

The hidden costs of borrowing from your retirement savings



Many retirement plans allow participants to borrow from their plan accounts. You may have taken a loan in the past or may be thinking of doing so soon. On the surface, a plan loan might seem to make financial sense: After all, you are only borrowing from your own retirement account and repaying yourself. However, with the exception of an emergency when you have no other resources, taking a plan loan may not be the wisest thing to do. In fact, there are several drawbacks to borrowing from your retirement plan.

✓ Zero tax advantage

Pretax salary deferrals are tax-advantaged in that they are taken out of your pay before federal income taxes are calculated. That's not the case with repayments on your loan, which you make with money that has already been taxed. And when that money is distributed to you at retirement, you'll pay taxes on it once more.

✓ Missed potential earnings

A plan loan reduces the size of your account balance, leaving you with less money that is invested on your behalf for your future. It is true that you will repay the loan with interest, but that interest could possibly be less than the return your plan investments would have earned had you not taken the loan. If you borrow money when the stock market is in a growth period, the missed earnings potentially could be substantial.

✓ Lower contributions

If you cut back on your regular plan contributions while repaying your plan loan, you would reduce your potential earnings even further. The reality is that stopping contributions even for a year or two could have a negative impact on how much money will be available to you for your retirement.

✓ Potential repayment issues

If you leave your employer and you still owe money on your plan loan, you will typically face a choice: repay the entire outstanding amount or allow it to become a distribution. If you can't afford to repay the loan in full and opt for a distribution, you will have to pay regular income taxes on the outstanding balance. In addition, if you are under age 59½, you may owe an early withdrawal penalty equal to 10% of the loan balance.

✓ See plan loans as a last resort

Your retirement plan is intended to provide you with future benefits so that you can enjoy your retirement. That's why it's not good to regard the money in your retirement plan as a funding source that you can turn to whenever you need cash. Instead, look into other alternatives -- a short-term loan from your bank or credit union, for example. Or, better yet, consider building an emergency fund so that you will have a financial cushion to fall back on when you are faced with a sudden expense.

If you would like some help with managing your finances, consider working with a financial professional. Together, you can map out a strategy for putting your financial life in order.