The TSP allows participants to take loans from their accounts – but is this is good idea? Is it sound financial decision-making to borrow from your retirement account? Unfortunately, the answer to the TSP loan question is not a simple "yes" or "no" but rather an emphatic "maybe" – so let's look a little closer to see when it makes sense to borrow from your TSP and when it doesn't.

First, a little background. You can borrow the amount you have contributed to your TSP, plus the earnings on your contributions, up to a limit of $50,000. A simple way to estimate how much you can borrow is 50% of your TSP account balance or $50,000 – whichever is less. If you already have an outstanding loan, or have had one in the last 12 months, the amount you can borrow is reduced by the amount of these loans.

You pay interest on your loan at the rate the G Fund is paying (currently 2.00%). When you pay interest on your loan, it goes back into your account. It does not go to the TSP. This is a widely-held misconception, but the fact is that the interest you pay on a TSP loan you pay to yourself (your TSP).

When you take out a TSP loan, you set up a repayment plan that can be as long as 5 years. Payments are made through payroll deduction. If you leave your job for any reason, your loan must be repaid in full within 60 days, or the unpaid balance will be reported as a taxable distribution. If you are under the age of 59 ½, you will also be subject to a 10% early withdrawal penalty.

So, when does it make sense to take a loan from your TSP?

I advise people to take TSP loans when it is part of a carefully thought out plan, or strategy. A few examples of appropriate uses of TSP loans:

- To pay off high interest rate credit card debt
- To make a deposit or redeposit to your federal retirement
- As an alternative method of financing a car purchase
- As an alternative to a hardship withdrawal

The key distinction that makes these situations reasonable times to take a TSP loan is that the loan is being used as a tool – not as a method of living beyond your means.

A TSP LOAN SHOULD NEVER BE USED TO BUY "STUFF" – THINGS YOU DON'T HAVE TO HAVE, THINGS YOU CANNOT AFFORD WITHOUT BORROWING.

Each of the examples above use a TSP loan to build on someone's financial plan:

Paying off high interest rate credit card debt is an important step in reclaiming one's financial independence. Rather than paying interest rates of 15%, 20% or more to a credit card company, why not pay yourself back at 2%?

*** Anyone using this plan MUST be committed to not running up their credit card balances again. If they do, they are in a worse place than when they started – with credit card debt and a TSP loan.

Making a deposit or redeposit to your federal retirement can boost your retirement annuity significantly. If you do not have the funds elsewhere, borrowing from your TSP is a sound option.

Financing a car purchase with a TSP loan makes sense if you can borrow from your TSP for less than you can borrow elsewhere. Just don't fall into the trap of buying "more car" because the money is convenient (and the loan officer – you – is sympathetic).

Taking a loan instead of a hardship withdrawal preserves your ability to put the money back into your TSP. When you take a hardship withdrawal, you cannot repay the money back to your TSP. It is gone from your retirement account forever. If you borrow from your TSP, rather than taking a hardship withdrawal, you can repay the money so that you don't deplete your retirement account.

There are other ways to use TSP loans that make sense. This is not an exhaustive list. The important consideration is that you use a loan as part of a plan for building your financial future – not just to cover lifestyle expenses that you cannot otherwise afford. A TSP loan should never be "spent". A TSP loan should be used as part of a plan to advance your financial situation.

There are a few drawbacks, or risks, to taking a TSP loan. Before taking any TSP loan, consider whether the benefits you will receive outweigh these drawbacks and risks:

Opportunity Cost: The money you borrow from your TSP will no longer be invested in any of the TSP growth funds: C Fund, S Fund, I Fund or F Fund. In essence, when you borrow, you are moving the amount of your loan to the G Fund because that is the rate you will earn on your money. If the more dynamic TSP funds earn more during the period of the loan than the G Fund, you have missed out on these higher earnings. On the other hand, if these funds lose money during the time you have a loan out, you come out ahead because you have avoided the decline. Either way, you should be aware that when you take a loan, you will miss out on the potential earnings of the C Fund, S Fund, I Fund and F Fund.

NOTE: If you hold money in the G Fund, you can borrow this money with no opportunity cost because you will earn the same rate on your loan as you would on the G Fund.

Separation from Service: Perhaps the biggest risk of taking a TSP loan is the fallout if you leave federal service before you finish repaying the loan – whether it is your idea to leave or someone else's. If you leave federal service while you have a TSP loan outstanding, the entire balance of the loan must be repaid within 60 days or it will be reported as a taxable distribution. If you are under the age of 59 ½, you will also be liable for a 10% early withdrawal penalty.

Of course, right after you lose a job, repaying a TSP loan may be the last thing you can afford, and additional tax liability the last thing you need. This "piling on" effect makes repaying your loan, or paying more taxes, a particularly tough pill to swallow.

Giving an Alcoholic a Drink: If you use a TSP loan to pay off credit card debt, you MUST be committed to NOT running up your credit card balances again. The risk here is giving credit cards with zero balances to someone who has abused them in the past. There are strategies for dealing with this situation – canceling the credit card accounts altogether, cutting up the credit cards themselves, keeping the cards in a can of water in your freezer, etc. You just have to be absolutely sure that you do not abuse the cards again. If you do, you will be in worse shape than before you took the TSP loan: you'll have the credit card debt again – plus the TSP loan.

Paying the Interest on the Loan with After Tax Dollars: This really isn't a big issue, but because opponents of retirement plan loans bring it up, I will address it. When you repay your TSP loan, the dollars you use are after-tax dollars – money you have already paid taxes on. When these dollars go into your TSP account, you will have to pay taxes on them when you withdraw them. This amounts to paying taxes on the same dollars twice – the first time before you used the dollars to repay your TSP loan and the second time when you withdraw the dollars from your TSP account.

The point is accurate, but the impact is much smaller than the benefit you receive from the loan in the first place. In other words, if you use your TSP loan to pay off credit card debt, you will save a lot more on reduced credit card interest than this double taxation issue will cost you.

Bottom line: TSP loans can be an excellent tool. If you use them properly, they can make a significant contribution to your financial plan. If they are abused, they are just another form of debt. The litmus test for using/abusing is whether the loan will be used in a way that improves your financial position, or if it will just be spent on a lifestyle you cannot afford.