Accessing Money from Employer-Sponsored Retirement Plan

What is it?

As the name suggests, an employer-sponsored retirement plan is a plan that an employer sets up and maintains for its employees' retirement. A qualified retirement plan is an employer-sponsored retirement plan that receives special tax treatment under federal law. 401(k) plans and profit-sharing plans are common examples of qualified employer-sponsored retirement plans.) The tax benefits of a qualified plan generally include pretax contributions and tax-deferred growth of investment earnings. In return for such benefits, qualified plans generally must comply with specific federal rules set forth under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC).

If your employer offers a qualified retirement plan and you have money in the plan, this may be a way for you to access funds for college-related expenses. However, it is usually not advisable to do so. Most financial professionals will tell you that the primary purpose of retirement accounts should be to fund your retirement. Consequently, you should consider using your retirement plan money to pay educational expenses only after you have exhausted your other options and consulted your financial advisor.

How do you access the money in your employer-sponsored retirement plan?

If you have decided that you must use your retirement plan money for college-related expenses, there are generally two possible ways to access your savings in the plan: 1) borrowing money from the plan, or 2) withdrawing money from the plan. However, the specific options available to you will be determined largely by the rules of your employer's retirement plan.

Plan loans

Some employer-sponsored plans allow you to borrow against the funds in your plan, as long as you have a vested balance in the plan. The amount of the loan you can take is generally limited to the lesser of $50,000 or one-half of your vested plan benefits. The advantage of plan loans is that they are not taxed or penalized like withdrawals, as long as the loan is repaid on time. Also, the interest rate is usually reasonable (e.g., one or two points above the prime rate), and the interest you pay is credited to your own plan account.

Drawbacks? If you do not repay a plan loan when required, it will generally be treated as a taxable distribution. Typically, you have to repay the loan within five years by making regular payments, at least quarterly. (The repayment period can be longer if the funds are used to purchase a primary residence.) Even worse, if you leave your employer's service (whether voluntarily or not) and still have an outstanding balance on a plan loan, you may have to immediately repay the loan in full. Other disadvantages are that the interest is usually not tax deductible, and the borrowed funds miss out on tax-deferred growth opportunities.

Plan distributions

In addition to plan loans, in limited circumstances, you may be able to withdraw funds from your employer-sponsored retirement plan. Your first step should be to find out your distribution options. Your plan may offer several methods of taking distributions, or your choices may be very limited. Consult your plan administrator to find out which distribution options from your retirement plan (if any) are available to you.

In general, you can take distributions from your employer's plan upon certain specified events. For example, you may be entitled to take distributions when you retire, or when you reach the plan's normal retirement age. You may also be entitled to take a distribution upon job termination, disability, plan termination, or financial hardship. Depending upon the type of retirement plan and the provisions of the plan, you may be eligible to receive certain distributions while you are still working for your employer as well as after your employment has ended. However, some plans may only allow distributions after your employment has ended.

Unlike plan loans that are repaid on time, distributions you take from an employer-sponsored retirement plan generally must be included in your taxable income for federal (and possibly) income tax purpose. Any plan distribution you receive will increase your taxable income for the year of the distribution, possibly even pushing you into a higher federal income tax bracket. In addition to ordinary income tax, you must also pay a 10 percent premature distribution penalty tax if you are under age 59½ at the time of the distribution (unless an exception applies).

If you have ever made any after-tax contributions to your employer's retirement plan, those amounts will not be included in your taxable income when distributed from the plan. Consult a tax advisor for further details.

How do you know if this strategy is right for you?

Unlike a traditional IRA or a Roth IRA, a qualified employer-sponsored retirement plan offers no special advantages to parents who use the money to fund higher education expenses. Besides, you should always try to avoid using retirement money for non-retirement purposes. If you are faced with a choice between withdrawing or borrowing from your plan, however, borrowing is generally the better of the two options.

There are typically no taxes or early withdrawal penalties on a plan loan, and you will eventually replace the money in the future. Plus, the interest rate is relatively low, and you are essentially paying interest to yourself. Yet this does not necessarily mean that borrowing from your plan is a good idea. The loan must be repaid in regular installments within five years, which may create a strain on your budget, and the interest you pay is not tax deductible in most cases. You also lose out on tax-deferred growth opportunities when you borrow from the plan. Under most circumstances, this is probably not the best option for funding your child's private school or college tuition.

Plan withdrawals fare even worse, assuming they are even available to you. If you have other options available (including loans from your plan), you probably should not even consider withdrawing money from your employer's plan. A plan withdrawal will generally be included in your taxable income (excluding any portion that represents after-tax contributions to the plan), and may push you into a higher income tax bracket. You may also have to pay a 10 percent premature distribution tax if you are under age 59½. Finally, unlike a plan loan, a plan withdrawal cannot be repaid. Nevertheless, plan withdrawals may be a ready source of cash if your plan does not allow loans, you have few other assets, and you believe you'll have trouble borrowing elsewhere (due to poor credit, for example).
