# TAKING A LOAN FROM YOUR 401(K) PLAN: TIPS FOR PARTICIPANTS

Taking a loan from your 401(k) plan can be a way to access funds when other sources may not be available. That said, there are some things to know before deciding to borrow from your 401(k) plan.

**Participant Tip:**
**Participants may wish to explore other options before deciding upon taking a loan from the 401(k) plan. The 401(k) is intended for long-term savings for retirement; keeping the account fully invested according to the participant's risk tolerance increases the likelihood of growth to fund retirement.**

## THE COST OF THE LOAN?

A common belief among participants taking loans from their 401(k) plans is "I'm borrowing my own money." Technically, a participant taking a loan is borrowing from his or her account in the plan. In addition to the fee to initiate the loan, which commonly range from $50-100, the participant is paying interest that is typically 1-2% above the prime interest rate at the time the loan is taken.

In an environment where interest rates are very low, the participant's account is crediting interest that may range from 2.5 to 4%. While there is not a guarantee, a well-diversified investment portfolio may generate higher returns for the participant, resulting in lost earnings over the length of the loan. When compounded over several years, lost earnings due to the loan may represent significant cost in terms of growth of the participant's account.

**Participant Tip:**
**Before taking a loan from your retirement plan, make sure you understand how your employer will, or will not, support repayment of the loan. Additionally, you may wish to verify that your income allows for repayment of the loan without adversely impacting your budget.**

## POTENTIAL TAX CONSEQUENCES?

A loan from a 401(k) is made possible under a special provision in the Internal Revenue Code. As long as a participant loan is repaid timely, in accordance with the payment schedule provided at the time the loan is taken, there are no adverse tax consequences to a participant.

That said, if payments are missed or delayed significantly, the loan could go into default, as with other commercially available loans. If the loan goes into default, the unpaid amount can become a "deemed distribution" or "offset loan" in the year the loan defaults. The amount of the "deemed distribution" becomes taxable income to the participant, reported to the IRS, and includable on the participant's tax return for that tax year. If a participant is not expecting additional reportable income, there could be an unpleasant surprise when filing the tax return including additional tax, if the participant is under age 59 $^{1}/_{2}$.

**Participant Tip:**
**Prior to taking a loan from your 401(k) plan, consider whether you are likely to remain with the employer for the term of the loan. If you are expecting to change companies, you may wish to refrain from taking the loan to avoid being taxed on the unpaid amount of the loan.**

## IMPACT OF LEAVING AN EMPLOYER?

A participant with an outstanding balance may trigger adverse tax consequences when he or she leaves the employer sponsoring the 401(k) plan. The amount of the unpaid loan balance may be due immediately or may not be eligible to be rolled over to a new employer's plan. Rolling over a loan balance to an IRA is not permitted by the IRS. If the participant is leaving the employer involuntarily, having an outstanding loan balance may create taxable income at a time when the participant has lost his or her employment, which may trigger further financial hardship.

# TAKING A LOAN FROM YOUR 401(K) PLAN: TIPS FOR PARTICIPANTS (CONTINUED)

**Participant Tip:**
**Have discussions with your mortgage advisor prior to applying for a loan from the plan to determine whether a plan loan will create problems. Disclosure on the mortgage application is crucial in order to avoid the question of mortgage fraud.**

## IMPACT ON PENDING MORTGAGE APPLICATION?

If planning on purchasing a home, you should consider whether borrowing money for the down payment will impact your ability to qualify for the mortgage since the loan from the plan would create a fixed repayment as well as will the mortgage. Additionally, underwriters may have a concern about money being borrowed from the plan to make the down payment.