401(k) Plan Loans

Allowing loans within a 401(k) plan is allowed by law, but an employer is not <u>required</u> to make loans available. 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 loans.

"Most Americans have not saved enough for retirement, Fiduciaries should consider this when determining whether or not to allow loans in their retirement plan. At very least, consider limitations on loans if allowed" – MVP.

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 recommends utilizing the following policy:

1. The minimum loan an amount allowed to be taken is $1,000.
2. 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 paid by the Participant shall be credited only to the account(s) of the Participant.
3. 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.
4. Loan payments are required to be payroll deducted.
5. Loans must be paid back within a 5-year period.
6. Any loan granted or renewed shall bear a reasonable rate of interest. A commonly used rate of interest used is *prime rate plus 1%*.

Some IRS Provisions Regarding Loans from Qualified Plans . . . .

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, if that employer's plan allows.

"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 in a manner other than intended." - MVP

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

"If a participant cannot fully pay back the loan before leaving employment with the Plan Sponsor, the outstanding loan balance will become taxable to the participant and they could also be subject to an early withdrawal penalty." - MVP

1. Planning to leave their job within the next couple of years.
2. If there is a chance they could lose their job due to a company restructuring.
3. Nearing retirement.
4. Can obtain the funds from other sources.
5. Can't continue to make regular contributions to the 401(k) plan.
6. Can't pay off the loan right away if they are laid off or change jobs.
7. Need the loan to meet everyday living expenses.
8. Utilize the loan 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 very few or 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 if the money remained invested in the plan.
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 (or when otherwise distributed), 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 usually no flexibility in changing the payment terms of a loan.