Seven Things to Consider Before Taking a 401(k) Loan

1. Less take-home pay equals less money to save

If you borrow money from your 401(k) plan, you will need to make payments through payroll deductions until it has been completely paid off. In many cases, this can take years. This may make saving for retirement difficult because you are adding a loan payment to the amount you are already deferring. The purpose of having a 401(k) plan is to save for your future, and if you use it as a loan, you may be missing out on future savings.

2. You are losing money

You will be missing out on any potential growth in the stock or bond markets. The extremely low interest rate you are paying to yourself with your loan payment is likely to be minimal in terms of return on investment when compared to the market appreciation that you are missing. Remember, the return you earn while the money is invested in your 401(k) account is free, while the interest you pay on a loan is money "out of your pocket." Also, you are paying back interest to yourself with after-tax money. If you are in the 25 percent tax bracket, earning $1.00 only gives you $0.75 toward repaying the loan, and that $0.75 will be taxed again when you retire and withdraw it from your plan. While the interest rate on the loan may be low, you are actually losing money due to tax implications.

3. Time will work against you

Long-term investing–such as saving for retirement–assumes your money will grow over time. Most calculations suggest that on average, your money will double every eight years. A 401(k) plan permits each loan to be held for up to five years or longer. Loan holders not only lose out on what should have been an opportunity to nearly double their money, but they are also left unable to make up for the lost contribution and growth opportunities. Over time, their balance is unlikely to ever reach the total that it would have reached had contributions continued uninterrupted.

Example: John has a balance of $16,000. He takes out a loan for $8,000 to be paid back over five years.

Within the next year, his investments earned an average rate of return of 25 percent. If the full $16,000 would have been in the account, he would have earned approximately $4,000[1] in interest that year. Because the money he borrowed was not invested in the account at the time, he earned roughly $2,000[1] or *half* the interest.

[1]Actual amount may differ based on the timing of payments and/or contributions into the account.

4. If you leave your job with an outstanding loan, you could lose even more money

Should you leave your employer before your 401(k) loan is paid off, you will be given only a few weeks to pay it in full.[2] If a full payoff is not possible (as is the case in the majority of situations), the entire remaining balance will be treated as a withdrawal and will be subject to current income taxes, in addition to a 10 percent early withdrawal penalty if you are under age 59.5.

[2] Loans generally need to be paid in full within 60 days of the last payment but could vary based upon your particular plan provisions.

5. You lose your emergency option

Taking a loan from your 401(k) plan should only be done in the worst of circumstances and after you have completely exhausted all other potential sources of funding. Many plans restrict loans to only one or two outstanding at a time. If you take money from your plan to fund a vacation or pay off higher interest loans, the money will not be there to borrow if you really need it.

6. It suggests you are living beyond your means

The need to borrow from your savings can be interpreted as a red flag–a warning that you are living beyond your means. When you cannot find any other way to fund your lifestyle than by taking money from your future, it could be time for a re-evaluation of your spending habits. We recommend asking yourself: is the purchase you are planning to make so important that you are willing to put your retirement future in possible jeopardy and go into debt in order to get it? If the answer is no, it would be a good idea to look into alternative options.

7. It violates the golden rule of personal finance

The golden rule of finance is to"pay yourself first." Violating this rule is never a good idea. Don't short-change your future to finance your lifestyle today. You should consider re-evaluating your current expectations and needs. Scaling back on your expenses not only reduces the burden on your wallet, but increases the odds that a sound retirement nest egg will be waiting for you in the future!

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