MVP
PLAN ADMINISTRATORS

401(k) Plan Loans

Allowing loans within a 401(k) plan is allowed by law, but an employer is not required to do so. Many small businesses just can't afford the high cost of adding this feature to their plan. Even though most plans pass along the cost of processing a loan to the participant, the plan sponsor is still liable for tracking and making sure payments are being made according the amortization schedule. If offered, an employer must adhere to some very strict and detailed guidelines on making and administering them.

If the employer chooses to allow loans, a Loan Policy must be in place which describes how loans are governed within the plan. Because the loans must be reasonably available to all participants, and be treated in a uniform and nondiscriminatory manner, MVP(k)plan will utilize the following Loan Policy:

i. No loan in an amount less than $1,000 shall be granted to any Participant.
ii. All loans shall be considered a direct investment from the account(s) of the Participant maintained under the Plan. As such, all payments of principal and interest made by the Participant shall be credited only to the account(s) of such Participant.
iii. Only one (1) loan per Participant is allowed during any given time. Full payment of an outstanding loan to a Participant must be made before another loan can be granted.
iv. Loan payments are payroll deducted.
v. Loans must be paid back within a 5-year period.
vi. Any loan granted or renewed shall bear a reasonable rate of interest. The rate of interest used for this plan shall be the *prime rate plus 1%* at the time the loan application is completed.

If a participant has had no other plan loan in the 12 month period ending on the day before they apply for a loan, they are usually allowed to borrow up to 50% of their vested account balance to a maximum of $50,000. If the participant had another plan loan in the last 12 month period, they will be limited to 50% of their vested account balance, or $50,000, minus the outstanding loan balance in the preceding 12-month period, whichever is less.

Funds obtained from a loan are not subject to income tax or the 10% early withdrawal penalty (unless the loan defaults). If the participant should terminate employment, often any unpaid loan will be distributed to them as income. The amount will then be subject to income tax and may also be subject to 10% withdrawal penalty if the individual is under the age of 59 ½. A loan cannot be rolled over to an IRA but might be allowed to be rolled over into another employer's qualified retirement plan.

Loans from 401(k) plans are not always the best idea. Participants should consider the "pros and cons," some of which may be surprising. And remember, the purpose of a 401(k) plan is to fund for retirement, loans will shortchange a participant's golden years by treating their 401(k) plan as a checking account.

When a Participant Probably Shouldn't Borrow from their 401(k) Plan

1. They are planning to leave their job within the next couple of years.
2. There is a chance they could lose their job due to a company restructuring.
3. They are nearing retirement.
4. They can obtain the funds from other sources.
5. They can't continue to make regular contributions to the 401(k) plan.
6. They can't pay off the loan right away if they are laid off or change jobs.
7. They need the loan to meet everyday living expenses.
8. They want the money to purchase some luxury item or pay for a vacation.

The Pros:

1. It's convenient. There is no credit check or long credit application form. Just a completion of the Loan Application.
2. There is a low interest rate. The participant will pay the rate set by the Loan Policy, (usually, prime rate plus 1%).
3. There usually are no restrictions.
4. The participant pays the interest back to themselves, not to a bank or a credit card company.

The Cons:

1. There are "opportunity" costs. According to the U.S. General Accounting Office, the interest rate paid on a plan loan is often less than the rate the plan funds would have otherwise earned.
2. Loan payments are taxable. The amount borrowed from the plan is typically pre-tax dollars which means the participant pays back the loan plus the loan interest on an after-tax basis. At retirement, loan balance and the interest are taxed again once distributed.
3. Smaller contributions. Because participant's now have the burden of a loan payment, they may be tempted to reduce the amount they are contributing to the plan and thus reduce their long-term retirement account balance.
4. Loan defaults can be harmful to participant's financial health. If a participant quit working or changes employers, the loan must be paid back right away. A typical requirement is full repayment of a loan within 30 days of termination of employment. If the participant can't repay the loan, it is considered defaulted, and will be taxed on the outstanding balance, including an early withdrawal penalty if the participant is not at least age 59 ½.
5. There are fees involved.
6. Interest on the loan is not tax deductible, even if used borrow to purchase a primary home.
7. There is no flexibility in changing the payment terms of a loan.