Borrowing from a 401(k)

By ANNA CHANG-YEN | Green Shoot Media

Socking money away in a 401(k) is a tenet of retirement planning. Between an employee's savings and any matching contributions made by an employer, with long-term growth of those investments, one can tuck away a hefty sum for retirement.

When it comes to putting together a down payment for a home, it's easy to see how that stashed-away cash becomes attractive for homeowners to tap.

If you're trying to decide whether you should dip into your 401(k) savings for a home or have already decided to do so, there are some things you should know about how your taxes and future retirement savings will be affected.

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LOAN VS. WITHDRAWAL

Withdrawing money from your 401(k) for a home purchase is probably not financially wise decision. In addition to the money being taxed at regular federal and state income tax rates, you'll be hit with a 10 percent penalty if you're younger than 59.5. If you must withdraw money for this purpose, Forbes recommends doing so early in the year so that any property tax deduction to which you might be entitled can help offset the high costs of the withdrawal.

A much better idea is to borrow the money from yourself. Tax law allows you to borrow money from your 401(k) for a home purchase, without having to pay income tax or penalties, provided the company that holds the account allows loans. You can repay the loan over a longer term than loans you take for general purposes (15 years vs. five years), and the interest rate will be low. (You actually pay the interest back into your 401(k) account, so you're paying yourself.) You can borrow up to half your vested balance or $50,000, whichever is less.

Don't forget, however, that if you change jobs or are fired or laid off, the entire balance of the loan will be treated as a distribution for tax purposes, which would instantly trigger income taxes and penalties (if you're under 59.5).

CONSIDER THE IMPACT

Before taking a withdrawal or loan from your 401(k), you should consider the impact on your future retirement savings. That money, after all, was originally intended to meet your needs later in life. Although you will pay yourself interest for the money borrowed, you could potentially earn more by leaving it invested. Loan repayments are made after taxes, further complicating the effect of borrowing. The considerations are so complicated, in fact, that Bankrate offers a calculator to help borrowers understand how choosing to borrow from a 401(k) might echo through time, at http://bit.ly/2lTVfIb. Use the calculator and compare the cost of the loan to other potential sources of borrowing the money, such as a credit card. You might decide that while your 401(k) is a tempting piggy bank, it's better to leave it on the shelf for later.

REAL ESTATE 101

IRA Withdrawals

Withdrawing money from an IRA for a home purchase is more complicated. You can withdraw up to $10,000 from a traditional IRA without penalty, but you will still have to pay income taxes on the money. Roth IRAs have more complex rules because some money is contributed after taxes. To read the IRS rules about these types of withdrawals, visit **http://bit.ly/2jtESUo**.

HOMEWISE Real Estate Tips and Advice

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HOMEWISE GLOSSARY

Gift letter: A letter that a family member writes verifying that s/he has given you a certain amount of money as a gift and that you don't have to repay it. You can use this money towards a portion of your down payment with some mortgages.

SOURCE: Federal Trade Commission

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