

RETIREMENT PLAN LOANS;

DO YOU REALLY WANT TO BE YOUR EMPLOYEE'S BANKER?

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I. **WHAT THE INTERNAL REVENUE CODE SAYS ABOUT RETIREMENT PLAN LOANS**

A. Under Internal Revenue Code ("IRC") Section 72(p)(2)(A) plan loans are limited to the lesser of:

1. \$50,000; or
2. 50% of the participant's vested account balance.

B. Under IRC Section 72(p)(2)(B):

1. Generally, the loan must be repaid in no more than five years.
2. If the loan proceeds are used to acquire a principal residence, it may be repaid over a reasonable period that extends beyond five years.

C. Under IRC Section 72(p)(2)(C):

1. Payments must be made at least quarterly.
2. The loan must be repaid by level amortization.

D. If IRC Section 72 is violated, the loan is treated as a taxable distribution.

II. **WHAT ARE THE DEPARTMENT OF LABOR'S REQUIREMENTS FOR RETIREMENT PLAN LOANS?**

A. The requirements of DOL Regulation Section 2550.408b-1 must be met.

- B. The requirements for the loan include:
 - 1. Must be available to plan participants on a non-discriminatory basis.
 - 2. Must be made pursuant to the terms of the plan.
 - 3. Must bear a reasonable rate of interest.
 - 4. Must be adequately secured.

III. MUST ALL RETIREMENT PLANS (INCLUDING 401(K) PLANS) HAVE A PARTICIPANT LOAN FEATURE?

- A. Plan loan features are optional.
- B. It has been estimated that almost 90% of all 401(k) plans have some type of loan feature.
- C. Loan features are not a “protected benefit” and can be removed prospectively.
- D. Loans may not be made from SEPs SIMPLEs, Traditional IRAs or Roth IRAs.

IV. WHERE ARE THE RULES GOVERNING RETIREMENT PLAN LOANS FOUND?

- A. Employers have the discretion to decide whether they will offer loans from their retirement plans.
- B. If loans are authorized, the retirement plan document will confirm this.
- C. Participants can also make this determination by reviewing their Summary Plan Description.

D. The rules governing plan loans are often contained in a Loan Procedure.

V. MUST A PARTICIPANT DISCLOSE THEIR REASON FOR THE LOAN?

A. Unlike certain types of distributions (i.e. hardship in a 401(k) plan) plan loans can be used for any purpose.

B. Employers have the discretion in designing their Loan Procedure to decide what, if any, purpose or standard must be met to qualify for the loan.

VI. WHAT IS THE MAXIMUM AMOUNT A PARTICIPANT MAY BORROW FROM A RETIREMENT PLAN?

A. The IRC specifies that the loan amount can't exceed the lesser of:

1. \$50,000; or
2. 50% of the participant's vested account balance.

B. Note that the \$50,000 maximum limit must be reduced by the amount by which the highest outstanding loan amount in the past twelve months exceeds the current loan balance.

C. Employers may set lower maximum limits if they desire in their Loan Procedures.

D. The employer may actually permit participants to borrow more than 50% of their vested account balance up to a maximum of \$10,000.

E. Example of how the maximum loan limit works:

1. Sam has a \$110,000 vested account balance on June 1, 2017.
2. Sam took a \$50,000 loan on July 1, 2016.

3. Sam's loan balance on June 1, 2017 is \$42,000.
4. Sam wants a new loan on June 1, 2017.
5. The \$50,000 loan limit is adjusted by \$8,000 ($\$50,000 - \$42,000 = \$8,000$).
6. The new loan limit on June 1, 2017 equals the lesser of:
 - a. One-half of the vested account balance; or
 - b. \$42,000 ($\$50,000 - \$8,000$).
7. Therefore, no new loan for Sam.

VII. WHAT IS THE MAXIMUM LOAN REPAYMENT TERM A PARTICIPANT CAN RECEIVE FOR A PLAN LOAN?

- A. The general rule is that plan loans must be repaid in no more than five years.
- B. Many plans actually limit the term to less than five years.
- C. The law permits a plan to extend the term to a "reasonable period" if the loan is for the purpose of acquiring a principal residence.
- D. Offering lengthier terms often creates problems so that many employers choose to limit the term to five years.

VIII. WHAT LATITUDE DOES A PLAN HAVE IN SETTING THE TERMS OF REPAYMENT? CAN THERE BE A BALLOON PAYMENT? CAN PAYMENTS BE MADE ANNUALLY?

- A. Plan loan repayments must be amortized ratably over the term of the loan. As such, loan repayment amounts will generally be level.

- B. Loan repayment amounts must be made no less frequent than quarterly.
- C. Employers may require payments to coincide with payroll dates (weekly, bi-weekly, monthly, etc.).
- D. Most plans today receive loan repayment through payroll withholding.

IX. LOANS MUST BE ADEQUATELY SECURED. WHAT CONSTITUTES ADEQUATE SECURITY?

- A. Most plans accept a participant pledging a portion of their vested account balance.
- B. Participants can only pledge 50% of their vested account balance as security for a loan.
- C. Theoretically, the plan could also require additional or other assets (i.e., a mortgage on a principal residence) as security.

X. WHAT CONSTITUTES A "REASONABLE" INTEREST RATE?

- A. The rate must provide the plan with a return comparable to the interest rate charged on a similar commercial loan.
- B. The plan may consider factors such as risk of loss; however, how great is the risk of loss when a participant uses their account as security?
- C. As a practical matter, most plans simply use prime, plus one or two percent as the interest for plan loans to participants.

XI. WHAT HAPPENS IF A PARTICIPANT DEFAULTS IN MAKING A PAYMENT?

- A. Plans may provide for a grace period for a missed payment.

1. The maximum grace period must end on the last day of the calendar quarter following the calendar quarter in which the payment was due.
 2. Some plans use shorter grace periods.
- B. When the default occurs, the entire loan balance is treated as a “deemed distribution” and becomes taxable.
1. A 1099R is issued at the year end.
 2. Not subject to any withholding, so the participant must make sure the tax is paid.
 3. The distribution will also be subject to the 10% early distribution excise tax, if appropriate.

XII. CAN PLAN LOANS BE REFINANCED TO A LOWER INTEREST RATE (AND POSSIBLY BORROW ADDITIONAL AMOUNTS)?

- A. Once again, it depends on the plan document and/or the Loan Procedure.
1. Some plans require one loan to be repaid before a participant may be eligible for a new loan.
 2. Other plans will allow multiple loans at the same time.
- B. In refinancing, you cannot extend the repayment of any of the old loan balance to more than five years.
1. You may re-amortize the loan at a lower interest rate over the remaining term of the original loan.
 2. You may amortize the new money based upon the date the new money was loaned.

XIII. WILL THE INTEREST PAID ON A PLAN LOAN BE DEDUCTIBLE?

- A. Generally plan loan interest is only deductible if the proceeds are traced to such uses as purchasing a qualified residence or for investment.
- B. Generally plan loan interest is not deductible if the proceeds are used for personal purposes.
- C. Interest paid on loans secured by 401(k) or 403(b) plan account balances are never deductible.
- D. Interest paid on loans to “Key Employees” is never deductible. Key Employees generally include 5% owners, officers with more than \$130,000 of compensation, or 1% owners with more than \$150,000 of compensation.

XIV. WHAT ARE THE REQUIREMENTS FOR A “HARDSHIP DISTRIBUTION” FROM A 401(K) PLAN?

- A. Is a “hardship distribution” provision a good alternative to a loan provision?
- B. Hardship distributions may only be made under very limited rules:
 - 1. Generally “in-service” distributions prior to age 59 ½ are prohibited.
 - 2. To qualify for a hardship distribution the following is required:
 - a. The plan must allow for hardship distributions.
 - b. The IRS rules will allow distributions for medical expenses, the purchase of a principal residence, tuition and related expenses, funeral expenses, payment to prevent foreclosure on a principal residence, or

payments for repair of casualty damage to a principal residence.

- c. The amount available is limited to the amount needed to pay the distribution and taxes owed taking into account other sources that may be available.

XV. WHY SHOULD AN EMPLOYER PROVIDE FOR PLAN LOANS IN THEIR RETIREMENT PLAN?

- A. Employees will feel more comfortable deferring amounts in the employer's 401(k) plan if they have a reasonable expectation of those amounts being made available to them in a time of need.
- B. Without a plan loan opportunity, employers face the prospect of good employees terminating employment simply to get access to their accounts.
- C. Employees may be uncomfortable attempting to qualify for hardship distributions from 401(k) plans, not wanting to disclose to their employer personal hardship situations.
- D. Employees will appreciate the ability to borrow funds without jumping through all of the hoops that a commercial lender may require.
- E. If the loans get repaid there is no "leakage" of retirement benefits (thereby maximizing retirement benefits) that may otherwise occur if the plan provides for hardship distributions or other in-service distributions.
- F. There are no income tax consequences for a plan loan that gets repaid.
- G. There is no 10% premature distribution excise tax for a plan loan that gets repaid.

- H. Since most 401(k) plans allow participant loans, should an employer allow itself to be perceived as taking away an employee benefit?
- I. It's a "cheap benefit" for most employers since the employees usually bear the cost.
- J. The costs of borrowing from a retirement plan are often less than from a commercial lender.

XVI. WHY SHOULD AN EMPLOYER FOREGO PLAN LOAN OPTIONS IN THEIR RETIREMENT PLANS?

- A. The ability to borrow against an employee's retirement benefits often creates "leakage" (the reduction of retirement benefits) due to the employee's inability to repay the loan.
- B. Ready access to retirement plan benefits through plan loans may facilitate impulsive spending or the use of retirement benefits for the wrong reason (a new boat, a vacation, etc.).
- C. Many plans provide that a participant who has a loan outstanding must suspend future deferrals until the loan is repaid.
- D. The interest that a participant pays to repay a plan loan from a 401(k) plan is generally not deductible. Other loan sources may be available to the employee (an equity line of credit) where the interest is deductible.
- E. The interest that any employee pays on a plan loan from a 401(k) plan will likely be subject to "double taxation." Since the interest paid is not deductible and paid with "after tax dollars," they are also taxed a second time when those amounts are distributed from the plan to the employee.

- F. The interest rate paid by an employee (which is credited to their account) is often less than they may have earned if their account remained fully invested.
- G. Employees will have a smaller take home pay because of the likely payroll withholding to repay the plan loan.
- H. The plan loan will become taxable and may be subject to a 10% excise tax on early distributions if there is a default.
- I. The plan loan will likely become taxable and possibly subject to a 10% excise tax on early distributions if the employee terminates employment.
- J. The plan loan will likely become taxable and possibly subject to a 10% excise tax on early distributions if the employer terminates the retirement plan.
- K. Does an employer really want to be the employee's banker?