Taking a Loan from Your Workplace Retirement Plan - Transcript

Tom Mullooly: In episode 97 we talk about taking loans from your retirement plan.

Welcome to the Mullooly Asset Show, I'm your host Tom Mullooly and this episode number 97. We got a call from an old client today who was thinking about taking a loan from their retirement plan at work and we are not fans of it.

They asked us our opinion. We had several different reasons why and we thought, you know we've written about this, Tim you should link to this in the show notes because I know that we've podcasts, videos and we've made posts on our website about the risks that come with taking loans from a retirement account.

The first thing that we want to tell you is if you can avoid it you should. Don't do it. It's not really a good idea. The main reason that we say that is, in most cases you're not actually retiring a loan you're just replacing one loan with another. Most of the time when people tell us they're thinking about taking a loan from their retirement plan they say, "Yeah, I've got some credit card debt," or, "I've got this Escalade that I want to pay off," or, "I've got this other loan that I want to get rid of."

Our advice, suck it up. Pay the loan off because all you're doing is replacing one loan with another loan. You're not really helping yourself. And people will try and tell me, "Yeah but the interest rate on this thing is 8% and I can borrow at 6% over here." I tell them, "You know what? The interest rate doesn't matter." What we're talking about are cash flow issues.

The interest rate on a loan doesn't matter if you're current on the loan. It's when you fall behind and the loan continues to compound at 6% or 8% or 10%. That's when you have a real problem. Don't get hung up on the number. When you're refinancing your mortgage, I know I'm getting a little off topic here, but when you're refinancing your mortgage, look at the payments that you're making. You may be stretching out and going from 20 to 30 years. The only money that's really exchanging hands is the money that you're giving to the mortgage broker.

Be really careful about this. Talk to a planner when it comes to borrowing money. One of the things we hear all the time is, "Hey but if I take a loan from my 401K or my deferred comp account at work, I'm paying myself." That's false. That's fake news.

I want to just walk through some of these things. When you take a loan from your retirement plan, the retirement plan sells the mutual fund shares in your plan. They sell them. You're going to lose that potential for growth over the payment schedule of that loan, normally five years. You're eliminating any kind of chance for compounding and growth from the market for the next five years when you take a loan.

You're locking in a maximum return of whatever interest rate it's going to be. Most 401Ks and deferred comp plans, it's prime rate plus 1%. Prime rate today, as we're recording this, is 5%. You're locking in some low returns on this and you're foregoing all the potential gains that you could have in your plan.

When you're replacing a car loan or some other kind of loan or worse, paying off a credit card I want you to just think about this. You're replacing, say a credit card loan, which ultimately is a variable loan in the sense that you're minimum payment may be two or $300 but you can pay them back whatever amount you can afford. Instead you're trading in a variable loan for something that's now fixed over the next 60 months, five years, you're going to have to make that payment no matter what.

So you lose a lot of flexibility by doing that. And since most people who take these retirement plan loans are really just refinancing or replacing one loan with another, a lot of times these same people come back to us three or four years later and they've got more debt than they had before. Be really careful about this.

When you're making payments on a retirement plan loan, understand that your payments are going in after tax. Your contributions go in before tax, your payments on the loan are going in after tax. So you have to set up another account. It could be at a credit union or it could be at a bank but that money has to get drafted out of that account. So you're going to get your paycheck, you're going to have taxes taken out, then the money's going to come out of this account to pay for the loan.

So that money gets added on a post-tax basis. That's really important to understand because at retirement what's going to happen is, you're going to have a portion of the money that's going to be eligible to be rolled over into an IRA and it's all going to be on a tax deferred basis. But the money that you paid for the loan is going to be post-tax. It's important to understand that some of this money is going to be post-tax. Some of it'll be pre-tax, some of it post-tax. That's really important.

Another point that we want to bring up and it's really important because there is a real risk with this. If you fall behind on your mortgage or you fall behind on your, you're going to get letters from your mortgage company. If you fall behind on your car payment you could get your car repossessed. What happens if you fall behind on your 401K loan or your deferred comp loan?

You miss two payments, two payments, you are in default on your loan. So what happens with that? Well couple of things, the first is, you're never going to be able to borrow money from your retirement plan at work ever again if you default. So it's just not an option any more. The second thing, more important is that whole loan, the entire loan, becomes taxable income to you that year. Which means at the end of that year, at the beginning of the next year, you're going to get a 1099R, it's going to show the whole thing distributed to you. So that's all taxable income, now you got to report it, pay tax on it, you may be in a higher tax bracket now because of this.

One more thing, if you're under 59 and a half, you're going to have a 10% penalty because you took money out of a retirement plan prior to age 59 and a half. Be super, super careful when it comes to these things. Definitely don't default if you've got a retirement plan loan.

You could avoid taking, or it's possible that you could avoid taking a loan from your retirement plan in the first place, like we said, really in most cases you're not actually borrowing money,

you're just replacing a loan. You're increasing the amount of money debt that you have. A little bit of planning can go a long way. Speak with a financial planner.

One of the options that we laid out for a couple of our clients who were considering this was, hey look, if you reduce the amount for a year that you're putting into your retirement plan you may be able to pay off this other loan that you want to tackle without even getting involved in a loan. Many cases what we're talking about, these are not debt problems, these are cash flow problems. You need to speak with a financial planner when you're talking about cash flow issues.

The biggest item for us when it comes to these retirement plan loans from our point of view is that the loan amount is out of the market for the next five years while that loan gets repaid. You could miss out on a ton of potential tax deferred gains that you may be able to get from the market. Be super careful when you're thinking about taking a loan from your retirement plan at work.

That's going to wrap up episode 97. Thanks for watching.