

Will I Pay Taxes Twice on a 401k Loan?



Are 401k Loans Double Taxed?

Most 401k retirement programs permit participants to take out loans if the participant meets specified criteria. Typically the loans are limited to the lesser of 50% of the vested plan balance or \$50,000 and are repaid over five years via payroll deduction (or in a lump sum upon separation from the employer).

Conventional wisdom holds that 401k loans result in double taxation on the participant. The loan is repaid with after-tax dollars (1st tax) and the money is again taxed when it is taken out in retirement (2nd tax).

In fact there is no double taxation - at least on repayment of the loan principal. [This academic study from the Federal Reserve](#) goes into complex modeling to mathematically prove there is no double taxation on 401k loans. A less arcane discussion is found in [this personal finance blog post](#).

Here, in summary form, are 5 key points to help you understand why the double taxation of 401k loans is largely a myth:

1. You already own the assets in your 401k. A 401k loan is less a loan than a pre-retirement withdrawal coupled with a schedule of automatic replacement contributions.
2. You could "borrow" \$10,000 from your 401k and return the exact same \$10,000 a year later. You didn't pay taxes when the money was taken out and you don't pay taxes on the \$10,000 when it is put back in. Very clearly, there is no taxation on the loan principal.
3. Of course, you will be required to pay interest on the \$10,000 (say 5%, or \$500). Loan interest payments are like new 401k contributions and, ideally, would be made with pre-tax dollars. However, the interest payments will be made with after-tax dollars, so there is some justification to say the interest portion dollars are double taxed (i.e. when you pay the interest in with after tax dollars and when you withdraw the same money in retirement). The earlier mentioned Federal Reserve analysis shows mathematically that even the interest portion is not truly double taxed due to the present value considerations - but this argument is too complex to summarize here.¹

4. Aside from the tax deduction benefits of mortgages and HELOCs, interest paid on all loan types is made with no tax-advantaged dollars. Paying after-tax dollars into a 401k for interest is not a huge negative for 401k borrowers. In fact, it can be a positive in some situations:

(A) household whose motivation is to maximize contributions to the 401(k) (e.g., if they are constrained by the contribution limit) might prefer a 401(k) loan with a sufficiently high interest rate simply as a way to get more assets into the tax-favored account. For example, while the limit on 401(k) contributions is \$15,500 in 2008, a household could effectively get more into the account by taking a 401(k) loan if the loan carried an interest rate higher than the expected 401(k) return over the repayment period. In such a case, the loan would actually increase the amount of tax-favored saving.

In summary, there are many good reasons to tread carefully when considering a 401k loan. However, fear of double taxation is a myth that should not be one of them.

Notes:

1. OK...here is the argument for those willing to try and follow it: "Loan interest payments, on the other hand, can indeed be considered double-taxed under traditional consumption tax principles—since interest payments are like new contributions, they should be made with pre-tax dollars and then taxed upon withdrawal. In practice, however, the double-taxation of loan interest relative to a consumption tax is offset by the break borrowers get on the timing of their tax payments: recall that rather than paying taxes on loan proceeds when they are distributed (i.e., consumed), borrowers pay the taxes gradually over the following five years as they repay the loan with after-tax dollars. The time value of these delayed tax payments offsets the double taxation of interest—perfectly so, if the discount rate is the pre-tax rate of return; only partially if the discount rate is lower."

This article is also available at the following link:

<http://www.401kplanning.org/top-401k-planning-questions-and-answers/should-i-take-a-401k-loan-and-other-401k-loan-questions/will-i-pay-taxes-twice-on-a-401k-loan/>