The 401(k) Loan: Let Borrowers Beware

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If you're thinking of taking a loan from your 401(k) or a similar retirement plan at work, there are a few hidden costs you probably won't hear about.

In fact, the main thing you're likely to hear about retirement-plan loans is how great they are. And, in many cases, they are.

Most plans allow you to borrow as much as half your account balance, with a cap of $50,000. Generally, you have five years to pay the loan back, longer if the money is used to buy a home. And the interest you pay goes back into your own account.

For some people, this isn't a bad deal at all, *if* they otherwise would have borrowed the money from a more expensive source. Indeed, for some middle-class people who have built up a decent stash in their 401(k), these loans can allow them to buy a house that they otherwise couldn't afford.

But even if you have a sound goal, borrowing from your retirement plan isn't always as good a deal as you think it is, and you sometimes might be better off taking out a home-equity loan or borrowing from a margin account. Here are five things the benefits folks won't necessarily emphasize to you:

Easy Money

More employees are taking loans from 401(k) plans than ever before

	1992	1996
Participants with loans outstanding	25%	29%
Avg. loan balance	$4,456	$6,174

Note: Only eligible participants at companies allowing loans are included

Source: Profit Sharing/401(k) Council of America

- **You're not really borrowing.** The people who run 401(k) plans love to tell you that the interest rate you pay, typically the prime rate plus 1%, is an incredible bargain, because you would pay a lot more if you borrowed from your credit card or one of those outfits that hire retired baseball players as spokesmen in ads on late-night TV.

Well, if you *were* borrowing money, that would be true; it would be cheaper. But you aren't borrowing money from a lender that runs the risk that you'll run off to Las Vegas under an assumed name. There is no credit risk. There's no default risk. This isn't a loan: It's your money. If you take money from your mattress or bank account and put it back, that isn't borrowing, is it? Same deal with your retirement plan. No wonder it's "cheaper."

To be fair, proponents of 401(k) loans could argue that such a loan allows you to tap money from a money-filled mattress that you otherwise couldn't touch until retirement. And that, of course, is true.

Yet if you turn out to be a deadbeat, you're the only one who suffers. If you borrow $10,000 and don't pay it back (say you get laid off and can't afford to repay), the amount you borrowed will be considered a premature "distribution," or withdrawal, from your retirement plan. This means you'll owe income tax on the money, plus a 10% penalty if you're under age 59½.

And F.Y.I.: This month, the IRS proposed imposing taxes and penalties on the "interest" you have already paid back if you default on your loan. This can't be good news for low-income people and those who recently have been turned down for a loan — the very folks most likely to borrow, and to default, according to a report by the General Accounting Office.

- **You're not really paying interest.** Just as you aren't really borrowing, you aren't really paying interest. You're breaking even.

If you lent your brother money for no interest, you actually would be losing money. After all, if you had left the money invested, you certainly would have

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