News Alert

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401(k) Loans - Should you consider this a source of financing?

Why would you want to take out a loan from your retirement account?

Any number of scenarios could cause you to gaze longingly at your 401(k) balance, wishing you could just get some of that money to use right now. Maybe tough economic times or an unexpected expense have depleted your cash and other savings, the line of credit that you have come to rely on for emergencies has been closed because your bank is tightening its credit belt, or maybe you have heard that your 401(k) is the best source of funding for any project because you can "borrow money from yourself and pay yourself interest."

How does this whole process work? What are the rules and restrictions?

In general, any withdrawals from your retirement plan before you reach age 59 1/2 will result in a 10% penalty assessed by the IRS. Most retirement plans (including 401(k)s) will allow the owner to borrow some of the funds within the account without incurring any early withdrawal penalties. The amount you can borrow is limited to half of the balance in the account or $50,000, whichever is less. The loan then must be repaid, with interest, within 5 years (10 years if the money is used to purchase a primary residence by a qualified buyer) or else the distribution becomes taxable and the 10% penalty kicks in.

What are some other options to get cash out of my account?

- If you are under the age of 59 1/2 and in desperate need of cash, you may take what is called a hardship withdrawal from your 401(k). We recommend avoiding this option if at all possible since the distribution is subject to the 10% penalty and you are not allowed to contribute to the account again for at least six months after the withdrawal. In addition, hardship "reasons" are restricted. You must have an "immediate and heavy financial need" such as funeral expenses for a family member, medical expenses, mortgage payments on your primary residence, college tuition, etc. Don't forget, hardship withdrawals are subject to income tax.

- If you are close to age 59 1/2, try to wait it out until you reach that age and then begin taking normal, taxable distributions without fear of any penalty.

- Certain distributions are penalty-free if you are meet the definition of "disabled" or pay medical expenses (subject to restrictions).

- There is another, less well known, option available for getting a steady stream of withdrawals for an extended period of time - if your plan allows and the age requirements are met. You have the option to take a series of withdrawals based on your life expectancy - subject to several limitations and involving different calculation methods. This option should only be used if you can commit to taking steady distributions with no flexibility once they begin. Again, these distributions will be taxable (but not subject to the 10% penalty).

- Do you have a Roth 401(k)? If so, you may be allowed to take distributions of your contributions but you may lose the tax advantage if the restrictions aren't met. Make sure to think it through - you might regret the loss of future account growth.

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What are the potential advantages of taking out a loan from your 401(k)?

- It is easy to access the money. Most plans do not require much administrative work to get your loan. This can often be very appealing when compared to the lengthy mess of applying for a loan from a financial institution. You don't have to show an "immediate and heavy financial need" as in the case of a hardship withdrawal.

- The interest you are paying on the loan is going back into your account. With a traditional third party loan, the interest payments bolster the cash account of someone else. With the 401(k) loan, you pay the interest right back to yourself. (This might seem too good to be true, but keep in mind that you are also losing the opportunity for compounded growth within the retirement account over the period of time during the loan.) If the interest rate that you are paying on the loan is higher than what the account would have made on its own, then you might have a good deal on your hands.

What are the potential traps and problems with the loan?

- While it may seem ideal to get to pay interest to yourself rather than to someone else, it is important that you also think of the tax consequences of the transaction. There is essentially a double tax on the interest that you are paying on the loan. Interest payments are made from after-tax dollars and when you start taking regular distributions out of your account when you retire, those dollars are taxed again - double taxation.

- When you take out a home equity loan, the interest you pay to the financial institution is tax deductible (subject to limitations). The interest you pay back to your 401(k) is not deductible.

- As mentioned above, the money that is taken out of the account does not have the opportunity to share in the compound growth that happens within the 401(k) over the term of the loan. Depending on the growth rate, you might miss an opportunity.

Do we recommend borrowing from your 401(k)?

This question cannot be answered without looking at your individual situation. Several things would need to be analyzed to determine if this strategy would be a good idea, such as your tax rate, rate of return within your retirement account, interest rates available from outside lenders, age, etc. It is important to remember that retirement accounts are meant to be used for just that - retirement. Always be cautious when playing with your long-term savings. Whatever your reason for looking into this strategy, it is always good to look at the pros and cons and carefully weigh your options along with all other possibilities.

If you would like to know more or would like us to do a personalized analysis to determine if this is a financially sound strategy for you, please contact:

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