401 (K) LOANS:
If It Seems Too Good To Be True...

by **Jim Sampson**

Employees who have invested money in their company's 401(k) program have likely wondered when they would actually see that money again. One possibility for access is a loan on the employee's account.

Many plans offer a loan provision (roughly 88%, according to a recent Employee Benefit Research Institute study), even though they are not required to. But while loans can seem like an easy way to obtain funds in a pinch, there are key considerations employees need to be aware of.

- The Good: The benefits of taking a 401(k) loan are well-documented. Employees don't need to deal with any creditors or banks to "approve" whether they can access money or determine what interest rate they are eligible for. Instead, the interest rate is set, usually at Prime + 1, for the entire plan, and employees simply need to sign the appropriate forms. When the employee's check arrives in the mail a week or two later, no taxes are withdrawn and no 10% penalty is deducted (withdrawals from a 401(k) prior to age 59 ½ are subject to a 10% pre-retirement penalty). The employee can pay the loan back through payroll deduction, so they don't need to worry about missing a payment. And they even pay themselves back the interest. Sounds like a pretty good deal, right? Not so fast.

- The Bad: Once the employee borrows the money, it's no longer working for them in their investment choices. (Conversely, if the market were to go down while the employee's money is out of the account, this fact could actually work in their favor.) And if an employee borrows money from their cookie jar or under the mattress, would they pay themselves back with interest? Probably not. More importantly, the employee must make those repayments to their account with after-tax money. Remember, the employee put the money into the account with pre-tax dollars, which will be taxed as ordinary income upon withdrawal at retirement. So, they will end up paying taxes twice on the money borrowed, and then paid back to their account. And that's not even the worst thing that could happen.

- The Ugly: Let's say an employee has an outstanding loan and leaves the company. They'll have 60-90 days (depending on the plan's provisions) to repay the outstanding amount in full to avoid having the loan go into default. Chances are that the employee doesn't have that money lying around to cover the amount. And the money borrowed was probably used for something specific, so it has already been spent. So what happens when the loan defaults? The entire outstanding amount becomes taxable income to the employee for that year. In essence, the employee is taxed for "income" they don't have. And if the employee was expecting that refund come tax time, they may want to make other plans.

From an employer's standpoint, loans can be a convenient feature to offer employees. But if not administered correctly, they can become a big headache. It's important to start loan repayments on time, per the amortization schedule. Not following that schedule is where many problems start. Another best practice tip is to only offer one outstanding loan at a time, without the option to re-finance. Plans could also limit loans for the purpose of a financial hardship, which can help to avoid having the loan feature feel like a revolving door.

When used properly, a loan feature can be a nice safety net for an employee who might hit a financial snag, especially if they are prepared for what could go wrong.

> "They will end up paying taxes twice on the money borrowed, and then paid back to their account. And that's not even the worst thing that could happen."

Jim Sampson
Managing Principal
Cornerstone Retirement Advisors