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Should You Borrow From Your Retirement Plan to Buy a Home?

By Andrew Cayer

We see many young individuals who would like to purchase a home but simply lack the down payment to get started. This is especially true for those living in high cost urban areas and who have student debt. Often, the only savings they have is their company retirement plan. Should they borrow from their retirement plan to buy a home?

First some facts. Most 401k plans allow you to borrow against your savings using the balance as collateral. The maximum loan you can borrow is the lesser of $50,000 or 50% of the total vested amount in your account. You do have to pay interest on the loan (the rate typically tied to the prime rate), but that interest goes directly to your account. It's also relatively easy to borrow, requiring almost no paperwork with few questions asked. But borrowing from your 401k can be expensive, here's why:

401(k) Loan Disadvantages

High Opportunity Costs

There are two opportunity costs when borrowing from your 401(k). The first and potentially the highest is the inability to make contributions while you have a loan balance. Many employers restrict normal contributions while a loan is outstanding. As a result, you cannot take advantage of the tax benefits of making pre-tax contributions and you forfeit any employer's match while the loan is outstanding.

The second opportunity cost is a borrower does not earn a return on the amount borrowed until the loan is repaid, resulting in a lower closing value at retirement.

Repayment Required if You Leave Your Employer

What if you want to leave your current employer? Be prepared to pay back your loan within a couple months. Employers typically require 60 days for repayment. The rule applies if you quit, change employers, or get fired. If you fail to repay, the outstanding balance be deemed a distribution and will be taxed as ordinary income plus a 10% penalty.

Double Taxation

Normally, contributions are made with *pre-tax* dollars. Yet one has to use after-tax dollars for interest payments when a loan is outstanding. Then, when the money is withdrawn during retirement, the interest you paid is taxed again at ordinary income rates. Fortunately, the double taxation is only on the interest paid and does not apply to repayment of the principal.

In addition to double taxation, unlike mortgage interest, the interest you pay on your 401k loan is not tax-deductible. It's a triple hit in total.

Can You Borrow From an IRA?

An IRA loan is allowed but not recommended due to its short-term nature. The law requires a 60-day period for repayment, otherwise the loan is deemed a distribution and will be taxed as ordinary income, plus a 10% penalty. A better alternative may be a straight with-drawal. Unlike a 401(k), the law allows first-time home buyers to withdraw up to $10,000 for financing a home without penalty, although taxes will be due.

There's a better option for those with a Roth IRA. A Roth IRA allows tax- and penalty-free withdrawals on contributions any time and the same can be done on earnings if the Roth has been open for more the five years. Only earnings during the first five years count toward the $10,000 limit. After this period, you can withdraw as much as you need without any cost or penalty. Once again, however, the opportunity cost will be high as you may no longer even qualify to make future Roth contribution to replenish what you withdrew.

Bottom Line:

Using your retirement savings for a down payment can be expensive, especially if your employer matches your contributions. Your first step should be to contact your benefits administer to understand the ins and outs of your company's specific plan. However, even if the money comes at a price, it may still be worth it to start the home ownership journey. At least you are using the money to invest and not to consume!

Artemis Financial Advisors
54 Chandler Street
Boston, MA 02116

617-542-2420