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Retirement plan loans: pros and cons

In Shakespeare's *Hamlet*, Polonius counsels: "Neither a borrower, nor a lender be." Sage advice when considering a loan from a 401(k) or other company retirement plan—especially considering the fact that with these kinds of loans you are actually both borrower and lender, making your decision twice as wrong from Polonius' point of view.

And, in most cases, you never would consider withdrawing funds from your company retirement plan account. After all, the whole purpose of making contributions is to watch your money grow continuously until you reach retirement. If you leave your money where it is, the more that you have growing tax deferred, the bigger the reward.

Still, according to recent statistics, somewhere between 17% and 20% of participants eligible for a plan loan have obtained one.

Overview

If you are considering a loan from your retirement plan, the first step is to find out the details of your company plan's loan requirements. Here, we highlight the features that most plan loans have in common.

Loan size. Generally, plan participants are permitted to borrow 50% of their account balance, up to a maximum of $50,000.

Repayment. In most cases you are required to repay the loan in 60 equal monthly installments within a five-year period. (Exception: A longer repayment period may be permitted when loan proceeds are used to obtain a mortgage for a primary residence.)

Most companies provide for loan repayment through payroll deductions. However, your loan may be repaid at any time.

Interest. The interest that you will pay on your loan is determined when you receive the loan. Interest rates vary plan by plan but usually are expressed in terms of the prime rate—"prime plus one," for example.

Minimums. Almost always, a minimum loan amount is established by the plan. A common minimum is $1,000.

Positives and negatives

But there is a certain appeal to borrowing from your retirement plan account. First, you are making interest and principal payments to yourself. And plan loans certainly are convenient and relatively easy to obtain quickly. There's less paperwork than the typical loan application.

On the other hand, your account might not continue to grow as you would like it to. The interest that you pay may be less than the return that you could earn by choosing other plan investments.

But the really bad news comes if you don't repay the loan according to plan requirements. The unpaid portion of your loan will be considered a taxable distribution from your account, triggering an income tax liability and, if you are under age 59 1/2, an additional 10% "early distribution" penalty.

Another choice: hardship withdrawals

Most plans offer participants another choice if they want to tap their retirement account: a *hardship withdrawal*. It's a path less frequently traveled. Why?

First, the amount that you withdraw is subject to income tax and, usually, a 10% penalty as well.

Second, hardship withdrawals are not easy to obtain. You must be able to establish that you have an "immediate and heavy financial need" for funds for: (1) medical expenses not covered by insurance; (2) the purchase of a principal residence; (3) postsecondary tuition; or (4) avoiding eviction. (Some plans may include additional needs such as funeral and child support expenses.)

Third, you must show that there are no other resources available to meet your expenses, including a loan from the company plan.

Four, once you take a hardship withdrawal, you are barred from participation in your company plan for at least 12 months.

Alternatives?

In sum, you should consider all your alternatives before choosing to borrow from the company plan. If you are a homeowner with significant equity in your home, explore a home equity loan. There may be a bonus with this kind of loan: The loan interest, within certain limits, may be tax deductible.

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Any developments occurring after January 15, 2007, are not reflected in this article.