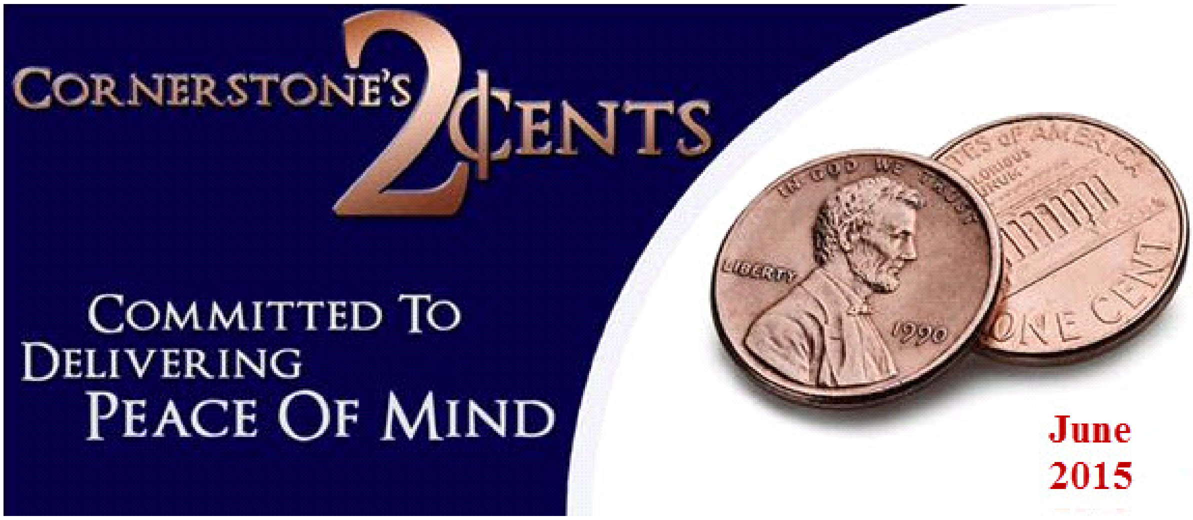

Here’s what happens when you take out a loan on your 401(k)

By **Elizabeth O'Brien** for [MarketWatch]

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Most of today’s workers won’t have pensions to fall back on in older age. Given that we’re on our own in funding our retirement, why are so many of us sabotaging our future security by borrowing from our 401k plans?

Just over one in four, or 26%, of 401k participants has a loan outstanding, according to a recent report from Aon Hewitt, a benefits consulting and administration firm. While that study didn’t capture the reasons why, a separate one conducted last year by TIAA-CREF found paying off debt to be the primary reason why people took out a loan, followed by paying for an emergency expenditure.

While 401k borrowers are borrowing from themselves, this isn’t a harmless transfer of money from one pocket to another, experts say. “The best spin you could put on it is it’s the lesser of several evils,” said Greg McBride, chief financial analyst for Bankrate.com.

After all, most Americans aren’t sitting on 401k balances that they can afford to skim. According to Fidelity, the average 401k balance was $91,300 at the end of 2014. That sum won’t even cover the average retiree’s health-care costs, according to Fidelity’s own estimates. (A 65-year-old couple retiring in 2014 will incur an average of $220,000 in retirement healthcare costs, Fidelity projects.)

Weighing the options

Some 94% of mid and large-sized employers allow loans on contributions employees have made to their 401k account, while 73% allow loans on contributions the employer has made, according to Towers Watson, a professional services firm. Some organizations let workers take out more than one loan at a time.

The Internal Revenue Service generally limits a participant’s plan loans to a total of $50,000 or half of the participant’s vested balance, whichever is smaller. Generally, repayments must occur within five years, with interest that the participant pays to himself.

The plan administrators must set a “reasonable” interest rate that reflects the prevailing market rate for similar loans. Although IRS guidelines provide examples in which the plan trustees set an interest rate reflecting market-rate loans for the borrower’s credit profile, experts say in practice many plans don’t look at the individual’s creditworthiness and set a default interest rate at 1% or 2% over the prime rate, a benchmark that’s currently at 3.25%.

Those considering a 401(k) loan should compare the rates they can get on other types of loans, such as a home equity line of credit. For people with solid credit, that will likely be a better option than borrowing from the 401k, experts say. Those with credit scores below 680 will have fewer outside borrowing options, and those with scores below 620 will have a hard time borrowing at all, McBride said.

Recognizing the pitfalls

Borrowing from a 401k plan exacts a big opportunity cost. Borrowers miss out on any compound growth that their investments would otherwise have earned in the market. Many plan participants either stop contributing to their 401k or reduce their contribution for the duration of their loan, so they also miss out on the company match.

Unless the money is repaid quickly, the loan represents a permanent setback to retirement planning, McBride said. (There are some rare exceptions, he notes. For example, people who borrowed right before the stock market tanked in the summer of 2008 might have come out ahead when they repaid their loan. But that’s not a circumstance that anyone can predict or plan around.) Bankrate has a tool that calculates how much money borrowers can expect to lose from 401k loans, given certain assumptions.

Those who borrow from their 401ks lose out on tax efficiency, too. Loans are repaid with after-tax dollars. In other words, someone in the 25% tax bracket would need to earn $125 to repay $100 of the loan. Savers’ 401k money is taxed again when withdrawn in retirement, so those who take out a loan are subjecting themselves to double taxation.

Employees who leave their jobs, are laid off or fired typically have to repay their loan within 60 days. If they don’t, the loan amount is considered a distribution, subjected to income tax and a 10% penalty if the borrower is under 59 and a half.

Most 401k plans also allow for hardship withdrawals, which aren’t repaid. Each plan trustee sets its own eligibility criteria, including a specific definition of hardship that participants must meet. Those who take a hardship exemption are generally prohibited from contributing to their plan for at least six months, must pay taxes on the amount withdrawn, plus a 10% penalty if under age 59 and a half unless the borrower meets strict qualifications for an exemption.

Individual retirement accounts (IRAs) don't allow loans, but they do allow withdrawals. Money contributed to Roth IRAs is taxed on the way in, so it can be withdrawn without penalty. While this might seem like a tempting option, the government caps IRA contributions at $5,500 annually—or $6,500 for people 50 and over—so withdrawn funds can never be fully replenished. "Once it comes out, it's a one-way ticket," McBride said.

Looking beyond loans

While many plan participants take out loans to repay debts, there are other ways to tackle such obligations. Non-profit credit counseling agencies can help people work with creditors to establish a repayment plan that often lowers the interest rates on the affected accounts, said Bruce McClary, spokesperson for the National Foundation for Credit Counseling. (Note: these non-profits are separate from the for-profit debt settlement agencies that solicit through the mail.)

McClary recalls one client he had when he worked for a credit-counseling agency. A woman in her late 30s or early 40s, she had a medical emergency that led to $40,000 in debt. By that time in her career, she had also amassed a sizeable retirement account. "She did not want to touch that 401k," McClary said. "She was adamant about that."

Many medical providers will establish payment plans for patients without charging any interest or penalties. Yet the woman's debt had already gone into collections, so she didn't have the option of working directly with her doctor or hospital. McClary helped the woman and her creditors create a plan to repay her debts.

People faced with big expenses can also get a part-time job and/or tighten their belts to come up with extra cash, said Andy Smith, a certified financial planner and co-host of the Mutual Fund Show. Sure, lifestyle changes aren't as easy as tapping a 401k, but they can save precious retirement funds. "You may not like eating baked beans and shredded wheat for six months, but that might be what it takes," Smith said.

Smith's list of acceptable reasons to take a 401k loan is short: to pay back taxes or other money owed to the IRS, to pay a tax lien, or to try to avoid bankruptcy. (For those who can't avoid bankruptcy, retirement assets are generally shielded during the process.)

Other experts have a broader opinion. "If a participant takes a loan once and repays it, it's not such a problem," said Robyn Credico, defined contribution practice leader, North America, at Towers Watson. "It's the ones who use the 401k as a checking account who are a problem."

Indeed, the first 401k loan can act as a "gateway" to serial borrowing, according to Fidelity. A large-scale Fidelity analysis of 401k investors last year shows that one out of two first-time 401k borrowers went on to take additional loans.

Loans for home purchases receive favorable treatment under some plans, with a 10-year timeframe for repayment instead of just five. As tempting as it may be to borrow for a down payment, this extension just prolongs the loss of compound growth and should be avoided if possible, experts say.

Preventing the need in the first place

It's easy to see 401k funds as found money, there for the taking whenever the budget gets strained. And sometimes, taking a loan makes sense -- say, if we're sure we can repay the money quickly, or if the alternative is putting a big bill on a credit card with a high interest rate.

But to the extent possible, experts say it's best to avoid getting into a situation where we need fast cash in the first place. That means setting aside a liquid emergency fund of six months' expenses. Good credit counseling agencies will help folks with budgeting, McClary said.

People are living longer than ever, with fewer safety nets. That makes the 401k sacrosanct, Smith said. He recommends that those of us tempted to dip into it remind ourselves, "This is what has to last me for the rest of my life."