# Not-So-Fun Facts About the 401(k) Loan

**FUND TRACK**

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earned a return. So if you charge interest, you aren't being mean; you're simply getting back the full value of the money.

It's the same with the "interest" you pay back to your 401(k). If you didn't put back interest, you'd actually be putting back less than the money is worth. Because this is a retirement plan with special tax rules, putting back less than you take out would constitute a premature distribution (which would be taxable). To prevent that, the IRS requires that you put back more than you take out. For simplicity's sake, that extra amount is called interest. But it isn't.

Which brings us to the next crucial fact that some employees don't realize:

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• **You aren't earning a return on your money.** Really. The "interest" you're paying yourself is not—repeat, not—a return. You're earning nothing. Let's say you take $20,000 from your retirement account: money that was invested in, say, the stock market, which returned 33% last year. Now go spend the money on lawn furniture. Notice how the money you borrowed is no longer earning a return, because it isn't invested in stocks, a money market or even a squirrel farm.

Meanwhile, go down to the bank and pull out the 10% "interest" to repay the loan. When you use your own money to pay yourself back, you aren't earning a return—you've just shifted your own money from one pocket to another. You aren't ending up with more money than you already had. In other words, if you found a wallet full of cash on the street, you would have more money to put in your pocket. Instead, when you borrow from yourself, you're simply picking your own pocket. To make matters worse, you're not earning a return on the money you use to pay interest, either.

It's not obvious, which is why even benefits officials get confused. Kent Frese, information-systems manager at Alliance Benefits Group, a Harrisburg, Pa., firm that designs and administers retirement plans, insists that a person who takes out a loan actually could be doing better than he would by leaving the money invested in the stock market. If he had left the money in a conservative investment earning only 6%, he would be better off paying himself interest of 10%, says Mr. Frese. "He's actually enhanced his retirement savings," Mr. Frese claims.

No, he hasn't. Let's say that you borrow $10,000 from your retirement plan, spend it and pay yourself back, plus 10% "interest." After the loan is repaid, you have $11,000. But if you don't borrow the $10,000, it could grow to $11,000. (Assume a historical average return of 10% on stocks.) Meanwhile, you'll still have $1,000 in the bank, plus interest. Total assets: $12,000, plus interest on the money in the bank.

• **You pay taxes twice on the money you borrow.** The money and "interest" you use to repay the loan is made with aftertax dollars. That money, on which you already have paid taxes, will be taxed again when you withdraw it in retirement. Depending on your tax bracket and the number of years involved, the hidden tax costs to borrowing can nearly double the total cost of the loan. Something to think about.

• **Other loans can be better deals.** There are other ways to borrow by using your own assets as collateral. Home-equity loans have lower rates than nonsecured loans, and you can deduct the interest.

If you have a brokerage account, you may be better off with a margin loan than with a loan against your 401(k). The interest is low, generally prime plus 1%, because your account balance serves as your collateral. That's why you can borrow only half of your brokerage account.

These might be better than loans from retirement plans for another reason: because a margin loan is really a loan; all your investment holdings remain fully invested. For example, if you have $100,000 in mutual funds or other investments in an account with discount broker Jack White & Co., you can borrow $50,000 at 8.25%. Meanwhile, all of your $100,000 account is still invested, earning a return.

Sure, you don't pay the interest into your account, as you would with a 401(k) loan, but neither are you losing the opportunity to earn a return on the $50,000 you borrowed. In contrast, with a 401(k) loan, the money you borrow is no longer in your account, so it isn't earning a cent. With a margin loan, you can borrow far more than you could from your 401(k), and you face no tax consequences should you not repay the sum in time.

It's also worth noting that the insurers, brokerage firms and mutual-fund companies that run the retirement plans have an incentive to make loan provisions. Employees put more money into retirement plans when they're allowed to borrow it back.

There is, unfortunately, one fact you *can't* act on. Some retirement plans build a portion of the loan costs into the plan, and those costs are paid by all the people in the plan, including those who don't borrow. So even if your motto is "Neither a borrower nor a lender be," you may be subsidizing other borrowers. As Shakespeare might say, tough luck.