401(k) Loan Facts

The following is intended to provide information on taking loans from a 401(k).

How much $ can I take out?

IRS laws state that an employee can take out a loan from a 401(k), but there is a limit. The maximum any employee can borrow is whichever is smaller between the following:

$50,000 or half (50%) of the vested account balance

There is another stipulation to the rule: if an employee already took a loan within the past 12 months or has an outstanding loan, the highest outstanding loan balance from the past 12 months must be subtracted from the dollar amount that the employee would otherwise be eligible to withdraw for a loan (the lesser of $50,000 or 50% of the vested account balance).

Here are a few loan scenario examples:

(1) Pat hasn't taken a loan in the past 12 months, does not have an outstanding loan and had a vested account balance of $195,000, he could take out the legal maximum of $50,000.

- $195,000 X 50% = $97,500
- 50% of Pat's vested balance is greater than the $50,000 legally allowed maximum, so Pat is restricted by the legal limit rather than his account.

(2) Chris has a vested account balance of $24,000 and has never taken a loan from her 401(k) account, so she could take a loan up to $12,000.

- $24,000 X 50% = $12,000
- $12,000 is less than the legal maximum of $50,000, so that limitation has no bearing on Chris's situation.

(3) Alex has a vested account balance of $142,000 but took a $10,000 loan 8 months ago. He already repaid the loan in full. Now Alex wants to take a loan for $50,000. Unfortunately he can only take out $40,000 since he had an outstanding loan within the past 12 months.

- $142,000 X 50% = $71,000
- 50% of Alex's vested balance is greater than the $50,000 legally allowed maximum, which is Alex's first limitation.
- Alex must also account for the highest loan balance he had within the past 12 months, which was $10,000.
- $50,000 - $10,000 = $40,000

It is important to note that some plans limit loan eligibility and size based on stricter rules than the IRS legal maximums. Read through your plan documents carefully prior to taking a loan so you know the limits you face for your current loan and the resulting limitations you will face in case you want to take another loan in the future.

How are loans funded?

One common misconception is that the employer that provides the retirement plan is lending money, and the employee is repaying the employer. If you take a loan from your work retirement plan account, you are borrowing from yourself – meaning you actually must sell funds from your 401(k) account to take the loan. In most cases plans will sell off funds proportionally to keep percentage allocations the same.

How do I repay the loan, and how are payments calculated?

Since you are borrowing from yourself, you will have to repay yourself through after-tax paycheck deductions. To figure out how much is taken out per paycheck you need to know:

- The loan amount
- The loan term (repayment period)
- Frequency of repayment installments
- The interest rate

The administrator of your 401(k) will plug this information into a calculator to determine how much your employer will withhold per paycheck. In this example, each loan repayment would be $566.82:

- $50,000 loan
- Repaid over four years (48 months)
- Paid twice monthly (24 payments per year)
- 4.25% interest rate

Most plans will allow employees to repay the loan early. Early repayment must be a single lump-sum repayment.

How many loans may I take?

The number of simultaneous loans varies by plan. If you are not allowed to take an additional loan, you could consider paying a loan and then taking another loan in a few weeks. Please consider the example #3 on the prior page.

So what's the big deal if I'm borrowing from myself?

There are several reasons to avoid taking a loan from a 401(k) account:

- **The loss of growth potential for loaned money.** The reduction in shares and account value from the loan will lead to proportionally less in market gains.
- **You're repaying yourself, so you aren't actually making money from the loan – unlike an investment (see the previous point).** Even if the market is down and the interest rate at which you'd be repaying yourself seems appealing, remember that you are paying yourself with interest.
- **You could ultimately own fewer shares as a result of the loan.** When you sell off shares to fund a loan, the market could be lower than it will be as you repay the loan.
- **For traditional (non-Roth) 401(k) plans, repayments are made with after-tax money but will be taxed again upon distribution at retirement.** Originally, your 401(k) contributions were pre-tax. Loans are not taxed. For that reason, repayments must be made from after-tax money, even though the funds will be taxed again when you take distributions.
- **You might be tempted to reduce or eliminate new contributions.** Since 401(k) loan repayments have to be paycheck deductions, people are tempted to reduce new contributions so that net paychecks don't shrink. Reducing or eliminating new contributions could mean losing free money in the form of the company match, and it would certainly degrade your long-term savings efforts and the positive impact of compounding interest.
- **Typically there is a loan origination fee.**
- **You would likely be required to repay the loan in lump sum form or allow the loan to go into default if you leave the employer that sponsors the plan.** Default results in a taxable event.
- **Interest payments for 401(k) loans are not tax deductible like home loan interest.**

There are a lot of complex things to account for when considering a loan from your 401(k). Please contact us if you would like further guidance.

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