When you’re a bit strapped for cash, it may be tempting to think about dipping into your retirement account. Taxes and penalties generally discourage people from taking an outright withdrawal, but a growing number of retirement programs offer temporary access to those funds through what is called a participant loan. However, before you do, you might want to consider the potential costs.

How It Works

If your workplace retirement savings plan has a loan option (they aren’t required to), you generally can borrow from your retirement account an amount up to half your vested account balance or $50,000, whichever is less. For anything other than the house you live in, the loan must be paid back in five years (loans for your principal residence still have to be repaid within 15 years). As with most loans, you must repay with interest - your local bank’s “prime” rate, plus 1% is typical. Your program also may impose a minimum amount for the loan ($1,000 is typical), as well as charges for processing your loan request. As with any loan, make sure to read the “fine print” to make sure you understand the costs and commitments.

The Advantages

- It’s generally easier than getting a loan other places (such as a bank).
- It’s cheaper than running up the balance on your credit cards.
- Repayment is generally via convenient payroll deduction.
- You are, effectively, paying your retirement plan savings back, with interest.

So, what’s the “catch”?

Simply stated, you may be taking money away from your best investment option—dramatically slowing your rate of retirement savings—and replacing it with money that is more expensive than you may think.

The Bottom Line

While it may seem like a good idea to borrow from your 401(k), remember:

- The money you take from your retirement account is not earning tax-sheltered returns, so it may take you longer to achieve your retirement savings goals,
- If you change jobs, you may have to pay back the remaining amount of the loan immediately—or have it netted against your current retirement plan balance withdrawal. Either way, you will have a tax bill to settle with the IRS.

Taking a loan from your retirement plan isn’t exactly borrowing money from yourself, nor is it “robbing” Peter to pay Paul—but only if you pay back the money you borrow.

You can do some additional planning with the free calculator resources available [HERE].