INFORMATION ON 401K LOANS

Making loans available within a 401k plan is allowed by law, but an employer is not required to do so. However, loans are a feature of most 401k plans. Here is some basic information about 401k loans.

Basics

- You are allowed to borrow up to 50% of your vested account balance to a maximum of $50,000.
- Loan payments are deducted from your payroll checks.
- The interest rate will vary by plan, but the rate most often used is what is termed the "prime rate" plus one or two percent.
- Funds obtained from a loan are not subject to income tax or the 10% early withdrawal penalty.
- In the event of termination of employment, any unpaid loan will be deemed a distribution and thus taxable income, and may be subject to a 10% withdrawal penalty.
- A 401k loan cannot be rolled over to an IRA.
- 401k loans can always be paid off at any time with no penalties.
- You may be required to obtain the consent of your spouse before obtaining a loan.

Just because you can obtain a loan from your plan doesn't mean it is always the best idea. Think about the "pros and cons" and remember that the purpose of a 401k plan is to fund your retirement.

The Pros

- It's convenient. There is no credit check or long credit application form.
- There is a low interest rate.
- There are usually no restrictions. Most plans allow you to borrow for any reason.
- You are paying the interest to yourself, not to the bank or Credit Card Company.

The Cons

- There are "opportunity" costs. According to the U.S. General Accounting Office, the interest rate paid on a plan loan is often less than the rate the plan funds would have otherwise earned.
- Smaller contributions. Because you now have a loan payment, you may be tempted to reduce the amount you are contributing to the plan and thus reduce your long-term retirement account balance.Loan defaults can be harmful to your financial health. If you stop working or change employers, the loan must be paid back right away. If you can't repay the loan, it is considered defaulted and you will be taxed on the outstanding balance, including a possible early withdrawal penalty.
- You may be subject to fees.
- Interest on the loan is not tax deductible.
- There is no flexibility in changing the payment terms of your loan.

When You Probably Shouldn't Borrow from Your Plan

- It is probably not wise to take out a 401k plan loan when:
- You are planning to leave your job.
- There is a chance you will lose your job.
- You are nearing retirement.
- You can obtain the funds from other sources.
- You can't continue to make regular contributions to your plan.
- You can't pay off the loan right away if you are laid off or change jobs.
- You need the loan to meet everyday living expenses.
- You want the money to purchase some luxury item or pay for a vacation.

Commonly Asked Questions

What are some of the most common reasons people take out a plan loan?

- The most common reasons of a plan loan are:
- To pay college tuition
- Uninsured medical expenses
- The purchase of a primary residence
- Payments necessary to prevent being evicted or defaulting on a mortgage

If I want to borrow for a down payment on the purchase of my primary residence, do I have to pay the loan back in five years?
No, most plans allow longer pay back terms when the loan is going to be used to purchase a primary residence. Ten to fifteen years is common.

How long do I have to pay off my loan if I quit my job?
Typically, if you quit working or change employers, it is not uncommon for plans to require full repayment of a loan within 60 days of termination of employment.

Will a 401k loan appear on my credit report?
Loans from your 401k are not reported to the credit-reporting agencies.

If I default on my loan, will the default be reported to the credit-reporting agencies?
If you default on a 401k loan, the default will not be reported to the credit-reporting agencies and it will not negatively impact your credit rating.

If I can't afford to keep making the payments on my loan, can I stop them?
Once the loan has been made, your payments will be deducted from your pay each pay period and you generally can't stop this process.

If I default on my loan, how will I know the amount I must report as income on my federal tax return?
You will receive a 1099 from the plan which will show you the exact amount to report. The amount will also be reported to the IRS.

I still have a 401k account at a former employer. Can I get a loan from this old 401k?
Plans are not required to let former employees take plan loans and few allow them to do so.

Where can I learn more about how my specific plan handles 401k loans?
Talk to your plan administrator or ask them for a copy of your plan's Summary Plan Description (also known as an SPD). The SPD will spell out exactly how and why you can obtain a loan from your 401k.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.