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Borrowing from Your 401(k)



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, or longer if you use the loan to purchase your principal residence.

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 money isn'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 may miss out on the opportunity for more tax-deferred investment earnings.

Can you continue to contribute to the 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 any employer matching contributions.

What if your employment terminates?

If you terminate employment, your plan will typically provide that your loan is immediately payable. If you can't repay the loan, the outstanding balance will be treated as a taxable distribution to you (reduced by any after-tax contributions you've made). And if you're not yet 59½, a 10% early distribution penalty may also apply to the taxable portion of your distribution.

However, if you borrow from a Roth 401(k) account and you don't repay the loan, there will be no income tax consequences if your distribution is "qualified" (that is, your account satisfies a five-year holding period requirement, and you're either 59½ or disabled). Even if your distribution isn't qualified, only the earnings you've borrowed from your account, not your own contributions, will be subject to tax and potential penalty.

When should you consider a loan?

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

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