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# The 4 Step Guide to Borrowing From Your 401K – Read All the Steps Before Implementing The Strategy

Step 1)

You would borrow money from your 401K account and pay this money back with interest into the same 401K account. The 401K is being treated like a lender – and money is being taken from the "bank account" and repaid to the "bank account" as if the process was with a lender. The difference here is that your 401K is receiving the interest, and it is acting as the administrator, which means it is making sure that you are paying the loan back according to the rules. For doing this, the company running the 401K would receive a fee to oversee the process.

You will get a specified dollar amount that you can borrow - up to $50,000 or half the value of your 401K account. This amount would be adjusted lower if you have an existing loan against the 401K plan within the last year – see the second link below from the IRS. You will get a specified time to pay back the loan (up to 5 years unless the loan is for a principal residence). The interest rate you can charge yourself must be competitive to the other lenders, which means the typical rate charged is prime plus 1%.

http://www.401khelpcenter.com/loans.html
http://www.irs.gov/retirement/participant/article/0,,id=151787,00.html/

Step 2)

What are the advantages?

The interest on the loan is being paid back to your 401K. Therefore you get to keep the interest. There are fees to set up this arrangement but they are typically fairly inexpensive.

Since for the 401K plan, your loan is deemed to be an investment, the money being paid back will not be taxed until it is withdrawn from the 401K in retirement, as it would be with any other investment that is made within the 401K account. There is no withdrawal penalty either for this withdrawal as the money is being paid back to the plan, as long as it is being paid back according to the rules.

If you are using this 401K loan to pay off other debt, you may save money on the interest for the other debt if the interest rate is higher for the debt than the interest rate being paid on the 401K loan.

This 401K loan is deemed a non-credit event, so your credit score is not impacted by the issuance of the loan, or the default on the loan. Since you are paying yourself back, there is not any issue of having bad credit. If you apply for other debt, this 401K loan will be counted on your application as other existing debt. You can sell any part of your 401K investments to fund the loan – therefore you can keep some better performing investments and sell the losing ones.

Step 3)

What are the disadvantages?

If you leave your employer and you haven't paid back the loan, you would have to pay it back in its entirety within 60-90 days. If you are not sure about your income prospects, or you may be laid off or unemployed in the near future, this may be a large risk. If you default on the loan payments, you may also incur withdrawal penalties and income taxes if you are under the age of 59 ½.

Your employer may not allow such a loan to occur, but most of them would allow it. The reason for this is that this type of borrowing is too expensive for some employer pension plans to administer. Some plans may require a minimum loan amount of $1000.

You are normally able to deduct mortgage interest from your taxes. This would not happen if you borrow from your 401K and pay it back, because the payments are made with after tax money. See the links below.

http://financialplan.about.com/od/retirementplanning/a/401kloan.htm

http://retireplan.about.com/od/401kplans/a/401k_loan.htm

You may be losing future compounding within your 401K or future contributions, since money you would have contributed would be coming into the 401K as debt repayment instead of new money. If you have not contributed new money into your 401K plan for a time, any matching contributions from your employer would have to be forfeited over this time as well. This may also reduce the amount of money you would collect in the 401K plan. This will depend on your overall financial picture and whether the original reason for borrowing from your 401K was beneficial for your scenario.

You cannot change the terms of the loan agreement once you set it up.

Step 4)

How do I know it is worth it for me?

You would have to first ask: what will I do with the money from this 401K loan? If the answer is to go on vacation, or make your debt situation worse overall, the 401K loan is probably not a good idea. If you are using it to pay down higher interest debt or to get out of a temporary cash squeeze, this may be the answer for you. Do you have bad credit? If the answer is yes, this idea may work better than obtaining another type of loan.

The next question to ask is: will I be able to commit to paying the 401K loan off consistently until the entire amount is paid off? If you have a poor history when it comes to discipline, or problems paying off debt in general, this loan may not be for you.

The third question is: how likely is it that I will lose my job over the lifetime of the loan? If the answer is likely, or very likely, this loan would not be a good idea unless you have a means of paying the entire amount in a short term - 2 or 3 months.

The fourth question to ask is: what other alternatives are there to this type of loan? If you are borrowing due to a crisis, you may not have many options. If this loan is for a down payment on a house, there may be options but they may be too expensive. All other options should be explored before this one unless you have resources to pay the loan quickly.

You will need to obtain a Summary Plan Description (SPD) which tells you the rules for obtaining a loan from your 401K.

Example Calculation:

Assuming you can take out the loan, find out how much you can borrow. Find out the interest rate you would pay yourself – this would typically be prime plus 1%. Find out how many years you would need to pay the loan back. Use the calculator below to estimate how much interest you would pay:

[http://www.usbank.com/calculators/CalculatorServlet](http://www.usbank.com/calculators/CalculatorServlet)

Find out your current tax rate. Assuming this rate is 28% and it continues for the life of the loan, and your loan principal and interest totals $22,500 over 5 years, you would be paying $22,500 x 0.28 or about $6300 in taxes over 5 years to generate the money needed to pay off the loan. If you were paying a $20,000 credit card instead over 5 years, and the interest rate is 20%, you might be paying $11,800 in interest. Since this is after tax dollars, the taxes generated to pay this off would (20,000 + 11,800) x 0.28 or about $8900 in taxes. The 401K loan would cost $6300 to pay off (the taxes only since you keep the interest), whereas the equivalent amount used on a credit card loan would cost $19,700 ($11,800 + $8900 - interest plus taxes). In this case, the 401K loan is a good idea if all the restrictions can be met and the payments made according to the rules.

If you need specific information for your needs, contact me, Joe Barbieri by email at joetheinvestor.today@gmail.com, or by telephone at 647-286-8020 for an independent consultation on what your options are. **Note: This article is intended for people who want to learn about the world of finance and how to research for themselves. If you would like to buy or sell investment products, or specific advice on investment products, tax or legal issues, please consult your investment advisor, accountant or legal counsel.**