

Responding to Requests for 401(k) Loans without Providing Advice

Many employers are faced with this dilemma as employees use their 401(k) funds to pay down debts, purchase a home, or cover medical expenses. Offering a loan provision in your retirement plan is an important feature that provides employees access to their money when they need it.

Providing employees with a summary of the advantages and disadvantages prior to processing a loan request will reduce the questions HR needs to answer and has sometimes led people to rethink their original decision—it's not "easy money."

Consider providing a summary to employees before processing loan requests. Providing employees with this information can also lower your liability for misinformation.

While it can be tempting to use a 401(k) loan if you run into a cash crunch, the following advantages and disadvantages should be considered, as it can seriously impact your future retirement income.

The advantages are:

- No credit check—the loan is secured by your retirement plan balance

- Low interest rate compared with other loans available in the marketplace.
- No taxes to pay, since the loan is not considered a taxable withdrawal.
- You pay interest to yourself, not someone else.
- The loan could enable you to pay off higher interest debt.

The disadvantages are:

- The amount of interest you pay back may be much less than your account would have earned, depending on how your funds perform.
- If you retire or terminate your employment, you are usually given only a short period of time to pay your loan balance off. If you cannot do so, the amount of the outstanding loan will be treated as a taxable withdrawal—subject to income taxes and a 10 percent penalty for those under the age of 59 ½.
- If you use the loan to pay off debt, don't forget that you will have an additional after-tax payroll deduction. Should you assume more debt during your loan period, you could end up with twice as much debt as before.

- A loan fee is often charged when you apply for the loan and some plans charge an annual fee as well.

Be sure to indicate on your 1-page summary that in no way should the information you provide be construed as advice. Recommend that employees consult with a financial professional if they have specific questions about their individual situation.

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