

Participant Loans vs. Hardship Distributions

The True Cost

Assume a participant needs \$10,000 for education expenses. The entire amount of a hardship withdrawal is subject to income tax plus the 10 percent early withdrawal penalty tax if the participant is under age 59½. Typically, 25 percent to 40 percent of the amount withdrawn is lost in taxes. If a participant's tax rate is 27 percent, he or she must withdraw \$15,873 in order to have \$10,000 left after paying 37 percent (27 percent plus the 10 percent penalty tax) or \$5,873 in taxes. I have assumed the participant must withdraw enough to pay the applicable taxes in addition to the \$10,000 needed for the immediate expense. A participant who must withdraw \$10,000 for a hardship withdrawal isn't likely to have \$5,873 sitting around.

To get \$10,000 with a loan, the participant has to only borrow \$10,000. It would appear that there isn't any contest -- loans are much better than hardship withdrawals, right?

Not so fast. Assume you borrow \$10,000 that must be repaid over a five-year period at 8 percent interest. The monthly deduction to repay the loan will be \$202.76. The total amount that will be paid back into the account is \$12,166, including interest. But you must also pay income tax on this money before making the loan payments. Most participants will pay Social Security and state and local income/wage taxes in addition to federal income tax. And, by the way, you will pay income tax again on this same money when it is received as a benefit distribution.

By the time the \$10,000 loan is repaid, it will cost you \$18,617 in take-home pay, assuming the same 27 percent federal income tax rate as with the hardship withdrawal plus the 7.65 percent Social Security tax. (I have ignored the state and local income/wage taxes.) This is the breakdown:

A loan's impact on your take-home pay	
Loan amount	\$10,000
Interest (returned to your 401(k) account)	\$2,166
Federal income tax (27%)	\$5,027
Social Security (7.65%)	\$1,424
Earnings required to repay loan	\$18,617

Of course, the interest is paid back into your account so the net cost of the loan is \$16,451. Still, the impact of the total \$18,617 cost on your gross pay is almost double the amount you borrow.

With a hardship withdrawal, you must withdraw \$15,873 in the above example to have \$10,000 in hand. But, you must pay Social Security tax on amounts you contribute to a 401(k). This means you had to have earned \$17,188 in order to have \$15,873 to contribute to your 401(k) after paying Social Security taxes.

The fact that taxes are paid over a period of years after you withdraw the money with a loan gives loans an additional advantage, but the tax edge is much smaller than would normally be expected. The big issue with loans is that they aren't tax-free. You simply pay the tax each pay period as you repay the loan rather than in one shot. I realize you have to repay other loans with

after-tax money, too, but I'm not comparing 401(k) loans to other loans. I'm comparing 401(k) loans to hardship withdrawals.

Long-term Impact

The other point to consider is the impact of a hardship withdrawal on a participant's retirement nest egg. The real loss is what this money would be worth at retirement rather than the amount that is withdrawn. The ultimate cost of withdrawing \$15,873 at age 35 is \$210,598, assuming a 9 percent investment return and a retirement age of 65 (this is the cost if you withdraw the money and can't make it up with larger contributions afterward). This is a huge loss, which would be avoidable with a loan.

Participants who take a hardship withdrawal generally are forced by law to stop contributing to the plan for six months following the withdrawal. This would also appear to give loans an advantage. However, many lower wage earners can't afford to keep contributing to their 401(k)s while repaying a loan. (The availability of loans is sometimes used to encourage lower-paid employees to contribute to a 401(k) because of the ready access it gives them to their money.) How many employees who earn under \$20,000 can afford to make \$200 monthly loan repayments and still keep contributing \$200 per month to the plan? Those who can't afford to do both must stop making contributions during the loan repayment period. Using the loan example above, contributions would be suspended for five years instead of six months. The participant loses out even more if the plan has employer-matching contributions, because those would not be added to the account as long as contributions are suspended.

In addition, a participant who is making pretax contributions can afford to contribute more than a participant who is repaying a loan. Again assuming a 27 percent tax rate, a participant can afford to contribute \$277.75 per month before taxes following the six-month suspension, compared to a \$202.76 loan payment after taxes, and end up with the same take-home pay. The big question is the participant's relative account balance at the end of the five-year period. Assume the following:

1. Account balance before the withdrawal: \$20,000
2. Amount borrowed: \$10,000
3. Amount withdrawn: \$15,873
4. Monthly loan payment for 60 months: \$202.76
5. Monthly contributions for 54 months after six-month suspension: \$277.75
6. Annual investment return: 9 percent

With these assumptions, your account balance after five years will be \$24,736 with the hardship withdrawal compared to \$30,603 with the loan, which is a big plus. But there is one other factor to consider -- employer-matching contributions. Assume your employer contributes \$0.50 for each \$1.00 you contribute. Your balance after five years would be \$33,930 with the hardship withdrawal -- approximately \$3,000 more than with the loan.

The Bottom Line

The bottom line is that both loans and hardship withdrawals are much less attractive than they appear. As a result, they should be used only when absolutely necessary, rather than as a convenience. In addition, the general perception that loans are much better than hardship withdrawals is not necessarily so. You must consider the facts involved in your situation including your ability to pay the loan without decreasing your contribution rate and of course employer matching contributions. There are also other factors to be considered, which will be covered in a future article