RETIREMENT

Does It Ever Make Sense To Borrow From Your 401(k)?

Chris Carosa Senior Contributor
I help families/small businesses discover wealth-building strategies.

Follow

Nov 7, 2022, 09:40am EST

0

Listen to article 10 minutes

GETTY

It’s just sitting there, growing slowly over the years, beckoning you. Do you have the discipline to shun this siren? Or has life thrown you a curve ball and left you no choice?

“Taking a loan out of your 401(k) plan usually shouldn’t be viewed as the first option for financing; however, for some people, it may be the only

option available to them," says Jason Grantz, Managing Director at Integrated Pension Services in Highland Park, New Jersey. "This amounts to borrowing from their future selves, and as the loaner, they'll be paying their future selves back with interest."

As with most decision nodes, there is an upside and a downside to taking a 401(k) loan.

What are the benefits of taking a loan out of your 401(k)?

When your back is against the wall, the 401(k) loan can be the answer to your prayers. Not only that, but it comes with perks other types of loans do not have.

"The benefits of taking a loan out of your 401(k) include the ability to access funds from your retirement account before age 59½ without paying taxes or penalties," says Eric Presogna, Owner and CEO of One-Up Financial in Erie, Pennsylvania. "Further, any interest you pay on the loan is credited back to your 401(k) account instead of being paid to a financial institution. So, in a sense, you're paying yourself to borrow from your retirement account."

But wait. There's more. When the situation is dire enough, you may not find yourself in the position to obtain a loan through a more traditional method. Once again, the 401(k) loan can come to the rescue.

"401(k) loans don't trigger credit checks and can come in handy for borrowers with little-to-no credit history," says Presogna. "While interest rates on these types of loans have increased recently, they're still likely lower than rates on personal loans or credit cards, allowing investors the opportunity to consolidate high-interest debt and reduce interest costs."

MORE FROM FORBES ADVISOR

Best Travel Insurance Companies

By **Amy Danise** Editor

Best Covid-19 Travel Insurance Plans

By **Amy Danise** Editor

Is it better to borrow or withdraw from your 401(k)?

Many plans offer an alternative to loans. These include hardship withdrawals which you can take without the requirement of paying them back. Although this may be true, you'll still be on the hook for other costs associated with these premature drawdowns.

Investing Digest

Discover what's moving the financial markets and what smart money is buying.

Enter e-mail address

Sign up

You may opt out any time. Terms and Conditions and Privacy Policy

"By using a 401(k) loan, you can avoid paying the taxes and penalties associated with early withdrawals," says Steven Holmes, Director of Operations at iCASH in Hawkesbury, Ontario, Canada. "Additionally, even though it will be post-tax, the interest you pay on the loan will be redirected to your retirement account."

Remember, the answer to this question begins with your plan document. You'll need to see what kinds of provisions it makes regarding distributions.

In addition, your own age may impact this decision. For example, if you're over 59½, then it's likely there would not be any penalties for taking

money out of your 401(k) before you retire.

Does borrowing from your 401(k) hurt your credit?

Going through all these hoops may worry you that it will slap you with a red flag on your permanent record. In reality, this loan is just between you and yourself (with the 401(k) plan acting as a witness). That leaves the usual suspects out of the picture.

“As per my experience, 401(k) loans won’t necessitate a credit check or show up as debt on your credit record,” says Holmes. “Since credit bureaus won’t record the default, you won’t have to worry about it harming your credit score if you’re forced to default on the loan.”

Does taking a loan from your 401(k) hurt you?

Unfortunately, a 401(k) loan is not all sunshine and puppy dogs.

“401(k) loans are becoming increasingly popular, but there are some risks to consider before taking one out,” says Inez Stanway, Owner of Live Laugh Create in Atlanta. “A 401(k) loan is a loan that is taken out against the balance of your 401(k) account. The money can be used for any purpose, and the loan must be repaid within five years with interest. On the surface, taking out a 401(k) loan may seem like a good idea. The money is available when you need it, and you don’t have to go through the hassle of applying for a traditional loan. However, there are some downsides to consider.”

First and foremost, there could be a glaring opportunity cost associated with taking your retirement money out of equities.

“401(k) loans can be harmful from the perspective of investment returns,” says Ryan Shuchman, Investment Advisor Representative and Partner at Cornerstone Financial Services in Southfield, Michigan. “First, the market may appreciate significantly during the typical five-year loan term. During

this time, you may forgo the opportunity for significant market appreciation. This appreciation may exceed your borrowing cost from a lending institution."

Second, don't forget the taxes, whether you pay them today (because your interest payments are likely not deductible) or in the future (because when you ultimately take out those after-tax interest payments from your 401(k), they'll be taxed again).

"Sure, you're 'paying yourself the interest,' but don't forget that interest gets taxed on the back end when it comes out of the 401(k)/IRA account," says Jason R. Escamilla, Founder and CIO at IMPACTADVISOR in San Francisco. "In taking out a 401(k) loan, your cash flow used to repay the loan often comes at the expense of future 401(k) contributions. If you have to lower your 401(k) deferrals in the future, you are increasing your taxable income that year."

But wait (again). There are more taxes you could be liable for.

"Taking a loan from a 401(k) plan can be harmful if you separate from service without repaying the plan loan," says Marcia S. Wagner, Managing Member of The Wagner Law Group in Boston. "Not only will there be an inclusion in income, but also a loss of earnings from the removal of plan assets from the plan."

The consequences of separation can get complicated depending on the nature of the plan document and the state you live in.

"If you leave that employer or worse, get laid off, your 401(k) loan may become due within as short as 90 days," says Escamilla. "And if you do not have the cash to pay it back, not only does it become a taxable distribution, but also the 10% early distribution penalty may apply (plus 2.5% if you live in California). This means you could be on the hook for 40% or more in taxes and penalties, depending on your tax profile."

Finally, loans may encourage you to think of your 401(k) plan as a personal bank account rather than your retirement nest egg. That being said, the existence of a 401(k) loan provision in your plan may have been the impetus for you to begin contributing to the plan in the first place.

"Access to loans may trigger behavioral changes whereas employees view their retirement account as another form of short-term savings resulting in longer-term financial planning challenges," says Todd Feder, Vice President and Senior Retirement Plan Consultant, Girard, a Univest Wealth Division in Souderton, Pennsylvania. "It should be noted that research suggests the inclusion of a loan within a retirement plan increases employee deferrals as the appearance of access to money encourages people to save more for retirement."

Does this mean you should never take out a loan from your 401(k) account? You know what they say about never saying "never."

"There are circumstances when it may be appropriate to take a loan from your 401(k), for instance, an immediate short-term need for cash, typically less than one year, versus using a high-interest-rate credit card," says Megan Slatter, Wealth Advisor at Crewe Advisors in Salt Lake City. "Depending on how your 401(k) is invested, some of the best times to take a short-term loan are when the markets are underperforming. While there are situations when a 401(k) loan can be quite useful, it is critical to have a clear plan of how to repay the loan and how long that will take; otherwise, it can be quite detrimental to your future."

Keep your ears open to the Lorelei's call because sometimes you have no financial choice but to navigate on the edge of rocky shoals, but please stay aware of these dangers.

Follow me on Twitter or LinkedIn. Check out my website or some of my other work here.

Chris Carosa

Follow

Hamburger History Expert and Child IRA advocate, he's the author of the "The Parents Guide To Turning Your Teen Into A Millionaire: And How To Do It Before... **Read More**

Editorial Standards

Reprints & Permissions

Join Our Conversation

One Community. Many Voices. Create a free account to share your thoughts. Read our community guidelines here

Commenting as **Guest** Log in Sign up

Be the first to comment...

Powered by OpenWeb Terms | Privacy | Feedback