Borrowing from Your 401(k) Plan — The Good, the Bad, and the Ugly

The majority of 401(k) plans (89.41%) allow participants to take loans from their plan accounts.* But *should* you borrow from your 401(k) savings if your plan allows it? Here are some points you'll want to consider before taking a plan loan.

The Good

Borrowing is usually a quick, easy process. You can request a loan for any reason (although maximum loan amount limitations apply). While the plan may charge a fee in connection with the loan, the cost is typically modest.

The loan won't affect your credit rating. Unlike commercial lenders, 401(k) plans do not report loan activity to credit rating agencies.

You can avoid paying interest to an outside lender. The "interest" you pay on a 401(k) loan isn't going to anyone except yourself. It's really nothing more than additional money you are required to put into your plan account because you borrowed funds from it. And the "interest rate" on a plan loan may be low in comparison to the rates charged by credit card companies and other lenders.

You take money off the table. An opportunity cost is usually associated with 401(k) borrowing (i.e., the foregone investment returns on the borrowed amount). However, borrowing can turn out to be an "advantage" if returns are negative during the loan repayment period.

The Bad

Repayments are not pretax. Unlike regular 401(k) salary deferrals, loan repayments will come out of your after-tax income. When the plan distributes the repaid amounts to you, they will be taxed again.

You'll lose opportunities for investment growth. Because the money you've borrowed won't be invested, you'll sacrifice any positive returns you might otherwise have earned.

The Ugly

The tax bite could be substantial if you miss payments. Missing payments will likely cause your loan to go into default and be taxed to you (at ordinary rates) as a deemed distribution. You may have to pay a 10% early distribution penalty on the amount in addition to income taxes.

The plan may require you to pay off the loan quickly if your employment terminates, voluntarily or otherwise. Many 401(k) plans call for repayment within 90 days of separation from the employer. Failure to repay within the required time frame causes the outstanding balance to become taxable, and the 10% penalty also would apply unless you qualify for an exception.

Like other financial decisions, you'll want to talk to your financial advisor and weigh the pros and cons in view of your personal situation before you commit to a 401(k) plan loan.

* *58th Annual Survey of Profit Sharing and 401(k) Plans,* Plan Sponsor Council of America, 2015