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Understanding the Nuances of 401(k) Loans**

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**Understanding the Nuances of 401(k) Loans**

Two old college roommates were catching up over dinner one night. They hadn’t seen each other in nearly a decade. One had just gotten engaged. The other was saving for a down payment on a house but expressed she was having trouble coming up with the last $10,000.

“You should borrow from your 401(k),” the newly engaged friend advised.

“I didn’t know I could do that,” the other one said.

The friend who suggested a 401(k) loan was not a financial professional. But the other friend took her advice anyway.

This is a true story and this is the type of conversation with friends that inspires many of our clients to make big financial decisions like taking out a 401(k) loan. GOBankingRates found in its 2023 GOBankingRates Survey: Americans and Money Advice that 46 percent of Americans take financial advice from their friends and family.1

Before we go on, it’s important to note that there’s a vital difference between taking out a 401(k) loan and making a withdrawal. The latter has definite tax implications and the former might, depending on a variety of factors. In this article, we’re only going to go over 401(k) loans.

And 401(k) loans are generally discouraged, so we encourage you to call us first to see if there are other avenues to get access to the cash flow you need for whatever you’re considering a 401(k) loan. With that in mind, we still wanted to offer a general overview of the vehicles, when they might make sense and the risks involved.

**The 401(k) Loan: An Overview and When One Might Make Sense**

A 401(k) loan is one you can take from the money you have saved in your 401(k) if the plan your company offers allows you to take one.

The IRS notes that you can borrow up to 50 percent of your vested account balance, not exceeding $50,000. So even if your account balance is $200,000, you can still only borrow $50,000.2

Just like with any other loan, you have to apply and meet all the requirements that your plan stipulates. You can generally find both the specific requirements and the loan request form on your 401(k) administrator’s website. Note that not all requests are granted, however.

A 401(k) loan might make sense if you need a “bridge loan” financial advisor Blair duQuesnay told CNBC. She gave an example of something similar to our opening anecdote: when you need money for a down payment on a house, but only if you are selling another house and can quickly repay it.

**Know the Implications**

Just like with any loan, you need to know the implications of borrowing before you apply.

Every 401(k) plan is a little bit different, so acquaint yourself with your plan’s rules on 401(k) loans. For example, some plans require that if you are married, you get your spouse’s written consent before you can take out the loan. Be sure to know your specific plan’s guidelines.2

There are both pros and cons to taking out a 401(k) loan. Let’s dive into both. First, the pros:

* It’s relatively easy when compared to taking out a traditional loan.4
* It doesn’t impact your credit score.4
* You can pay it back through payroll deductions.4
* The interest goes back to you.4
* Interest tends to be lower than other types of loans, usually the prime interest rate plus 1 or 2 percent.5 As of this writing, the prime rate is 8.25 percent.6

Now for the cons:

* The IRS reports that you have to pay back your 401(k) loan within five years, but if you leave your job or are terminated, you have to repay the outstanding balance by the next tax-filing deadline. If you fail to do that, you’ll have to report the loan amount as a distribution from your 401(k) and you might be subject to the 10 percent early distribution tax.2
* Bankruptcy won’t discharge your loan.5
* Your plan and investments may suffer. The money you may miss out on investment earnings while you are paying the loan back.5
* There’s potential for double taxation. You pay back the loan with after-tax money and then when you withdraw it during retirement, you pay taxes on it again.5

As we said above, borrowing from your 401(k) is generally not recommended, but sometimes it might be a solution. If you’re considering taking this route, give us a call and we can go through the pros and cons and see if it makes sense in your specific circumstances.

**Sources**

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