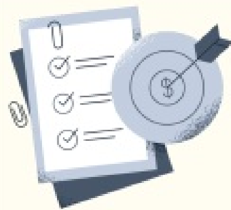

Financial Planning Topic of the Month - 401(k) Loans

By: Taylor Ledbetter

If you are an individual who has considered taking a loan from your 401(k), it's essential that you understand how these loans work and the potential consequences that may come with it. This significant decision can impact your ability to save for your future retirement. You want to make sure the short-term advantages are worth the long-term disadvantages. Even though retirement may feel far away, every choice you make now can impact the stability of your financial future. With that said, let's review how a 401(k) loan works, along with the pros and cons.

By law, individuals are allowed to borrow the lesser of $50,000 or 50% of the total amount of the 401(k). The interest rate for the 401(k) loan is usually a point or two higher than the prime rate, but it can vary. You typically have five years to have the loan repaid in full. If you change or lose your job before the loan is fully repaid, there is a grace period in which the full amount of the loan must be repaid. If the loan is not fully repaid at the end of the grace period, the total amount becomes taxable, and an additional 10% penalty is charged if you are under the age of 59 ½.

The funds you are borrowing were contributed to the 401(k) on a pre-tax basis. But you'll be paying your loan off with after-tax dollars. This means you will pay tax again when you retire and start withdrawing funds from your account. In addition, the interest you will be paying also goes into your retirement account, but it is not tax deductible. The significant disadvantage is that you will be taxed twice for those contributions.

The funds you borrow from your account will not earn an investment return. This is an "opportunity cost" because you are missing out on the growth. Depending on how you structure the loan, the opportunity cost could be hundreds of thousands of dollars! The bigger the loan, the greater the opportunity cost, which means a much lower account balance at retirement. This factor alone has the most significant impact on the account because of the missed compound interest.

401(k) Loans

Some plans have provisions that disallow you from making additional contributions as you pay the loan balance. Even if your plan doesn't account for this provision, it's very possible you could not afford to make additional contributions while repaying the loan. This halt in contributions will again deprive the account of compound interest. In addition, your take-home pay will likely be reduced because most plans require repayment via paycheck deductions. This may impact your ability to meet your monthly expenses.

A 401(k) loan is very convenient and better than an early withdrawal. An early withdrawal would automatically impose taxes and penalties on the amount withdrawn. This type of loan does not require a credit check and will not be listed as debt on your credit report. If you are forced to default on the loan, you won't have to worry about your credit being damaged because the default won't be reported to the credit bureaus. While this is a nice advantage, you should always make timely payments.

Borrowing from your 401(k) should be a rare occurrence and a lender of last resort. Try to exercise all other available options before taking out a 401(k) loan. You likely have better choices depending on what you need and when. It should only be used when absolutely necessary. When making big decisions like this, always uphold the importance of your financial future for short-term gratification.

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