Retirement Plan Loans: Do You Really Want to be Your Employee's Banker?

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- Retirement plans are not required to provide for plan loans
  - Optional for most plans
  - Generally permitted in 401(k) and 403(b) plans
  - Not permitted in SEPs, SIMPLE-IRAs

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- Both IRS and DOL have jurisdiction
  - IRS rules deal with taxability
  - DOL rules deal with prohibited transaction

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- Where are the rules governing plan loans found?
  - The plan document
  - The summary plan description
  - The loan procedure

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- Must participants disclose the reason for the loan?
  - Not required, but optional
  - Unlike hardship distributions in a 401(k)plan

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- What is the maximum loan available?
  - Lesser of $50,000 or 50% of vested account balance
  - Employers may set lower limits

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- What is the maximum repayment term?
  - Generally no more than 5 years
  - A reasonable period if used to acquire a principal residence

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- How must the loan be repaid?
  - Amortized ratably over the term
  - Installments must be made at least quarterly

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- What constitutes "adequate security"?
  - Most 401(k) plans use 50% of vested account balance
  - Other assets could be used instead

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- What constitutes a reasonable interest rate?
  - Comparable to the rate charged on a commercial loan
  - As a practical matter, it is generally prime plus 1% or 2%

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- What happens if there is a default in repayment?
  - Form 1099 issued and loan becomes taxable and could be subject to the 10% penalty for early distributions
  - Maximum grace period ends on the last day of quarter following the quarter of default

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- Is interest paid tax deductible?
  - If secured by employee deferrals, no
  - If made to most owners and officers, no

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TOP TEN REASONS WHY

YOU DON'T WANT

***TO* BE YOUR EMPLOYEE'S BANKER**

AND ALLOW PLAN LOANS

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#10

If there is a default, the loan becomes taxable and possibly subject to a 10% excise tax on early distributions.

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#9

If employer terminates the plan, the loan likely becomes taxable and possibly subject to a 10% excise tax on early distributions.

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#8

If the employee terminates employment, the loan likely becomes taxable and possibly subject to a 10% excise tax on early distributions.

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#7

Borrowing against retirement benefits often creates leakage (reduction of benefits) due to the inability to repay the loan.

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#6

The interest that an employee pays on a plan loan will likely be "double taxed." Since it is not deductible, it is taxed when earned and taxed a second time when distributed from the plan.

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#5

Other loan sources available to employees (an equity line of credit) may be deductible.

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#4

Many plans suspend future deferrals until the loan is repaid.

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#3

The interest rate credited to a participant's account is often less than they would have earned if their account was fully invested.

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#2

Employees have a smaller take home pay because of the likely payroll withholding.

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#1

Ready access to retirement benefits may facilitate impulsive spending for the wrong reason (a new boat, a vacation, etc.).

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TOP TEN REASONS WHY

YOU SHOULD BE

WILLING TO **BE YOUR EMPLOYEE'S BANKER**

AND ALLOW PLAN LOANS

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#10

There is no income tax consequence for a plan loan that gets repaid.

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#9

There is no 10% premature distribution excise tax for a plan loan that gets repaid.

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#8

It's a "cheap benefit" for most employers since the employees usually bear the cost.

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#7

Since most 401(k) plans allow participant loans, an employer may be perceived as taking away an employee "entitlement" if plan loans aren't offered.

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#6

The costs of borrowing from a retirement plan are often less than from a commercial lender.

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#5

Employees may be uncomfortable attempting to qualify for hardship distributions from 401(k) plans, not wanting to disclose to their employer personal hardship situations.

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#4

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.

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#3

Employees will appreciate the ability to borrow funds without jumping through all of the hoops that a commercial lender may require.

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#2

Without a plan loan opportunity, employers face the prospect of good employees terminating employment simply to get access to their accounts.

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#1

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.