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Warning: 401(k) Loans Can Be Hazardous to Your Wealth

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It sounds so simple. You need some quick cash because of a financial emergency and you decide to borrow from your 401(k) plan, provided your plan offers a loan feature. After all, it's your money and the principal and interest you pay goes back into your account. But as with most financial issues, it's not as easy as it sounds. In fact, for most people, borrowing from a 401(k) is not the best solution.

The Rules

Rules can vary by employer, but typically, the minimum amount you can borrow is $1,000 and the maximum is up to 50% of your vested account balance up to $50,000, whichever is less. Repayment periods are set at a maximum of five years, unless you are borrowing for the purchase of a principal residence, which may allow a longer payback. Repayments are made by way of payroll deduction.

Like any loan, there are definite pros and cons:

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The Pros

1) Obtaining a loan is usually a very simple process. Most times you can arrange for a loan over the internet or telephone. 2) Any interest you pay on the loan goes back in to your 401(k) account. Typical interest rates for 401(k) loans are set at current prime rate plus 1%. Today, that rate is 6.5%.

The Cons

1) You are borrowing against your financially-secure retirement. The money you borrow -- or take --out of your 401(k) account is not available to take advantage of any investment gains, so you are potentially sacrificing significant investment returns. 2) Loan repayments are not tax-sheltered dollars anymore since all repayments are made with after-tax payments. Once you retire and begin taking withdrawals, you will pay taxes yet again. 3) The loan is not tax deductible. It's considered a consumer loan, therefore no tax advantage. 4) Unless you completely repay the loan, it is considered a premature distribution from the plan. You would owe federal and state income taxes as well as a 10% early withdrawal penalty if you are under age 59½.

The Bottom Line

It's better for most people to take out a home-equity loan or other line of credit, as you may be able to deduct the interest on your taxes. Accessing your 401(k) account prior to retirement affects your psychology of saving. If possible, your retirement money should sit untouched until you retire. It's too easy to get in the habit of dipping into your 401(k) account instead of saving for things you need along the way. To keep it in perspective, there are no lending institutions out there that will loan you money to retire.