the debt has not taken everything from you.

One possible alterative is to borrow against your 401K and use it as collateral. Now in this case you are still just swapping out debt for debt. But secured debt is often easier to get a favorable interest rate and you can cap it so the rate doesn’t float around like credit card debt. So there is some rational for going that route. But if that is an option, you are still putting a very important part of your financial future on the line so tread carefully.

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