

The Economics of Borrowing from Your 401(k)

When times are tough, that pool of dollars sitting in your 401(K) plan account may start to look attractive. But before you decide to take a plan loan, be sure you understand the financial impact. It's not as simple as you think.

The basics of borrowing

A 401(K) plan will usually let you borrow as much as 50% of your vested account balance, up to \$50,000. (Plans aren't required to let you borrow, and may impose various restrictions, so check with your plan administrator.) You pay the loan back, with interest, from your paycheck. Most plan loans carry a favorable interest rate, usually prime plus one or two percentage points. Generally, you have up to five years to repay your loan, longer if you use the loan to purchase your principal residence.

You pay the interest to yourself but...

When you make payments of principal and interest on the loan, the plan deposits those payments back into your individual plan account. This means that you're not only receiving back your loan principal, you're also paying the loan interest to yourself instead of to a financial institution. But the benefits of paying interest to yourself are somewhat illusory.

Here's why. To pay interest on a plan loan, you first need to earn money and pay income tax on those earnings. With what's left over after taxes, you pay the interest on your loan. When you later withdraw those dollars from the plan (at retirement, for example), they're taxed again because plan distributions are treated as taxable income. In effect, you're paying income tax twice on the funds you use to pay interest on the loan. (Note: Special tax rules apply to Roth 401(K) contributions.)

The opportunity cost

When you take a loan from your 401(K) plan, the funds you borrow are removed from your plan account until you repay the loan. While removed from your account, the funds aren't continuing to grow tax deferred within the plan. So the economics of a plan loan depend in part on how much those borrowed funds would have earned if they were still inside the plan, compared to the amount of interest you're paying yourself. This is known as the opportunity cost of a plan loan, because you miss out on the opportunity for more tax-deferred investment earnings.

Other considerations

There are other factors to think about before borrowing from your 401(K) plan. If you take a loan, will you be able to afford to pay it back and continue to contribute to the plan at the same time? If not, borrowing may be a very bad idea in the long run, especially if you'll wind up losing your employer's matching contribution.

Also, if you terminate employment, your plan may require that your loan become immediately payable. If so, and you don't have the funds to pay it off, the outstanding balance will be treated as a taxable distribution to you, and if you're not yet 59½, a 10% early distribution penalty may also apply to your taxable balance.

Still, plan loans may make sense in certain cases (for example, to pay off high-interest credit card debt, or to purchase a home). But make sure you compare the cost of borrowing from your plan with other financing options, including loans from banks, credit unions, friends, and family. To do an adequate comparison, you should consider:

- Interest rates with each alternative
- Whether the interest will be tax deductible (for example, interest paid on home equity loans is usually deductible, but interest on plan loans usually isn't)
- The amount of investment earnings you may miss out on by removing funds from your 401(K) plan