When You Need Your Money Now: Plan Loans

Ideally, you will never touch your retirement funds, allowing them to grow continuously for retirement. But we don't live in an ideal world! In case of emergency, your funds may be available to you in the form of loans and hardship withdrawals. If you become disabled or pass away, you or your beneficiary can immediately have access to your account. If you retire early, you may also take an early distribution. If you are considering taking money from your plan before you retire, please read this chapter closely to understand the options available to you.

Loans

One of the benefits offered by most 401(k) plans is the ability to borrow against your retirement savings in times of need. Currently, about 25 percent of employees eligible for a plan loan have taken advantage of the option, with an average outstanding loan balance of about $7,400. Loans provide two special advantages:

1. If your plan has a loan program, you have the security of knowing that your money is available "just in case." This means you can comfortably make the maximum contribution commitment to your plan without worrying if you might need those funds later.

2. Loans help prevent you from depleting your retirement savings when financial crisis occurs. If your plan offers loans, you will be required to take a loan first before you can take a distribution because once money is taken as a distribution, it cannot be replaced.

Let's assume you have an unexpected crisis and you need your money. What should you know?

Loan Basics

- Plans typically allow you to borrow up to 50 percent of your vested plan assets, up to $50,000, less the amount of any outstanding plan loans.
- Plan loans usually have a minimum amount requirement, which is typically $1,000.
- Loans may be taken from all vested funds, which includes your rollovers from other qualified plans.
- In nearly all cases, you must repay your loan in equal payments over a five-year period.
- In rare cases, your payment period may be longer when the loan is for your primary residence.
- The interest rate you pay will be set on the day you take the loan. While rates vary by plan, prime rate plus 1 percent is most common. Contact your plan administrator to find out what your loan rate will be.
- Most plans charge some type of loan fee, such as a loan origination fee or an annual fee.
- Almost all plans use payroll deduction for repayment of your loan. Other methods of repay ment are rare.
- You can repay your loan in full at any time.
- Many plans allow more than one plan loan.

Pros and Cons

Plan loans are convenient, but they aren't always the right solution. Consider both the positives and negatives to determine if a plan loan is best for you, and always compare the overall cost of a plan loan with other possible loans.

Plan Loan Advantages

- *Less paperwork.* There are no credit checks or long credit application forms. You may be able to get a plan loan by simply visiting your benefits office, calling your plan's 800 number, or going online.
- *No restrictions.* Most plans let you borrow for any reason. Check your plan.
- *Fast.* You could receive a loan in mere days, depending on how often your plan processes transactions.
- *Good rates.* Prime rate plus 1 percent is the interest rate banks charge their best customers. This is a very good rate of interest for an individual borrower.
- *Higher return.* The rate of repayment for your loan may be greater than the rate of return you were receiving on your fixed investment. If you replace assets from your money market fund (paying 4 percent) with your plan loan (paying 7 percent) you would be earning a higher rate of return.

Plan Loan Disadvantages

- *Loan default.* Failure to repay counts as a hardship withdrawal, which means your money is taxed and you must pay a 10 percent early withdrawal federal income tax penalty on the out standing balance if you are under age 59 1N2.
- *Fees.* Eighty-one percent of plans charge a one-time loan fee, with an average $72 fee. Another 28 percent of plans also charge a yearly service fee, with an average $35 per year.
- *Alters financial plan.* You've done the work to determine your retirement goal and pick the right investment mix. But when you take a plan loan, money must be removed from your plan investments. If the loan must be taken from your equity investments, this may diminish your overall plan return.
- *Market cost.* Cash for your loan may come from selling shares from mutual funds or stocks. If you sell when the market is down and take a loss, you will reduce your long-term investment return. Similarly, if your loan repayments are reinvested when the market is up, you will reduce your long-term investment return.
- *Lower return.* The rate of repayment for your loan may be lower than the rate of return you were receiving on your fixed investment. If you replace assets from your diversified equity fund (paying 10 percent) with your plan loan (paying 7 percent) you would be earning a lower rate of return.
- *Spousal consent.* You may need to get your spouse's permission for a loan.

How Loans Work

In a sense, all investments are a kind of loan. You are lending money to the government or to a corporation through the stable value, money market, or bond funds in your plan. However, the return (or interest) generated from these loans comes from the borrowing party. When you loan yourself the money you are simply replacing the return you would already be receiving with interest payments from yourself.

Plan Loans and Your Investments

To preserve your asset allocation when taking a plan loan, you should withdraw the funds for a loan from the fixed income allocation side of your portfolio or the lowest returning investment option. Let's assume you have 50 percent of your money invested in stock, also known as equities, and 50 percent invested in fixed income. When you borrow 50 percent of the money in your plan, you want to take the funds entirely from the fixed income side and maintain all the equities. Some plans will ask you to make that decision, others will reduce all of your investments proportionally by the amount of your plan loan. In that event, you need to go back and rebalance the remaining investments to the proper equity and fixed allocation ratios.

Warning: Don’t Default on Your Loan

This is crucial: If you leave your current employer, have no outstanding plan loans. Whether you find a new position or you are laid off, in most cases, your plan loan will come due when employment ends. You will be given a limited amount of time to pay off your loan, and if you cannot repay it will be placed in default. If you take a loan, be sure you understand the repayment requirements in case you terminate employment.

"In default" means your employer will report to the government that you were unable to pay the loan, and the government will then treat the defaulted amount of your loan as a hardship distribution. You will no longer make loan payments to the plan. However, you will pay income taxes on the defaulted amount plus a 10 percent hardship withdrawal penalty if you are younger than age 59 1N2. Depending on your federal tax bracket and the tax rate of your state, you could pay taxes and penalties totaling as much as half of the defaulted amount. And, since your taxable income will increase due to the loan default, you may owe higher taxes on your other income due to phase out limits and higher tax brackets. Since you did not receive an actual distribution of money, you will need to pay these taxes and penalties from other assets you have accumulated. Some people will take a cash advance on their credit card to pay off the plan loan, because the 18 percent interest on the credit amount is still better than a 50 percent tax liability.