RetireReady

# Your 401(k) Is Not an ATM:

## 6 Things to Consider Before Taking a Loan from Your Retirement Plan

*Presented by C.J. Ferrari and Mark Miller*

If you are trying to bridge a financial gap and considering taking a loan from your retirement plan, pause for a minute. This is a major decision that should not be made lightly, as there are consequences that could affect your ability to fund your future retirement. Below are six things you need to be aware of before you borrow from your 401(k) savings:

1. **You'll incur double taxation.** You will repay the loan with after-tax dollars, and because the interest you pay is not tax-deductible, you will pay tax on it again in the future when you retire and start withdrawing funds from your account.
2. **Your take-home pay will be reduced.** Most plans require you to start repaying the loan (via paycheck deductions) almost immediately after you borrow the money. Your loan payment will reduce your take-home pay, potentially impacting your ability to meet your monthly expenses.
3. **Your taxable income may increase.** Most likely, you will reduce or eliminate your normal 401(k) contributions until you have repaid the loan. Your loan repayments are not tax-deferred, and they do not reduce your taxable income like 401(k) contributions do. As a result, you could shift into a higher tax bracket until you repay the loan and begin to contribute to your retirement savings again.
4. **Your repayment schedule will accelerate if you leave your company.** If you lose your job or leave the company, it's not uncommon for plans to require full repayment of a loan within 60 days. This could create additional unforeseen financial stress for your household.
5. **Failure to repay by the deadline will trigger a taxable event.** Most 401(k) plan loans must be repaid within five years. If you do not repay your loan based on the terms of the loan agreement, your employer will treat the loan balance as a distribution, triggering income taxes and the 10-percent early withdrawal penalty if you are younger than age 59½.
6. **You will lose the magic of compounding.** There is an opportunity cost associated with long-term compounding earnings. When you take a loan from your 401(k), you lose the ability to earn interest on that money, which can affect your total portfolio balance come retirement.

Your 401(k) plan is one of the best ways to save for retirement and help ensure your future security. Explore alternative options and consider all the implications before you take a loan or withdrawal from your employer-sponsored retirement plan. Otherwise, you may regret today's decision when you need this money most—at retirement.

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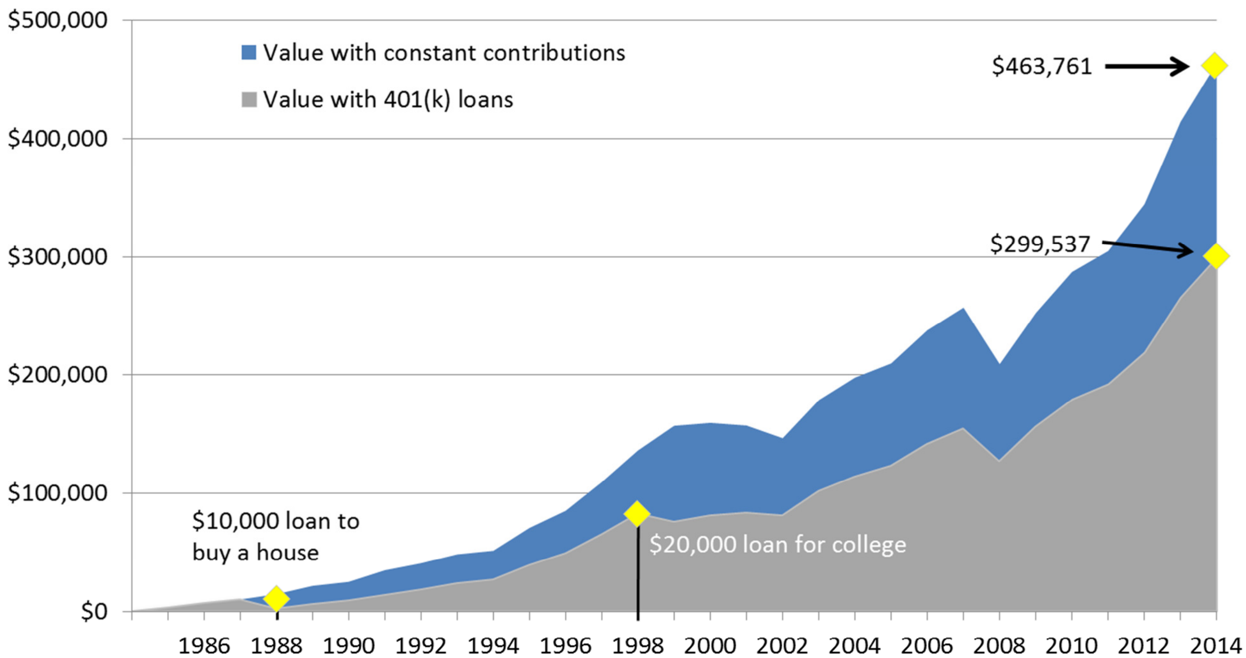
**Illustration: How 401(k) Loans Can Affect Retirement Savings**




*Source: Morningstar®/Commonwealth Financial Network*

**Assumptions:** The 401(k) participant began contributing to his 401(k) account at the beginning of 1985. The participant's starting salary was $30,000, with a 2.25% pay raise each year, and he contributed 6% of his salary to the account annually. The company matched 50% of his annual contribution at the end of each year. The participant's investments were allocated between the S&P 500 (60%) and the Barclays U.S. Aggregate Bond Index (40%). In the scenario where 401(k) loans were taken, the participant paid back both loans annually over four years, was assessed annual interest of 5% on the loans, and did not contribute to his 401(k) portfolio during those years. The first loan, for $10,000, was taken in January 1988 to help purchase a house and was paid back by December 1991. The second loan, for $20,000, was taken in January 1998 to help finance a child's college tuition and paid back in December 2002.

All indices are unmanaged, and investors cannot invest directly in an index. Unlike investments, indices do not incur management fees, charges, or expenses. Past performance does not guarantee future results. The **S&P 500**, or the **Standard & Poor's 500**, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. It is one of the most commonly followed equity indices, and many consider it one of the best representations of the U.S. stock market and a bellwether for the U.S. economy. The **Barclays Capital U.S. Aggregate Bond Index** is the most common index used to track the performance of investment-grade bonds in the U.S. The Barclays Capital U.S. Aggregate Bond Index is weighted according to market capitalization, which means the securities represented in the index are weighted according to the market size of the bond category.

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