Financing Your Retirement Future

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The Economics of Borrowing from Your 401(k)

When times are tough, that pool of dollars sitting in your 401(k) plan account may start to look attractive. But before you decide to take a plan loan, be sure you understand the financial impact. It's not as simple as you think.

The basics of borrowing

A 401(k) plan will usually let you borrow as much as 50% of your vested account balance, up to $50,000. (Plans aren't required to let you borrow, and may impose various restrictions, so check with your plan administrator.) You pay the loan back, with interest, from your paycheck. Most plan loans carry a favorable interest rate, usually prime plus one or two percentage points. Generally, you have up to five years to repay your loan, longer if you use the loan to purchase your principal residence.

You pay the interest to yourself, but …

When you make payments of principal and interest on the loan, the plan deposits those payments back into your individual plan account. This means that you're not only receiving back your loan principal, you're also paying the loan interest to yourself instead of to a financial institution. But the benefits of paying interest to yourself are somewhat illusory.

Here's why. To pay interest on a plan loan, you first need to earn money and pay income tax on those earnings. With what's left over after taxes, you pay the interest on your loan. When you later withdraw those dollars from the plan (at retirement, for example), they're taxed again because plan distributions are treated as taxable income. In effect, you're paying income tax twice on the funds you use to pay interest on the loan. (Note: Special tax rules apply to Roth 401(k) contributions.)

The opportunity cost

When you take a loan from your 401(k) plan, the funds you borrow are removed from your plan account until you repay the loan. While removed from your account, the funds aren't continuing to grow tax deferred within the plan. So the economics of a plan loan depend in part on how much those borrowed funds would have earned if they were still inside the plan, compared to the amount of interest you're paying yourself. This is known as the opportunity cost of a plan loan, because you miss out on the opportunity for more tax-deferred investment earnings.

Other considerations

There are other factors to think about before borrowing from your 401(k) plan. If you take a loan, will you be able to afford to pay it back and continue to contribute to the plan at the same time? If not, borrowing may be a very bad idea in the long run, especially if you'll wind up losing your employer's matching contribution.

Also, if you terminate employment, your plan may require that your loan become immediately payable. If so, and you don't have the funds to pay it off, the outstanding balance will be treated as a taxable distribution to you, and if you're not yet 59½, a 10% early distribution penalty may also apply to your taxable balance.

Still, plan loans may make sense in certain cases (for example, to pay off high-interest credit card debt, or to purchase a home). But make sure you compare the cost of borrowing from your plan with other financing options, including loans from banks, credit unions, friends, and family. To do an adequate comparison, you should consider:

- Interest rates with each alternative
- Whether the interest will be tax deductible (for example, interest paid on home equity loans is usually deductible, but interest on plan loans usually isn't)
- The amount of investment earnings you may miss out on by removing funds from your 401(k) plan

Ask the Experts

What is assisted living?

The wide range of assisted-living options makes defining the term difficult. Generally, assisted-living facilities offer rental rooms or apartments, housekeeping services, meals, social activities, and transportation. Their primary focus is social, not medical, but some do provide limited medical care.

Assisted-living facilities may or may not be state-licensed, and primarily serve senior citizens who typically need more help than those who live independently. Other terms used to describe assisted-living arrangements are board and care homes, rest homes, and community residences. Continuing care retirement communities (CCRCs), also called life care communities, also fit loosely into this category, although they provide what other assisted-living facilities do not: long-term nursing care and guaranteed lifetime services.

Most assisted-living facilities create a service plan for each resident upon admission.

The service plan should detail the personalized services you require, and the plan should be updated regularly to ensure that you, or your parent, receive the appropriate care as conditions change.

The cost of assisted living varies with the residence, apartment size, and types of services needed. The basic rate may cover all services, or there may be additional charges for special services. Most assisted-living residences charge month-to-month rates, but a few require long-term arrangements. Most residents pay for the cost of care from their personal financial resources. Some costs may be reimbursed if you have long-term care insurance. Medicaid waiver programs help pay for assisted-living services in some states.

To find out more about assisted living, start by contacting your local area agency on aging (AAA). Contact the U.S. Administration on Aging's Eldercare Locator at 1-800-677-1116 or visit www.eldercare.gov to find the AAA office closest to you.

How do I choose an assisted-living facility?

Choosing an assisted-living facility for you or your parent can be challenging because you may not know what kind of help will be needed in the future. However, certain factors other than cost can help narrow your choices. The following considerations can help you with your search for the right assisted-living facility:

- Is the facility close to family and friends?
- Are there shops and businesses nearby? Is transportation provided?
- Are social, recreational, and spiritual activities provided?
- What kinds of personal care are provided? Is there help with bathing, dressing, toileting, grooming, eating, housekeeping, laundry, and medications?
- What happens if you get sick? Can you be asked to leave the facility if your physical or mental health deteriorates?
- Is the facility licensed or unlicensed? If licensed, check state reports.
- What professionals are on staff?
- Is there enough privacy and adequate security?
- Is the facility well designed and safe?

To research a facility:

- Visit the facility several times, and visit at least once unannounced.
- Visit during mealtimes, and sample the food.
- Observe and talk with the residents and staff.
- Check with the Better Business Bureau and the state's long-term care ombudsman to see if any complaints have been filed.
- If the facility is connected to a nursing home, investigate that too.

Should You Roll Your 401(k) Money Over to an IRA?

If you're entitled to a distribution from your 401(k) plan (for example, because you've left your job), and it's rollover-eligible, you may be faced with a choice. Should you take the distribution and roll the funds over to an IRA, or should you leave your money where it is?

Across the universe

In contrast to a 401(k) plan, where your investment options are limited to those selected by your employer (typically mutual funds or employer stock), the universe of IRA investments is virtually unlimited. For example, in addition to the usual IRA mainstays (stocks, bonds, mutual funds, and CDs), an IRA can invest in real estate, options, limited partnership interests, or anything else the law (and your IRA trustee/custodian) allows. (Certain investments may not be right for everyone, and some may have adverse tax consequences, so be sure to consult your financial professional.)

While the investment flexibility that IRAs provide can be a benefit for some people, it may be a drawback for others. If you lack investment knowledge and experience, you may be more comfortable with the limited investment alternatives your 401(k) plan provides.

Take it easy

The distribution options available to you in a 401(k) plan are typically limited, usually to a lump-sum payout, or installments payable over a period of years. And many plans require that distributions start if you've reached the plan's normal retirement age (often age 65), even if you don't yet need the funds.

Similarly, 401(k) plans often require that a beneficiary take a lump-sum payment shortly after the plan participant dies. This may not be a problem if your beneficiary is your spouse--he or she can roll the funds over to an IRA after your death. But a nonspousal rollover is possible only if your 401(k) plan allows it. And some don't, forcing your beneficiary to take a distribution he or she may not yet need.

On the other hand, you can access the funds in an IRA at any time. You--and your beneficiary after your death--can take out as much, or as little, as you want. While you'll need to start taking required minimum distributions (RMDs) after you reach age 70½ (and your beneficiary will need to take RMDs after you die), those payments can generally be spread over your (and your beneficiary's) lifetime. (You aren't required to take any distributions from a Roth IRA during your lifetime, but your beneficiary must take RMDs after your death.) A rollover to an IRA lets you and your beneficiary stretch distributions out over the maximum period the law allows, letting your nest egg enjoy the benefits of tax deferral as long as possible.

Note: *Distributions from 401(k)s and IRAs may be subject to federal income tax. In addition, a 10% early distribution tax may apply if you haven't reached age 59½. (Special rules apply to Roth 401(k)s and Roth IRAs.)*

Gimme shelter

Your 401(k) plan may offer better creditor protection than an IRA. Federal law currently protects your total IRA assets up to $1,095,000--plus any amount you roll over from your 401(k) plan--if you declare bankruptcy. (The laws in your state may provide additional protection.) In contrast, assets in a 401(k) plan generally enjoy unlimited protection from your creditors under federal law, whether you've declared bankruptcy or not.

Let's stay together

Another reason to roll your 401(k) funds over to an IRA is to consolidate your retirement assets. This may make it easier for you to monitor your investments and your beneficiary designations, and to make desired changes. You may also want to consolidate all of your IRAs. However, make sure you understand how Federal Deposit Insurance Corporation (FDIC) and Securities Investor Protection Corporation (SIPC) limits apply if you keep all your IRA funds in one financial institution.

Fools rush in

- While some 401(k) plans provide an annuity option, most still don't. By rolling your 401(k) assets over to an IRA annuity, you can annuitize all or part of your 401(k) dollars.
- Many 401(k) plans have loan provisions, but you can't borrow from an IRA. You only can access the money in an IRA by taking a distribution, which may be subject to income tax and penalties.
- If you were born before 1936, lump-sum distributions from your 401(k) may be eligible for special 10-year averaging or capital gains treatment. A rollover may make you ineligible for these tax rules.

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Financing Your Retirement Future

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Dave Williams is originally from Philadelphia, PA. He has been a "transplanted" Hoosier for the past 30 years. Dave strives to educate his clients on how to invest profitably and avoid loss by providing conservative options. He is dedicated to properly helping his clients reap the rewards of a well planned retirement. In addition, Dave is a well established speaker in Indiana and is committed to educating the community with his workshops on topics relating to conservative alternatives. Dave is a graduate of Indiana University with a BS in Finance. He is also a member of the National Ethics Bureau. He resides in Indianapolis with his wife of 27 years, 3 mini-Daschunds, and is enjoying his granddaughter, Elly.

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