Tips from
Your Financial Coach
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401(k) Plan Loans

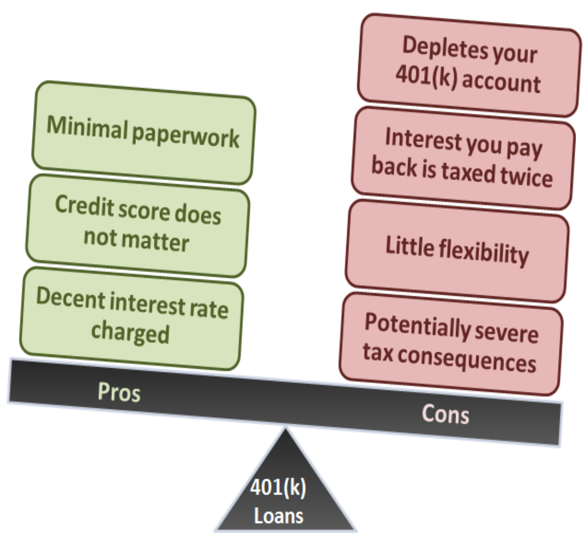
What is a 401(k) Loan:

If you find yourself in a situation where you require immediate funds, you may be able to borrow from your 401(k) account. However, before making that decision, there are certain considerations and requirements that you need to be aware of:

- *Your 401(k) Plan Document must permit loans*
- *You will only have access to 50% the portion of your 401(k) account that is vested*
- *Typically, the minimum loan amount is $1,000; therefore you must have $2,000 vested*
- *The maximum loan amount is $50,000*
- *Your repayments will include interest that is typically charged at the Prime Rate (currently 3.25%) plus 1% or 2%*
- *You will need to repay these loans within 5 years (term may be longer if the loan is a mortgage for your primary residence)*
- *Repayments are made through after-tax deductions from your paycheck and are required even if you are temporarily laid-off*
- *The portion of your loan that is not repaid within the 5 year term will be treated as a taxable distribution*
- *In most cases, if you lose or quit your job, you will be required to pay back your loan in full within 30 to 60 days or the unpaid balance will be considered a taxable distribution*
- *The taxable distribution that results when you default on your loan is taxed at your ordinary tax rate and an additional 10% early withdrawal penalty will be imposed if you are under age 59 ½*
- *All 401(k) Plans are not the same and you should be aware of the specifics of your plan*

The Pros and Cons:

As you can see, there are several factors to ***weigh*** if you are considering a 401(k) loan.



The primary reasons why people take these loans are either because the loans are fast and easy or the individuals will not qualify for another type of loan.

However, there are immediate drawbacks to borrowing from your retirement savings. You may have to liquidate assets during a down market. You will no longer be taking full advantage of tax-deferred accumulation or compounding. In addition, there are significant future tax consequences, if you do not repay your loan back as required.

Simplifying Life by Creating Wealth Solutions through Understanding.

It is imperative that before you even consider borrowing from your 401(k), you educate yourself on all of the potential consequences. Tax-deferred growth and compounding are two of the most powerful investment concepts, and by taking a 401(k) loan, you are immediately forfeiting both of these benefits.

Plus, keep in mind that loan repayments will be executed through an after-tax deduction from your paycheck. If you cannot afford to take this "cut in pay", a 401(k) loan is not an appropriate option for you.

Failing to repay your loan as required will present the harshest consequence of all – taxes! Loan amounts that are not repaid will be considered a taxable distribution, and this amount is taxed as ordinary income. This could very easily put you in a higher tax bracket. If you are under 59 ½, you will also incur a mandatory 10% early withdrawal penalty.

Worst-Case Scenario Example:

You borrow $25,000 from your 401(k) account

You must repay the loan back within 5 years

Loan payments come out of your paycheck and you take home $110 less each week

Your loan is being charged 5.25% interest

The interest that you pay is double-taxed

You lose your job

You cannot pay the loan back within 30 days as required by the plan

The unpaid balance is considered a taxable distribution

The taxable distribution will incur taxes at your 33% marginal tax bracket

The unpaid balance will incur an additional 10% early withdrawal penalty because you're not 59 ½

You owe the IRS 43% of the unpaid loan balance

Recommendation:

Clearly, there are numerous disadvantages to borrowing from your 401(k) plan, and the impact of them ***all*** occurring would be financially devastating. Today it is more important than ever to save for your retirement. Pensions are rare. Social Security is uncertain. Medical expenses and long-term care costs are soaring. Before borrowing from your retirement savings, make sure that you have exhausted all other options available to you.

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DEFINITIONS:

Compounding
The process of interest being earned on both an initial investment and previously earned interest

Ordinary Income
Income that is taxed according to your marginal tax bracket and does not receive a preferential tax rate

Prime Rate
The interest rate that commercial banks charge their most credit-worthy borrowers

Tax-Deferred
Income whose taxes can be postponed until a later date

Vested Balance
The portion of your 401(k) account that is not contingent upon continued employment

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