WARNING! Retirement Plan Loans Could be Hazardous to Your Wealth

Borrowing from your retirement plan should be your last solution, not your first, when you need a loan fast. Here's a look at the pros and cons.

It sounds so simple. You need some quick cash because of a financial emergency, and you decide to borrow from your retirement plan. After all, it's your money and the interest and principal you pay goes back into your account. But as with most financial issues, it's not as simple as it sounds.

In fact, for most people, borrowing from a retirement plan is not the best solution.

The rules:

If your retirement plan allows loans (most do), you can borrow up to 50% of your vested account balance or $50,000, whichever is less. You usually have a maximum of five years to repay the loan, unless you are borrowing for a first home, which allows a longer time to pay back.

Before we get into the pros and cons, one caveat up front: If you've got a financial emergency, and your only choice is between borrowing from your retirement plan or pulling the money out in a hardship withdrawal before you are age 59 ½, it's a no-brainer. By all means, borrow the money. That is because there is no penalty on borrowing, but there is a 10% penalty for early distributions.

Now, let's go through the pros and cons of borrowing from your retirement plan.

The pros:

- There is no credit check. You don't have to apply for the loan, and you can make plans knowing that you will get the loan.
- There is a low interest rate. You pay the rate set by the plan, usually a couple of percentage points above the prime rate.
- It provides a great return. If your money market account is earning 3% and you pay yourself back at 6% or 7%, it looks like a good deal.
- The interest is tax-sheltered. You don't have to pay taxes on the interest until retirement, when you take money out of the plan.
- It's convenient. Some plans only require you to make a phone call, while others require a short loan form.

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The cons:

- About that credit check: Of course there isn't one. You're not borrowing anything. You're spending your own money.
- You're losing earnings. The net effect is that you have less money to invest. The money you borrow -- or take out -- of your retirement plan no longer appreciates in value from market earnings, dividends and/or capital gains in conjunction with the rest of your investment portfolio. Remember that you aren't really borrowing. All you are doing is using money from one account, such as your checking or savings account, to repay the money you borrowed from your retirement plan. And when you take money out of that checking or savings account, that money loses interest, too.
- It's not tax-sheltered money anymore. Whether you repay the loan out of your salary or from a bank account, those payments are all made back into the plan with after-tax dollars. So, let's say your monthly interest payment is $300 and you're in the 28% tax bracket. You'll have to make $416 in gross earnings to make the $300 payment. Then, when you retire and take withdrawals, you pay taxes yet again.
- Unless you repay the loan, it is considered a premature distribution. You would owe federal and state income taxes as well as that 10% penalty if you are under age 59 ½.
- The loan isn't tax deductible. It's considered a consumer loan, so there is no tax advantage.
- It affects your psychology toward retirement saving. If possible, your retirement money should be untouched until you retire. It's too easy to get into the habit of dipping into your retirement plan instead of saving for things you need along the way. Keep your retirement plan in a loan free zone.

The bottom line:

It's better for most people to take out a home-equity loan if they're homeowners. In most cases (unless you're borrowing more than the value of the home), you can deduct the interest on your taxes. Another option is to use money currently sitting in a low-interest rate savings account or money market fund.

For detailed information about your plan loan options, please log in to Start Right, startright.bokf.com, or contact Participant Services Group at 1.800.876.9557.

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Impact of Taking a Loan

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