



Know the rules when borrowing from your 401K

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1) Loans from a 401K aren't rare

It's estimated that one-fifth of 401k investors have loans against their plan account. Before you take any funds, talk to your plan administrator to learn the process for doing so. Most people borrow for emergencies and to consolidate their credit card balances. Many people with adjustable rate mortgages that are re-setting upward will borrow to make their mortgage payments and avoid foreclosure..

2) There are borrowing limits

You can *borrow* up to 50% of your *vested* balance or \$50,000, whichever is less. If you haven't owned a home for two years, you can *withdraw* up to \$10,000 from your 401k penalty free, but you must pay ordinary income tax on the amount so withdrawn.

3) You have to pay it back

You have to pay back the loan – both principal and interest – in five years. You can stretch the repayment time to 15 years or the life of your mortgage if you are borrowing for a downpayment on a home. If you leave your job for any reason, you should pay off the loan within 60-90 days. If you fail to meet these payback requirements and are younger than 59 ½, you'll be subject to regular income tax on the amount of outstanding borrowings. This constitutes an "early withdrawal," so you'll be subject to a 10% penalty as well.

4) You must pay interest to the plan

The rate of interest that the plan charges you should be at least one to two percent above the prevailing prime rate. This is generally much less than you are paying on your credit card balance. Many people use a 401k loan to pay down their credit card balance. Interest on the loan is not tax deductible, even if you've borrowed to purchase your primary home. You will be paying interest to the plan, in effect paying interest to yourself. The plan does not have to pay tax on the interest payments it receives.

5) It is a "borrowing event"

Even though your loan will not be reported to credit agencies, you have to disclose it on any other loan applications you make.

6) Make sure you keep complete records

Keep – all documentation reflecting this transaction and your payments.

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7) Check with your employer's plan administrator before borrowing or withdrawing any funds

There might be alternatives you should consider. If you are younger than 59 ½, you might be eligible for a "hardship withdrawal" without incurring the 10% penalty. The amount you withdraw from the plan will be taxable to you, however. In addition, your administrator will want to know which investments in the plan you will want to liquidate. Remember, an employer has the right to establish the acceptable reasons for loans.

8) Know the downsides:

- ✓ You have to pay the loan back with after tax dollars. Repayment does not constitute a "contribution" to the plan
- ✓ Money removed from the plan reduces the amount of your savings that is earning tax deferred interest. This "break" in earnings will reduce the amount of the withdrawals you'll eventually be able to make in retirement.
- ✓ No one will pester you for repayment, so you must be disciplined in regularly paying down your loan.
- ✓ Your 401k balance is shielded from creditors in a bankruptcy, but the amount you withdraw for a loan is not.
- ✓ If your investment returns on your 401k increase during the course of your loan, you will miss out on that appreciation.

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<http://www.401khelpcenter.com/loans.html>

<http://moneycentral.msn.com/articles/retire/basics/4714.asp>

http://beginnersinvest.about.com/od/401k/a/aa122104a_3.htm

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