401K Loans: the good, the bad and yes…the ugly

For many investors, financing a rehab project with a loan from their 401K is an attractive and tempting option. But before dipping into your retirement plan, let's look at the repayment terms, double taxation and the true cost of this type of loan.

A 401K is funded with pretax dollars and when you withdraw money in retirement you pay the income tax. When you borrow from your 401K, you are paying a predetermined interest rate to the account and agree to pay back the full loan amount, typically within five years.

Repayment Terms

A five year payoff term might sound great, but your repayment can also be affected by circumstances out of your control. If you are laid-off, fired or leave your job by choice you will need to repay the loan, usually within two to three months. If you cannot repay the loan, you will also owe a 10% penalty and need to pay income tax on the amount you withdrew.

Think about this: would you be able to repay the loan in the middle of the rehab project if you lost your job? Additionally, having an outstanding loan on your 401k may limit your opportunities to seek new employment.

Double Taxation

You will pay income tax twice on the money you withdraw from your 401K. You may ask how that is possible and legal. Remember, the money you initially funded your 401K with was not taxed. But the money you are using to pay back the loan has been taxed. And when you retire and withdraw the money, you will pay income tax. Uncle Sam is grateful to those who volunteer to pay income tax twice!

The True Cost

Depending on your plan, you might find the interest rate on a 401K loan to be lower than a traditional lender. Sounds good, right? When you are the borrower, you want lower rates. When you are the lender you want the interest rate and fee to match the risk. But when you borrow from your 401K you are the lender and the borrower. With a 401k loan, you forgo the return your investment would normally earn. Typically, you will earn a higher rate of return from your 401K investments than the interest you will be paying to your 401K. Because you cannot know what your investments could earn until after the loan, it is impossible to calculate the true cost up front.

In a down market, it is easy to say, "My 401K is not earning anything, so I have nothing to lose."

A 401K is a long-term investment. The return may fluctuate annually, but it has the advantage of time and compound growth. Many people see a return of 8–10 percent, but depending on your investment strategy and funds, the return can be much higher.

The disadvantages for funding your next rehab project with a 401K loan far outweigh the advantages. Your 401K is a retirement account; it was never intended to be used as a revolving line of credit. **A better solution than a 401K loan is to take a short term loan for the purchase, improvements and closing costs.**

ReCasa Financial fills that need and we are ready to work with you on your next rehab project.