401(k) Loan Basics

Taking a loan from your 401(k) can be an affordable way to quickly access cash with relatively little hassle. But using a 401(k) loan as an emergency fund or for everyday expenses like vacations, parties or gifts isn't a healthy habit. In most cases, it would be better to leave your retirement savings fully invested and find another source of cash. If you feel like you must take out a 401(k) loan, here are some things to consider:

1. **You will pay fees.** There is a cost to both setting up and maintaining a 401(k) loan. A loan set up fee of $50.00 will be deducted from your account for each new loan processed. Additionally, you will pay an annual loan maintenance fee of $25.00 for each loan. So even though the interest rate on the loan may seem favorable, 401(k) loans can be expensive especially when borrowing small amounts of money.
2. **Repayment will cost you more than your original contributions.** The leading argument in favor of a 401(k) loan—that you are borrowing from yourself at a low cost—becomes questionable when you consider how you repay the money. When you take out a 401(k) loan, you are borrowing money that was set aside on a pre-tax basis. When you repay the loan, you are repaying with after tax money. For example, if you are in the 24% tax bracket, you only receive 76 cents for every dollar you earn—the rest goes to pay income and other taxes. As a practical matter, that means you need to earn $1.24 to pay back each dollar borrowed on a 401(k) loan.
3. **The low interest rate overlooks opportunity costs.** When you borrow from your 401(k), you stop earning investment returns on the money borrowed. In order to evaluate the true cost of the loan, you should consider the returns you lose on your investments. If the annual return on your 401(k) account is 6%, the true cost of money borrowed is 6% *plus* the interest rate on the loan and any fees charged.
4. **Failure to timely repay the loan means you will lose even more money.** If you are unable to repay the loan in a timely manner, the loan will default. When you later become eligible to receive a distribution from the Plan, the outstanding amount will be offset against your remaining vested account balance and will be taxed at your current income tax rate. And if you are under age 59 ½, you will also have to pay a 10% penalty.
5. **If you leave the Company…** you are required to repay the loan, in full, including accrued interest, immediately. Otherwise, the balance due will be treated as a taxable distribution. Are you prepared for this?

Alternatives to Taking a 401(k) Loan

The best way to resist taking a loan from your 401(k) is to build an emergency fund. Here are some steps you can take to build the fund:

1. **Make a Budget.** It's important to know where your money is going so you can identify savings opportunities. Through careful budgeting, you can identify spending habits and impulse purchases for things you can probably live without and use that money to create your emergency fund. There are many online resources that can help you establish a budget. Fidelity has a mini-workshop with helpful materials here https://workplaceservices.fidelity.com/mybenefits/employerservices/app/resourceslibrary/webinars/managingdebt_lc.
2. **If you receive a windfall, put at least some of it in your emergency fund.** Whether it's a tax refund or money in a birthday card from Mom, use it to boost your emergency fund.
3. **Make savings automatic.** Use direct deposit to automatically direct a portion of your pay to a savings account.