Motley Fool's *Rule Your Retirement* Newsletter

Pros and Cons of 401(k) Loans

Christy Bieber

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When you need to get your hands on some cash, you may have a number of loan options available to you. If you have a workplace 401(k) and your plan allows it, a 401(k) loan may be one of those options.

A 401(k) loan allows you to borrow money you've invested in your retirement account. This is typically a better way to gain access to the cash than simply withdrawing funds from a 401(k), which can trigger early withdrawal penalties if you haven't reached 59 1/2.

But just because you can borrow from a 401(k) doesn't mean you should. There are some pros and cons to consider, and you should carefully weigh the potential downsides before you borrow from your own retirement savings.

Pros of a 401(k) loan

There are a number of advantages of using a 401(k) loan compared with other methods of borrowing:

- **Approval is easy:** Since you're borrowing from yourself, you don't need to go through a rigorous loan approval process as you would if a lender provided financing. Even bad-credit borrowers can get 401(k) loans; it's usually just a matter of filling out some paperwork with your 401(k) administrator, as long as your plan allows loans.
- **Interest is low:** You'll usually pay a lower interest rate to borrow from your 401(k) than you would if you used a credit card or took out most types of personal loans.

- **You're paying yourself:** Although you do have to pay interest on a 401(k) loan, you pay this interest to yourself instead of to a creditor.
- **It's usually pretty quick to get the money:** Again, as long as your plan allows loans, it's just a matter of filling out paperwork -- the transaction can typically be processed quickly.
- **You have a long repayment timeline:** As long as you don't leave your job, you can usually repay 401(k) loans over a five year period of time. A relatively long repayment timeline keeps payments affordable.
- **You can use funds for anything you want:** Getting money out of your 401(k) before age 59 1/2 without triggering an early withdrawal penalty is typically possible only if you qualify for a hardship withdrawal, which is available only under limited circumstances. But you can *borrow* without incurring these penalties for pretty much any reason you want.

These pros are what make 401(k) loans seem attractive when you're looking for a loan to consolidate debt or cover other big expenses.

Cons of a 401(k) loan

Unfortunately, there are some big downsides that have to be weighed against the advantages of a 401(k) loan. Here are some of the cons to consider before you borrow against your retirement savings:

- **You could get penalized if you don't pay the loan back:** If you fail to repay your 401(k) loan on schedule, your loan will be treated as a withdrawal. The IRS requires payments to be made at least quarterly, and those payments must be "substantially equal" and include both principal and interest. If you don't pay back your loan as required and it is treated as a withdrawal, you'll be taxed on the withdrawn funds and face a 10% penalty for early withdrawals if you aren't 59 1/2.

- **Leaving your job could accelerate loan repayment:** If you quit, are fired, or leave your job for any reason, you have to pay the 401(k) loan back by the date your tax return is due, including extensions. So, if you took out a 401(k) loan and left your job 2019, you'd have to repay your loan by April 15, 2020, or by October 15, 2020 if you had an extension on your return until October. That's actually *better* than the 60 days you used to have before tax reform took effect in 2018, but it still means you may have to come up with a lot of cash pretty quickly depending when you took out the loan.
- **You're jeopardizing your retirement.** If you never pay back the loan at all, you lose out on the chance to earn returns on the borrowed funds. This could lower your retirement account balance substantially. Even if you do pay the loan back, you could miss out on up to five years of investment gains if you take the full five years allowed to repay the loan. Depending on when you borrowed and when you put the money back, you could miss out on some major investment profits that you could've otherwise earned over those five years.
- **You're double-taxed:** Money you borrow from your 401(k) is repaid with after-tax dollars. But, you still pay taxes on 401(k) distributions when you take out money as a senior -- even though some of the money comes from the loan you repaid with after-tax dollars. This means you're paying taxes twice on those funds, which can get expensive depending on your tax bracket.

Saving for retirement is one of the most important financial goals you need to achieve, so you need to seriously consider whether it's worth putting that goal at risk to borrow from your 401(k).

Should you take a 401(k) loan?

Ultimately, it's up to you to decide whether the pros of a 401(k) loan outweigh the cons. Unless you're confident you're borrowing for an important purpose and you know you can pay back what you've borrowed so you don't get hit with early withdrawal penalties, you should think seriously about whether taking out the loan is worth putting your retirement security at risk.