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401(k) loans: The very last financial resort

Certain retirement plans, such as a 401(k) plan, include an “escape hatch” in the event of a participant’s financial emergency—taxable withdrawal of some or all of the fund before retirement. Another "safety valve" in many plans is the provision for plan loans. Loans do not trigger taxes unless they are not repaid, which normally must be within five years.

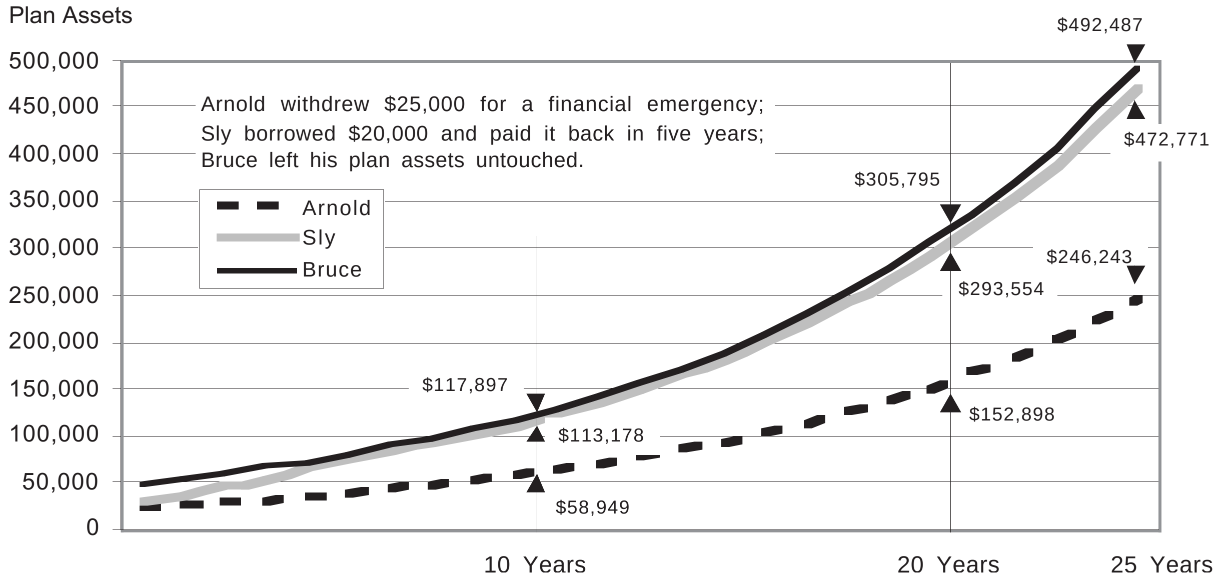
The availability of loans or emergency withdrawals is widely credited with making 401(k) plans more popular. However, tapping your 401(k) account should be thought of as a very last financial resort. Withdrawals before retirement can dramatically erode financial security during retirement.

Take Arnold, Sly and Bruce, for example. Each has $50,000 in plan assets today, and each needs $20,000 right away. Arnold makes an emergency withdrawal of $25,000—he needs the extra $5,000 to help cover the income taxes and tax penalties that will be due. Sly borrows $20,000 from his plan—no income tax consequences, but he does have to pay the money back, with 6% interest. Bruce gets a $20,000 advance on his inheritance from his Uncle Mel.

The graph on the next page shows where the plan assets of the three friends stand after 10, 20 and 25 years. We’ve assumed that there are no additional contributions to their accounts, that the investments have an average return of 10% throughout the period, and that Sly’s plan earnings are reduced for the first five years to reflect the lower interest rate on his loan repayments

Of course, every participant has the chance to try to “make up” for early

Early withdrawals compromise retirement security



withdrawals by making larger contributions in later years. Unfortunately, time is then no longer on the participant’s side. For Arnold to make up the shortfall in the last 15 years before retirement, he’ll have to make contributions of almost $8,500 every year. That total of $127,500 in added plan contributions is another measure of the “true cost” of a premature plan withdrawal.

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Any developments occurring after
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