What You Need to Know Before You Cash Out Your Retirement

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Cashing out your retirement isn’t something to consider lightly. Although many people choose to make early withdrawals from their retirement accounts to cover expenses, they can end up paying a lot more than they planned.

Many people choose to cash out their retirement during a divorce. For some, the money may be used to cover legal expenses while others may be trying to protect their own assets from the division of marital property.

Know When Can You Withdraw From Your Retirement Account

Retirement accounts have restrictions on the timing and amount of withdrawals that can be made. Before you cash out your retirement, you should review the terms of your account.

Consulting with a family law attorney can help you determine the best option to take when withdrawing from a retirement account during a divorce. Knowing when you can make withdrawals helps you avoid the penalties that can often be applied.

Retirement accounts that are deemed “marital property” may be divided according to a wide range of factors that family law courts consider.

The division of retirement accounts can be complex, and it can create a large number of tax issues. You need to work with an attorney with experience in handling cases that involve retirement accounts and other similar assets.

Limitations When Cashing Out Retirement Accounts

Cashing out your retirement early results in penalties. Divorce and the financial needs that can arise during a divorce case don’t exempt individuals from these penalties or taxation.

In addition to facing a 10 percent penalty for early withdrawals, the money you withdraw may be taxed, further reducing the amount you actually receive.

The taxation of retirement funds depends on the type of contributions that were made. Pre-tax retirement accounts are only taxed when the money is withdrawn.

Some retirement accounts may waive penalties in cases that involve specific medical costs or college expenses.

When Withdrawals Are Allowed

An individual retirement account (IRA) is created using pre-tax income. This allows individuals to receive tax benefits from the annual contributions they make.

As a result, account holders are expected to keep their IRA funds in place for an extended period of time.

Cashing out your IRA before the age of 59 ½ results in the 10 percent penalty along with federal and state income taxes.

With an IRA, you can avoid these penalties if the money is being used to buy a first home, cover health insurance and medical costs, and provide financial resources in the event of a disability.

Roth IRAs are funded with after-tax income. This gives you more flexibility in making early withdrawals. Account holders must understand the difference between annual contributions and their earnings.

Your original contributions may be cashed out without any penalties, but this doesn't apply to the earnings in your account. You can also make withdrawals of your contributions for any reason.

But you need to wait at least 5 years from the date of the contribution until it can be withdrawn.

In divorce, funds in a retirement account may be transferred to a spouse in cases where the assets are divided. The transfer must be included as part of the divorce decree and can only be made once the divorce is finalized.

Any contributions made during the marriage are viewed as marital property by the courts. Your attorney can help you develop the legal strategies to protect your financial wellbeing in divorce.

Understanding the implications related to cashing out your retirement account early is the first step in avoiding costly issues and complicated divorce proceedings.

The terms of retirement accounts will vary, and taking the time to understand what contributions you can and cannot make ensures the best outcome in your divorce.