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The Hidden Costs of Borrowing from Your 401(k) Retirement Plan

Taking a loan from your 401(k)-retirement plan may seem like an **attractive option** because you are borrowing from yourself. However, a closer look exposes the **potential drawbacks and hidden costs** associated with this decision. Following are **four reasons** why borrowing from your 401(k) may have **negative consequences** on your financial well-being.

1. **Repayment with After-Tax Money:** When repaying a 401(k) loan, you use dollars you have earned and must pay taxes on. This means that if you are in a 24% tax bracket, you'll need to earn $1.32 to repay every $1 borrowed. Essentially, it requires additional work and income compared to the original contribution. Remember that, in most cases, the money you repay to the plan will be taxed again when you withdraw it. In effect, double taxation!

2. **Opportunity Costs:** While you have a 401(k) loan, the borrowed funds are no longer earning investment returns. This missed opportunity for growth should be weighed against the perceived benefit of a low-interest rate on the loan.

3. **Financial Risks and Default:** If you face financial difficulties and cannot repay the loan, the consequences can be severe. A defaulted 401(k) loan is treated as a withdrawal, subjecting the outstanding balance to income tax and potentially a 10% early withdrawal penalty if you are under 59½ years old.

4. **Job Loss or Departure:** If you leave your job with an outstanding 401(k) loan, you will have a limited time to repay the balance. Otherwise, it will be treated as a withdrawal, triggering taxes and penalties as described in #3 above. This restriction can limit your flexibility in pursuing new job opportunities or force you to come up with the outstanding balance quickly.

While the option of borrowing from your 401(k)-retirement plan may seem tempting, it is crucial to consider the long-term consequences and hidden costs. Repayment with after-tax money and missed investment opportunities are among the potential downsides. Before deciding to take a loan from your 401(k), it is advisable to explore alternative solutions and consult with a financial advisor to ensure you make informed choices about your financial future.