Borrowing from Your 403(b): Questions to Ask First

Before you take a loan from your 403(b) account for any reason, be sure to consider all of the possible consequences of your decision. It is recommended that you exhaust all other loan alternatives first.

The following questions discuss the risks that come with borrowing from a retirement account to help you make an informed decision.

Can I afford the monthly payments?

A 403(b) loan must be paid back within 5 years (59 months), which might cause your payments to be larger than anticipated. On the other hand, the maximum duration of education and home improvement loans is not limited to 5 years. Having a longer time period to pay back the loan can greatly reduce monthly payments.

Will I pay taxes on my loan amount?

Funds borrowed from your plan are not treated as taxable distributions, provided they are repaid in accordance with the terms of the loan. No taxes are due when the loan is received. However, by borrowing, you lose the advantages of tax-deferred earnings. For example, funds left in the 403(b) account have the opportunity to earn interest on a tax-deferred basis, but borrowed funds cannot accrue interest other than the interest you pay on your loan.

Are my loan payments tax deductible?

The monies you borrow from your retirement account are not tax deductible. When you repay your loan, you are paying it with after-tax income. You cannot deduct the interest or payments on your tax return because the loan payments are being used to simply replace the account earnings on which taxes are still being deferred.

Alternatively, qualified student loans through the U.S. Department of Education may be tax deductible, depending on your adjusted gross income level. Student loans and even home equity loans are generally more advantageous than a 403(b) loan when the interest can be deducted from your income for tax purposes.

What if I default on my 403(b) loan?

A default is based on the unpaid balance of the loan plus 90 days of interest. In addition, if you are not yet 59½ years old, you will also incur an early withdrawal penalty of 10%. Loan defaults cannot be re-paid, and will not show on a credit report.

Will I still be able to meet my retirement goals?

Borrowing from your retirement account could sidetrack long-term retirement goals to meet a short-term need. If you will only be able to make loan payments, foregoing any new contributions, borrowing could leave you with less in your account at retirement than anticipated. It could also diminish the account considerably if you default.

You may incur opportunity cost if the loan replaces investments that provide a higher rate of return than the interest rate being paid back to the account. For example, if you are repaying the loan at a 9% interest rate, but the return on investments are paying an average annual rate of return of 12%, you will miss an opportunity to earn higher returns while you're repaying the loan.

Sound debt management is essential to financial success.

Borrowing to buy a depreciating asset is not generally regarded to be a wise use of retirement savings. In addition, while you are not penalized for taking a 403(b) loan, you risk the loss of earning potential. It is recommended that you consult a tax professional or lender before making your decision.

If you have any questions or would like more information about 403(b) loans, please call 1.855.558.3900.