Taking a Loan from Your Retirement Plan = Bad Idea

Why you should refrain from making this move.

Provided by John Ruzza, CFP®

Thinking about borrowing money from your 401(k), 403(b), or 457 account? Think twice about that, because these loans are not only risky but injurious to your retirement planning.

A loan of this kind damages your retirement savings prospects. A 401(k), 403(b), or 457 should never be viewed like a savings or checking account. When you withdraw from a bank account, you pull out cash. When you take a loan from your workplace retirement plan, you sell shares of your investments to generate cash. You buy back investment shares as you repay the loan.

So in borrowing from a 401(k), 403(b), or 457, you siphon down your invested retirement assets, leaving a smaller account balance that experiences a smaller degree of compounding. In repaying the loan, you will likely repurchase investment shares at higher prices than in the past – in other words, you will be buying high. None of this makes financial sense.[1]

Most plans charge a $75 origination fee for a loan, and of course they charge interest – often around 5%. The interest paid will eventually return to your account, but that interest still represents money that could have remained in the account and remained invested.[1]

Your contributions to the plan may be halted. Some workplace retirement plans suspend regular employee salary deferrals when a loan is taken. They can resume when you settle the loan.[1]

Your take-home pay may be docked. Most loans from 401(k), 403(b), and 457 plans are repaid incrementally – the plan subtracts X dollars from your paycheck, month after month, until the amount borrowed is fully restored.[1]

If you leave your job, you will quickly have to pay 100% of your loan back. This applies if you quit; it applies if you are laid off or fired. You will have 30-60 days (per the terms of the plan) to repay the loan in full, with interest.[2]

If you are younger than age 59½ and fail to pay the full amount of the loan back, the IRS will characterize any amount not repaid as a premature distribution from a retirement plan – taxable income that is also subject to an early withdrawal penalty.[1,2]

Even if you have great job security, the loan will probably have to be repaid in full within five years. Most workplace retirement plans set such terms. If the terms are not met, then the unpaid balance becomes a taxable distribution with possible penalties (assuming you will not turn 59½ in the year in which repayment is due). If you default on the loan, the retirement plan may bar you from making future contributions.[1]

Would you like to be taxed twice? When you borrow from an employee retirement plan, you invite that prospect. One, you will be repaying your loan with after-tax dollars. Two, those dollars will be taxed again when you withdraw them for retirement (unless your plan offers you a Roth option).[1]

Why go into debt to pay off debt? If you borrow from your retirement plan, you will be assuming one debt to pay off another. It is better to go to a reputable lender for a personal loan; borrowing cash has fewer potential drawbacks.

You should never confuse your retirement plan with a bank account. Some employees seem to do just that – in 2013, Fidelity researched participants in its retirement plans and found that 66% of those who had borrowed from 401(k)s had done so more than once. No doubt they became acquainted with the above dilemmas in the process.[1]

In a recent TIAA-CREF survey, 44% of those who had taken loans from their 401(k) plans said they regretted doing so. Why risk joining their ranks? Look elsewhere for money in a crisis, and borrow from your employer-sponsored retirement plan only as a last resort.[2]

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Citations.
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2 - mainstreet.com/article/why-you-cant-borrow-your-401k-and-only-way-you-should [7/24/14]