The red flags are many when borrowing from your retirement plan

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The COVID-19 pandemic has resulted in many people borrowing from their companies' qualified retirement plans, and the CARES Act provides some temporary rule changes to this loan type. However, given the risks and costs of borrowing from a retirement plan, it should generally be viewed as a last resort. From an estate planning angle, subtracting funds from your retirement plan will leave less for your heirs if you were to unexpectedly die before you can repay the loan.

Temporary plan loan rules

Not all qualified plans permit loans, but, if your plan allows them, you can normally borrow up to $50,000 or 50% of your *vested* account balance, whichever is less. Generally, the loan must be repaid in five years. Often, interest rates are lower than those of comparable bank loans.

The CARES Act temporarily liberalizes the plan loan rules in two ways. First, loan payments that would otherwise be due between March 27, 2020, and December 31, 2020, can be suspended for up to one year. Payments due after the suspension period will be adjusted to reflect interest that accrued during the suspension period.

Second, for individuals who took a plan loan between March 27, 2020, and Sept. 22, 2020, the maximum loan amount increased to the lesser of: (1) $100,000 minus any existing plan loan balances; or (2) 100% of the participant's vested account balance or benefit.

Not a "free" loan

Many people view borrowing from a retirement plan as "free." After all, you're paying the interest to yourself. But there are costs involved. For one thing, you'll lose the benefits of tax-deferred growth on the amount you borrow. Unless the interest rate you pay on the loan equals or exceeds the growth rate of the plan assets, your account's value will end up lower than it would have been without the loan.

Another potential cost is the loss of contributions to the plan (plus earnings on those amounts), either because you can't afford them while you're repaying the loan or because your plan prohibits contributions until the loan is repaid. If that's the case, you'll also lose any matching contributions your employer offers.

Accelerated loan payments

Costs aside, the strongest argument against borrowing from a retirement plan is the risk that the loan will be accelerated if you lose your job. Many employers require you to repay the outstanding balance in the event your employment terminates. If you can't, the balance will be treated as a distribution and subject to taxes and, if applicable, penalties.

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