NATIONAL ENDOWMENT FOR
FINANCIAL EDUCATION

WANT TO BORROW AGAINST YOUR RETIREMENT PLAN?
IS IT EVER A GOOD IDEA?

Consumers Should Understand the Financial Ramifications of Withdrawing Money from their Retirement Accounts

ENGLEWOOD, COLORADO—When cash is tight, borrowing money from a retirement account, such as a 401(k) or 403(b) plan, might seem like a tempting idea. You can withdraw the money quickly, you don't need to worry about a credit check and you pay the interest back to yourself. The process appears ideal.

However, before you borrow anything from your retirement plan, you should be aware of the financial consequences.

"Usually it's better to avoid borrowing at all or to borrow from other sources before dipping into your retirement savings," cautions William L. Anthes, Ph.D., president and CEO of the Colorado-based National Endowment for Financial Education® (NEFE®). NEFE is an independent, nonprofit foundation whose mission is to educate Americans about personal finance.

Anthes says, "You may be robbing yourself of your future financial security when you borrow from your 401(k). In some cases, borrowing from your employer-sponsored retirement plan might be a viable option, but only once you fully understand the related laws and regulations, the advantages and, particularly, the risks and downsides."

The Temptation to Borrow

Despite the recent bear market, many retirement accounts remain appealing sources for workers looking to borrow money to pay for college, make a down payment on a home, recover from a financial emergency or even fund discretionary purchases. Surveys stating the percentage of Americans who are borrowing from their retirement accounts are somewhat varied in their findings. The Profit Sharing/401(k) Council of America survey, for example, found that 23 percent of plan participants had loans in 2002, while the Employee Benefit Research Institute estimated that number to be 17 percent.

The Council also found that loans averaged $6,765 per borrower. EBRI's figures revealed considerable variance depending on age, tenure, salary and account balance. For example, borrowers with account balances less than $10,000 averaged loans that were 37 percent of their account's value, and workers in their 20s borrowed almost three times as frequently as those in their 60s.

Borrowing Basics

If you think you want to join those individuals already borrowing against their retirement, you should begin by understanding the regulations associated with this type of loan.

First, determine whether your employer's retirement plan permits loans. Federal law allows borrowing from 401(k) (including solo), 403(b) and profit-sharing plans, but not from simplified employee pension (SEP) plans, SIMPLE plans, Keoghs or individual retirement accounts. Also, not all employers allow plan loans, even if federal law permits them. According to the Profit Sharing Council, 14 percent of employers with 401(k) plans, and 66 percent of those with profit-sharing plans, did not permit plan loans in 2002.

If your plan does allow for loans, you can borrow up to $50,000 or 50 percent of the current value of the account, whichever is less. For example, if you have $60,000 in the account, you can borrow up to $30,000. If you have $120,000 in the account, the most you can borrow is $50,000.

There are a few exceptions to these rules. In the case of accounts valued at $10,000 or under, you can borrow up to $10,000 even though that amount represents more than half of the account's current value. However, you can't borrow more than the account's balance.

You may be able to borrow more than once, though federal law and most plans allow no more than two outstanding loans. To determine the maximum amount you can borrow on a second loan, consult your plan administrator.

Generally, plan loans must be repaid within five years at an interest rate set above the federal government's prime rate, which currently is 4 percent. Plans typically charge 1 percent above the prime rate, with a few charging as much as 2 percent.

There is a major exception to the rule stating that the loan must be repaid in five years, notes Anthes. "Loans used to buy a *principal* residence can go longer—even 10, 15, or 20 years, depending on the plan," he says. "Also, activated National Guardsmen and reservists, and regular military personnel in a combat zone, can borrow against a retirement plan that permits loans and then suspend their repayments for the length of their service or combat duty. However, in this case, the interest continues to accrue."

You also should be aware that loans on your retirement account must be paid back in equal payments at least quarterly, and more commonly, every month. You can't have balloon payments for such a loan.

Now comes a major risk that many borrowers don't realize, warns Anthes. Should you leave your employer's firm because you are changing jobs, retiring or losing your job, you must pay back any remaining loan balance within 90 days. Some plans impose a 30-day limit.

If you default on the loan, the IRS treats the outstanding balance as a "distribution." That means you pay ordinary federal, and perhaps state income taxes on the outstanding balance. And if you're younger than 59 1/2, you may have to pay an additional 10 percent early withdrawal penalty.

"If you don't have the money to pay the taxes, it will be deducted from the balance remaining in your retirement account," says Anthes. "And that money also will be taxed and perhaps penalized. That's why the failure to pay back a loan on a retirement account can be very expensive."

The Advantages

Loans from qualified retirement plans do have their advantages.

- They're easy to qualify for because you're borrowing from yourself.
- They generally are quick to set up.
- The interest rate usually is lower than many alternatives, such as credit cards or personal loans, though it's not always the lowest available.
- Repayment is easy because the payments usually are taken out of your paycheck.

The Disadvantages

Unlike with other loan alternatives, the most obvious disadvantage, already mentioned, is that should you leave your employment, you must pay off the loan promptly—something that may be difficult because a shortage of funds commonly is the reason people borrow in the first place.

A second disadvantage is one that you might have assumed would be listed under advantages—borrowing from yourself. Doesn't the idea of paying back yourself make more sense than borrowing from a traditional lender, such as a bank or credit union? Why pay the interest to a financial institution when you can pay it to yourself? However, in reality, it's not as advantageous as it might appear.

"Borrowers may not realize it, but they're taxed twice on that interest," says Anthes. For example, imagine you borrow $15,000 at 5 percent interest and pay off the loan in five years. You'll pay a total of $1,984 in interest back into your own account. But that $1,984 is money on which you already paid income tax. Then when you eventually withdraw that

$1,984 to help pay for retirement, you'll be taxed again on that same money.

Another drawback is that the money you take out of the account is suspended from growing tax free until you pay it back. Say you borrow at 5 percent, but the account earns an annual average of 8 to 10 percent during the time you're paying back the loan. Assuming a comparable interest rate, you would have come out better if you'd borrowed from an outside source, such as a home-equity lender. This is what critics mean when they say you stunt the ultimate size of your nest egg when you borrow from your own retirement account. However, there can be an exception to this disadvantage. Workers who borrow during a time when their account is losing money, such as during the bear market of 2000–2002, actually come out ahead. That's because they have fewer dollars exposed to the decline.

Still another potential disadvantage is that you usually cannot deduct the interest you pay back to your account. The exception is if you use the money to pay for a primary residence *and* the home is used as collateral for the loan (which often is not the case with these loans). On the other hand, if you take out a home-equity loan, you normally can deduct the interest for tax purposes regardless of how you use the money.

When to Consider Borrowing

While some financial planners say they would almost never recommend that a worker borrow from his or her qualified retirement plan, others say there can be exceptions.

An obvious one is in the event of a financial crisis where you have no other source of money to turn to in order to avoid bankruptcy or save your home from foreclosure.

Experts are divided over whether you should borrow to finance the purchase of a home, pay off high-interest credit cards or pay for college. In the case of credit cards, for example, some argue that paying off a card charging you 18 percent interest is a better return on your money than leaving it in a retirement account, which probably is earning less than that. However, if you choose to do this, beware of abusing your credit cards again. You don't want to depend on your retirement account as a way to pay off your credit card debt.

As for borrowing for college expenses, some critics contend that essentially you're stealing from your nest egg to put your child through school. Will your child be able or willing to help pay your way through retirement when the time comes? Instead of borrowing against your retirement, you may want to look into scholarships, financial aid and student loans. This way, your child can gain an education, and your retirement account can continue to grow.

While some planners have varied views on what financial instances call for borrowing against retirement, virtually all agree that you should never use a long-term account to make short-term consumer purchases. Unfortunately, surveys show that workers frequently take out loans on their retirement plans to pay for cars, vacations, furniture and even dining out.

"If you're seeking money for an essential need, consider other loan alternatives first, such as a home-equity loan or a loan from the cash value of a life insurance policy," recommends Anthes. "Better yet, see if you can avoid borrowing altogether. Every time you tap into your retirement account—whether to borrow or to take out money permanently—you're delaying the growth of your nest egg. And with people living longer and longer in retirement, they'll need every dollar they can muster."