Good Hands℠ **Retirement**

Plan

401(k) Plan Loans — Think Twice

When you need to borrow money to pay a big expense, taking a loan from your 401(k) plan may seem like a good idea. With a 401(k) loan, you are essentially borrowing from your own account rather than from a bank or other lender. Although the loan may be relatively easy to obtain, you'll want to take a closer look before you decide to go ahead with it.

It May Look Attractive

On the plus side, a 401(k) loan can be cost effective. Instead of paying the high interest rates that credit cards typically charge, frequently you can get a much lower rate from your 401(k) plan. In addition, all interest goes directly to your account. While loan payments to the plan must be made with after-tax money (unlike plan contributions), this is no different from most other loan options. (Mortgages are an exception, since interest is generally tax deductible.)

> "Before you take a retirement plan loan, you may want to look at other options."

But There May Be Complications

Your loan could become a cash problem if you change jobs. Usually, you have only two options when you leave your employer: Repay the entire balance or let the outstanding amount be classified as a taxable distribution. The second alternative would mean you'd have to pay income taxes on the unpaid balance of your loan *and* a 10% early withdrawal penalty (some exceptions apply). So, for example, if you had a $6,000 balance outstanding on the loan, you would have to pay $2,100 (tax and penalty) if you were in a 25% tax bracket.

Short Repayment Period

Another possible complication of taking a plan loan may be the length of the repayment schedule. By law, the term of a 401(k) loan is limited to five years unless you use the money to fund the purchase of your principal residence. That rule could cause timing problems if you intend to use your loan to pay for college expenses. If you take out a loan for freshman year expenses, you'd have to repay it just a year after graduation.

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Hardship Withdrawals

What about simply withdrawing the money you need? In certain situations, you may be eligible for a "hardship" withdrawal from your plan. Plans generally can allow hardship withdrawals for the following:

- Medical expenses
- To buy a principal residence
- College expenses for the person, his or her spouse, children, or other dependents
- To prevent eviction from or foreclosure on a principal residence
- Funeral expenses of a spouse, parents, children, or other dependents
- To repair damage to the person's principal residence that would qualify for the income-tax casualty loss deduction

You would have to have an "immediate" and "heavy" financial need for the withdrawal and show that you cannot attain the funds from other sources. Unfortunately, there would be tax consequences. Regular taxes — and a possible 10% early withdrawal penalty — would apply to the amount you withdraw.

A Better Way?

Before you take a retirement plan loan, you may want to look at other options. A loan that offers a longer term, such as a home equity loan, could be a more comfortable — and less costly — way to cover college costs or finance a major expense.

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