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When is it OK to tap the 401(k)?

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I heard from a family the other day that wondered about taking a loan out of the 401(k) -- or maybe a hardship withdrawal.

Did somebody lose a job? Was it hard to pay the mortgage? The car note?

No. The mom told me the son needed braces that would cost about \$5,000.

Bad idea? Not necessarily.

Right now, let's consider our economic world where credit card companies are stingy, consumer loans are tight or priced high out of reach and home values are so low that some families can no longer take out a home-equity line of credit.

I wouldn't recommend taking a 401(k) loan for holiday shopping. But -- I cannot imagine I'm saying this -- the loan might be reasonable for essentials, such as braces.

20% interest savings

Two economists at the Federal Reserve Board in Washington wrote a paper this year that suggests that households could save roughly 20% -- or about \$275 per year -- of their overall interest costs if they opted to borrow money from their 401(k) plans instead of taking on expensive consumer debt.

The interest rate that many people pay on a 401(k) loan is the prime rate plus 1% -- or 4.25% now -- but rates vary.

With the plans at General Motors Co. and Ford Motor Co., for example, the borrowing rate is the prime rate or 3.25% currently.

No credit checks are required, so if you had a bad credit score, you would not pay a higher rate.

While you might think that everyone is rushing to raid the 401(k) in a bad economy, the statistics show otherwise.

Last year, about 18% of all 401(k) participants eligible for loans had a loan outstanding against their 401(k) plan -- which was the same percentage for the two previous years, according to a study released in October by the Employee Benefit Research Institute and the Investment Company Institute.

The median loan balance was \$3,869 in 2008, down from \$4,167 in 2007.

Not all plans offer loans.

Under the law, participants are allowed to borrow up to 50% of their vested account balance or up to \$50,000 -- whichever is less. There is a possible exception if 50% of your vested account balance is less than

\$10,000. In that case, according to the Internal Revenue Service, you'd be able to borrow up to \$10,000. However, the IRS notes individual company plans are not required to offer you this exception.

Also, your plan may limit the number of loans you can have outstanding or the amount of time within loans.

Keep contributing

Do not ignore the pitfalls of a 401(k) loan.

First, what happens if you lost your job?

If you leave or lose your job, you could have to repay the entire outstanding loan nearly immediately after you leave some companies.

At other companies, you might owe all that money within 90 days to avoid a tax headache.

If you do not meet the deadline in such cases, any unpaid amount will be distributed to you as income, and will then be subject to federal and state income tax. If you are younger than 59 1/2, you may be hit with a 10% early withdrawal penalty, too.

If you retire or are terminated, you must keep making regular payments to avoid a default.

Second, be warned there can be a huge cost when you stop investing.

If the stock market is miserable, you're fine.

If stocks rebound and show gains of 8% or 10% or higher, you're losing out.

Pamela Villarreal, senior analyst for the National Center for Policy Analysis, a free-

market think tank in Dallas, noted that taking a \$30,000 loan out of a 401(k) plan and paying it back over 5 years could leave some retirees with \$200,000 less at retirement. Use a 401(k) loan calculator at www.retirementreform.ncpa.org.

The Federal Reserve economists -- Paul A. Smith and Geng Li -- said it's key to make regular 401(k) contributions while repaying the loan.

In general, loans must be repaid within five years. Loans from a 401(k) for the purchase -- not refinance -- of a principal home may be repaid within 15 years.

Still, should you avoid taking a 401(k) loan? Absolutely.

Additional Facts

Managing your 401(k) options by checking details on loan rules, rates

- Check your plan to see its rules and rates. Not all plans offer loans.
- Compare the possibility for a hardship withdrawal or a loan. Unlike a plan loan, you're not going to have to repay the money you've taken out of a 401(k) plan for a hardship withdrawal. Yet there are specific rules, according to the Internal Revenue Service, for when a hardship withdrawal is allowed from a 401(k) plan.
- The IRS allows hardship withdrawals from a 401(k) plan for specific reasons, including payment of college tuition and related educational costs for the next 12 months for participants, their spouse, dependents, or children who are no longer dependents; payments necessary to prevent eviction of participants from their home, and funeral expenses of a

spouse, parent or dependent and other reasons.

- There are some drawbacks to taking a hardship withdrawal. You won't avoid taxes. Hardship withdrawals are subject to income tax and, if you under 59 1/2

years old, there could be a 10% withdrawal penalty.

- Look into other options. Could you borrow from family or possibly even withdraw money from an Individual Retirement Account?