401(k) Loans, Hardship Withdrawals and Other Important Considerations

You may be able to tap into your 401(k) plan assets during a financial emergency. But while taking a loan or a hardship withdrawal may help solve an immediate need, there can be consequences that may reduce your long-term financial security.

401(k) Loans

If you need cash, you may be tempted to borrow from your 401(k) rather than applying to a bank or other lender. While not all plans permit loans, many do. And with most plans, you repay your loan through payroll deductions so you're unlikely to fall behind as long as you remain employed. When you borrow from your 401(k), you sign a loan agreement that spells out the principal, the term of the loan, the interest rate, any fees and other terms that may apply. You may have to wait for the loan to be approved, though in most cases you'll qualify. After all, you're borrowing your own money. The IRS limits the maximum amount you can borrow at the lesser of $50,000 or half the amount you have vested in the plan. Sometimes there's also a loan floor, or minimum amount you must borrow. You must also pay market interest rates, which means the rate must be comparable to what a conventional lender would charge on a similar-sized personal loan. Normally, the term of a 401(k) loan is five years. That's the longest repayment period the government allows—though if you prefer a shorter term, you may be able to arrange it. The only exception occurs if you're using the money to buy a primary residence—the home where you'll be living full time. In that case, some plans allow you to borrow for 25 years.

Spousal Stamp of Approval

If you're married, your plan may require your spouse to agree in writing to a loan. This is because a spouse may have the right to a portion of your retirement assets if you divorce. If you borrow, change jobs and don't repay, that money may be gone, and your spouse's share may be affected.

Coming Out . . . Going In

When you borrow from your 401(k), the money usually comes out of your account balance. In many plans, the money is taken in equal portions from each of the different investments. So, for example, if you have money in four mutual funds, 25 percent of the loan total comes from each of the funds. In other plans, you may be able to designate which investments you'd prefer to tap to put together the total amount.

Weighing Pros and Cons

Before you determine whether to borrow from your 401(k) account, consider the following advantages and drawbacks to this decision. On the plus side: You usually don't have to explain why you need the money or how you intend to spend it. You may qualify for a lower interest rate than you would at a bank or other lender, especially if you have a low credit score. The interest you repay is paid back into your account. Since you're borrowing rather than withdrawing money, no income tax or potential early withdrawal penalty is due. On the negative side: The money you withdraw will not grow if it isn't invested. Repayments are made with after-tax dollars that will be taxed again when you eventually withdraw them from your account. The fees you pay to arrange the loan may be higher than on a conventional loan, depending on the way they are calculated. The interest is never deductible even if you use the money to buy or renovate your home. CAUTION: Perhaps the biggest risk you run is leaving your job while you have an outstanding loan balance. If that's the case, you'll probably have to repay the entire balance within 90 days of your departure. If you don't repay, you're in default, and the remaining loan balance is considered a withdrawal. Income taxes are due on the full amount. And if you're younger than 59½, you may owe the 10 percent early withdrawal penalty as well. If this should happen, you could find your retirement savings substantially drained.

Hardship Withdrawals

You may be able to withdraw from your 401(k) account to meet the needs of a real financial emergency. The IRS sets certain guidelines citing a number of circumstances that may qualify as a hardship withdrawal, including: out-of-pocket medical expenses; down payment or repairs on a primary home; college tuition and related educational expenses; threat of mortgage foreclosure or eviction; and burial and funeral expenses. However, it is up to your employer to determine the specific criteria of a hardship withdrawal. For instance, one plan may consider a medical expense to be a hardship, but not payment of college tuition. Even if your plan allows for a hardship withdrawal, you should probably think of it as a last resort. Companies often prohibit contributions for at least six months after taking the withdrawal, and hardship distributions permanently reduce your account balance. In addition, you will have to pay taxes on the amount you withdraw, plus a 10 percent penalty if you are under age 59½. You may be expected to withdraw any after-tax dollars you've contributed to your 401(k) account, borrow the maximum permitted from the plan, and apply for commercial loans as part of the qualification process. Your plan administrator also may follow up after the withdrawal to verify that you used the money as you indicated you would in your application.

Dealing with Creditors

If you're in debt, or if you get divorced, your creditors or your former spouse may want a share of your 401(k) plan assets. Their rights, and yours, are spelled out under federal and state law. If you're in debt, your creditors—businesses, family or governments—may try to collect what you owe. But whether or not they will be able to force you to liquidate your 401(k) assets to meet your obligations depends on who they are, and the legal routes they take. It's generally true that your 401(k) is safe from commercial and professional claims—such as car repair bills or legal fees—whether you're sued in either federal or state court. That's because the federal ERISA law, which governs all 401(k) plans and supersedes state laws governing retirement plans, protects your money from these creditors. You won't be ordered to withdraw from your plan to pay now, nor can your account be frozen until you pay the debts. For the most part, you cannot be forced to use your 401(k) money to pay state and local income, property or other taxes. However, if you owe child support, alimony or federal income taxes, a court may order you to withdraw money from your 401(k) to pay those debts. Because state and federal laws differ, you may want to seek legal advice to be sure which will apply.

Dividing Your 401(k) Assets

If you divorce, your former spouse may be entitled to some of the assets in your 401(k) account or to a portion of the actual account. That depends on where you live, as the laws governing marital property differ from state to state. In community property states, you and your former spouse generally divide the value of your accounts equally. In the other states, assets are typically divided equitably rather than equally. That means that the division of your assets might not necessarily be a 50/50 split. In some cases, the partner who has the larger income will receive a larger share. For your former spouse to get a share of your 401(k), his or her attorney will ask the court to issue a Qualified Domestic Relations Order (QDRO). It instructs your plan administrator to create two subaccounts, one that you control and the other that your former spouse controls. In effect, that makes you both participants in the plan. Though your spouse can't make additional contributions, he or she may be able to change the way the assets are allocated. Your plan administrator has 18 months to rule on the validity of the QDRO, and your spouse's attorney may ask that you not be allowed to borrow from your plan, withdraw the assets or roll them into an IRA before that ruling is final. Once the division is final, your former spouse may choose to take the money in cash, roll it into an IRA or leave the assets in the plan. If there's a cash settlement, income taxes will be due on the amount that's taken out of the account. If your spouse gets the money, he or she is responsible for paying that bill. But if as part of the settlement, the money goes to your children or other dependents, you owe the tax.