Borrowing From Retirement Plans

Many company-sponsored retirement plans, such as 401(k) and 403(b) type plans, allow employees to borrow funds from their retirement plans to be used for current spending. This borrowing privilege is not required to be offered under the law, but is commonly offered because it tends to increase the participation rate of employees in such plans. There are, however, limitations on the amount and length of the loan. A maximum of $ 50,000 may be borrowed from any plan, in one or more loans, and in any event, the amount borrowed cannot exceed 50% of the participant's vested ownership in their account. Typically, the loan principal must be repaid within a maximum of 10 years. The loan must also be repaid with interest, usually set at about 1% above the prime lending rate. Normally, employers will set up a monthly deduction from an employee's payroll to repay the loan. When you repay your retirement plan with interest, you are in effect paying yourself the interest.

This arrangement appears to be quite attractive on the face of it; you can obtain access to your retirement funds before age 59-1/2 without taxes or penalties, and you can pay yourself a competitive rate of interest. However, a deeper examination of the financial realities reveals that borrowing from your retirement plan should be an alternative of last resort, for most people.

Loss of Tax-Deferred Investment Returns

Let's take an example of a person who decides to borrow $ 20,000 from their retirement plan to do some home remodeling and purchase new furniture. Immediately upon initiation of the loan, that $ 20,000 is removed from your retirement account and stops earning whatever investment returns would otherwise be available if it was left in the account and invested in the

available fund selections. Depending on how it would otherwise be invested, you can expect to be losing the opportunity to earn from 5% to 15% annually over long periods of time. Furthermore, you are losing the tax-deferred benefit of that foregone return, which compounds the loss.

Interest Paid to Yourself Is Taxed Twice

You may convince yourself that it's not so bad, since after all, you do get to pay yourself a market rate of interest, let's say 5% assuming the prime rate is 4%. But is this 5% return a real increase in your total worth? Not at all, because you are merely transferring the interest payment from your own bank account into your own retirement account. You have just moved money from one pocket to another. You may think this is still not so bad, because you have at least gotten the amount of the interest into an account where it can now grow tax deferred. But consider this–the interest payment you make into your retirement account was already taxed once, when you earned it, before it got into your bank account. When it is withdrawn at some time during your future retirement, it will get taxed a second time, since it is now considered a taxable distribution from your retirement plan!

Loan Due In 60 Days If Job Is Lost

Perhaps the most compelling reason to not borrow from your plan is the consequences if you leave your current employer (other than for retirement, death, or disability.) Regardless of whether you left voluntary or were terminated, your former employer has the right to demand repayment of the total outstanding loan balance within 60 days of your termination; most will invoke this right, since they have no mechanism to collect monthly payments once you have left the payroll. You have to come up with the cash very quickly, perhaps at a time that you are between jobs and are either trying to conserve what cash you do have, or are no longer able to obtain other sources of credit. If you do not repay the loan within 60 days, your former employer is

required to report the outstanding balance to the IRS as a premature distribution (before retirement), and you must pay the income taxes, as well as a non-deductible Federal penalty of 10% of the amount, plus a state penalty (currently, 2.5% in California). Most people will have barely 50% left by the time the taxes and penalties are applied. Furthermore, you have no way to repay the amount back into your tax deferred plan later–the opportunity is lost forever!

Interest Paid to Yourself Not Tax-Deductible

Lastly, the interest you pay back to yourself into your retirement plan is not tax-deductible. In our example, the 5% interest rate on $ 20,000 borrowed does not provide a tax deduction. If instead the money was borrowed as part of a home equity loan, or borrowed "on margin" against securities held in a taxable brokerage account, the interest paid probably would qualify for a tax deduction. At a 35% marginal tax rate, the after-tax cost of the interest would be only 3.25%, or a 1.75% interest cost savings equal to $350.

The power to borrow against your retirement savings is a good option to have if it makes you more comfortable contributing to a tax-deferred plan, knowing you have a way to get at your investments before retirement. Just remember–only use it as a last resort, when you need the funds and don't have any other suitable alternative.

For additional information on this or related topics, or to learn more about the investment management and financial planning services offered by us, please visit our website www.strategicpartners-insurancegroup.com.

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