



Chapter 7

# Loans From Tax Qualified Retirement Plans

by **Richard A. Naegele, J.D., M.A.**  
Wickens, Herzer, Panza, Cook & Batista Co.  
35765 Chester Road  
Avon, OH 44011-1262  
Phone: (440) 695-8074  
Email: [RNAegele@WickensLaw.com](mailto:RNAegele@WickensLaw.com)  
Website: [www.WickensLaw.com](http://www.WickensLaw.com)

**Ohio State  
Bar Association**

November 9, 2016

© Copyright 2016 by Richard A. Naegele, J.D., M.A.

975344.pptx

Updated: 09/14/2016

## I. INTRODUCTION

### A. Availability of Loans.

1. As a general matter, a loan from a plan to a party in interest is a prohibited transaction. ERISA §406(a)(1)(B), I.R.C. §4975(c)(1)(B). However, a bona fide loan from a plan to a participant or beneficiary is exempt from the prohibited transaction rules. ERISA §408(b)(1) and I.R.C. §4975(d)(1).

© Copyright 2016 by Richard A. Naegele, J.D., M.A.

2

## 2. Bona fide loan.

- a. The loan must be adequately secured;
  - a true debtor-creditor relationship must exist;
  - there must be a reasonable rate of interest charged to the borrower (usually the prevailing rate);
  - a definite repayment schedule must be established; and
  - the availability of loans must be on a non-discriminatory basis. ERISA §408(d)(1) and I.R.C. §4975(d)(1).

- b. If there is an express or tacit understanding that the loan will not be repaid, or, for any reason, the transaction does not create a debtor-creditor relationship or is otherwise not a bona fide loan, the amount transferred is treated as an actual distribution from the plan for purposes of the Internal Revenue Code and is not treated as a loan or a deemed distribution under IRC §72(p).

The transaction could violate the non-alienation provisions of IRC §401(a)(13) and disqualify the plan. Treas. Reg. §1.72(p)-1, Q&A-17.

### **3. Broad definition of loan.**

In addition to direct loans, the indirect receipt of a loan by a participant or a beneficiary is also considered a loan. For example, an assignment or pledging of any portion of a participant's or a beneficiary's interest in a qualified plan is considered to be a loan. Moreover, such an assignment or pledge is prohibited under the non-alienation provisions of I.R.C. §401(a)(13) and ERISA §206(d).

## **II. I.R.C. §72(p) LOAN REQUIREMENTS**

### **A. Failure to Follow Requirements.**

Plan loans made are treated as distributions unless the I.R.C. §72(p) requirements are met.

## **B. Enforceable Agreement.**

The loan must be evidenced by a legally enforceable agreement (in writing), which may include more than one document. Reg. §1.72(p)-1, Q&A-3(b).

1. The loan agreement must be set forth either:
  - a. In a written paper document, or
  - b. In a document that is delivered through an electronic medium that satisfies the requirements of Treas. Reg. §1.401(a)-21.

## **\* 2. Electronic Loan Requirements.**

- a. Confidential.
- b. Provides participant with confirmation of the terms of the loan within a reasonable time after request.
- c. Participant must have a reasonable opportunity to change or delete the loan request after the confirmation.
- d. Must provide participant with the option to receive loan information and documentation by paper.
- e. Must be understandable to the participant.

\* May still be issues regarding notarized spousal consent and state law enforceability of loan without a written promissory note.

## C. Terms of Loan.

### 1. Five-Year Limitation.

The term of the loan may not exceed five years. For purposes of this rule, reference is made to the actual terms of the loan document as opposed to the actual amount of time that the loan is outstanding.

- a. Exception for loans to acquire or construct a dwelling unit which is the principal residence of the participant. The loan must be repaid within a reasonable time with reference being made to the time of the loan. Although there is no set rule on time limitations, the IRS has approved a fifteen-year limit (LTR 8514091, 1-11-85). Also, a time and payment schedule must be agreed upon when the loan is made.

**b. Refinancing.**

In general, a refinancing cannot qualify as a principal residence plan loan. However, a plan loan used to repay a loan from a third party will qualify as a principal residence loan if the plan loan qualified as a principal residence loan without regard to the loan from the third party. Reg. §1.72(p)-1, Q&A-8.

**c. Loan must be actually repaid within five-year period.**

A loan outstanding at the end of a five-year period cannot be renegotiated. Thus, the outstanding amount will be treated as a distribution. Also, if the loan document indicates a six-year repayment schedule and the loan is actually repaid in two years, this would still constitute a distribution at the time the loan was made.

#### **D. Limitation on Loan Amounts.**

Under the §72(p) requirements, the outstanding balance of all of a participant's loans from all of the plans of an employer (taking into account controlled groups and/or affiliated service groups) may not exceed the lesser of \$50,000 or 50% of the participant's non-forfeitable accrued benefit. Irrespective of this rule, a minimum of \$10,000 may be borrowed (provided that there is adequate outside security for such a loan). I.R.C. §72(p).

- a. The accrued benefit is based upon the latest valuation, and this valuation can take place at any time during the last twelve months. Also, the fifty percent of the accrued benefit limitation is determined when the loan is made. Thus, a subsequent decrease in the participant's accrued benefit will not result in a violation of the §72(p) limitations.

- b. \$50,000 limitation is reduced by the highest outstanding loan balance during the 12-month period prior to loan.

### **E. Timing of Loan Payments.**

1. Loans from pension and profit-sharing plans must be repaid by level amortization with at least quarterly payments over the term of the loan.
2. A loan with a variable interest rate should specify how the payment will fluctuate with a change in the interest rate.



## F. Loan Refinancing.

1. If the loan amount or loan period are less than the maximum, the original loan may be replaced with a new loan that:
  - a. Increases the loan amount to the permissible maximum; or
  - b. Extends the repayment period to 5 years from the date of the original loan.

2. If a replacement loan is combined with an existing loan, it may be permissible for the repayment period to extend beyond 5 years from the date of the original loan if the amortized loan payments on the new loan are sufficient to repay the entire amount of the original loan within 5 years from the date of the original loan.

To the extent that the amount of the replacement loan exceeds the amount of the replaced loan, a new loan is amortized in substantially equal payments over a period ending not later than 5 years from the date of the replacement loan. Reg. 1.72(p)-1, Q&A-20.

## **G. Leave of Absence.**

### **1. Non-Military Leave of Absence.**

- a. Loan payments may be suspended for up to one year during which participant is on a bona-fide leave of absence.
- b. The loan (including interest that accrues during the leave of absence) must be repaid within 5 years from the date of the original loan (unless it is a home acquisition loan).
- c. Loan payments may need to be increased to amortize the loan over the remaining repayment period.

## 2. Military Leave of Absence.

- a. Loan payments may be suspended for any part of a period during which the employee is performing military service.
- b. Such suspension shall not cause the loan to be deemed distributed even if the suspension exceeds one year and even if the term of the loan is extended.
- c. Interest rate during military service is reduced to 6% compounded annually.
- d. Payments must resume upon the completion of military service.

## H. Trustee-to-Trustee Transfer of Loans.

1. A trustee-to-trustee transfer of notes receivable does not cause the loans to cease to qualify under §72(p).
2. Although a direct trustee-to-trustee transfer of a loan is permitted, a loan may not be rolled-over by the individual from one plan to another. PLR 9043018.
3. **Note:** If the Plan of the participant's former employer had a "loan due on employment termination" clause, the loan is deemed to be due in full on the Participant's termination and cannot be transferred to the Plan of the new employer.

### III. CONSEQUENCES OF LOAN NOT COMPLYING WITH I.R.C. §72(p) OR CONSTITUTING A PROHIBITED TRANSACTION

#### A. A Loan in Violation of I.R.C. §72(p) Limitations Will Be Considered a Distribution.

1. If the loan is in violation of any requirement of I.R.C. §72(p) in either form or operation, the entire amount of the loan will be considered a distribution; however, failure to comply with the §72(p) dollar limitations on loans will only result in a distribution to the extent that the dollar limitations are exceeded.

2. **Default.** The Regulations permit the plan administrator to allow a grace period before a loan will be declared in **default** and the outstanding balance on the loan will be deemed to be distributed from the plan. The **grace period** cannot extend beyond the last day of the calendar quarter following the calendar quarter in which the required installment was due. Reg. §1.72(p)-1, Q&A-10(a).

3. The amount of the deemed distribution will equal the entire outstanding balance of the loan at the time of the default (including the grace period). Reg. §1.72(p)-1, Q&A-10(b).

4. A deemed distribution is treated as an actual distribution for purposes of I.R.C. §§72(m) and 72(t). Reg. §1.72(p)-1, Q&A-11(b), (c). However, the distribution is not treated as an actual distribution for qualification purposes. As such, the plan will not be deemed to violate any prohibition on in-service withdrawals merely as a result of a deemed distribution. Reg. §1.72(p)-1, Q&A-12.

5. In a loan offset, the distribution is treated as a distribution for all purposes, including qualification requirements. A loan offset could occur where a participant requests distribution while a loan remains outstanding and part of the distribution is used to repay the loan. Reg. §1.72(p)-1, Q&A-13.

6. Deemed distributions and plan offsets are required to be reported on IRS Form 1099-R. Reg. §1.72(p)-1, Q&A-14. Withholdings must be made if there is a transfer of cash or property (excluding employer securities). Reg. §1.72(p)-1, Q&A-15.

## 7. Treatment of repayments.

Repayments of a loan treated as a distribution will be considered non-deductible employee contributions. However, they will not be subject to the annual additions limitations of I.R.C. §415. See IRS Notice 82-22. The amount of a loan included in income is treated as basis. Therefore, when a distribution is subsequently made a portion of the distribution will be tax-free. PLR 9122059. Reg. §1.72(p)-1, Q&A-21.

8. The distribution is deemed for tax purposes, but the participant still owes the money to the plan. The deemed distribution counts as an outstanding loan for purposes of both the 50% of vested accrued benefit and \$50,000 limitations on loans under §72(p). Reg. §1.72(p)-1, Q&A-19(b). Thus, the deemed distribution is considered an outstanding loan with continued accruing interest for purposes of determining any future loans for the participant.

9. **Noncompliance loans.** The failure of a plan to follow its terms with respect to a participant loan, resulting in a deemed distribution under IRC section 72(p) results in an Operational Failure under section 6.07 of Rev. Proc. 2013-12 (the EPCRS procedure). The correction method includes reporting the noncompliant loan as a deemed distribution for the year of the correction, rather than for the prior year that the deemed distribution should have been reported.

## **B. Effect of a Loan Constituting a Prohibited Transaction. I.R.C. §4975.**

1. As a general rule, a loan which constitutes a prohibited transaction will not result in plan disqualification but, rather, will result in the prohibited transaction penalties being imposed. A loan directly (or indirectly) from the plan to the sponsoring employer would be a prohibited transaction.



2. The first tier prohibited transaction tax is fifteen percent of the amount involved in each prohibited transaction for the period beginning on the date the prohibited transaction occurs and ending on the earliest of:
  - a. When the transaction is corrected;
  - b. When a deficiency notice is issued; or
  - c. The date on which the tax is assessed. I.R.C. §4975(f)(2).

3. Although there is an additional second tier 100% tax if the transaction is not corrected within the applicable period, the disqualified person has an additional ninety days to correct the transaction and avoid the additional tax. I.R.C. §4975(b).

4. If the loan is not bona fide, there is authority for disqualifying the plan on the basis that it does not exist for the exclusive benefit of the employees. See *Winger's Dep't Store v. Commissioner*, 82 T. C. 869, 5 EBC 1569 (1984).

5. In TAM 9713002 the IRS disqualified two pension plans after the trustee of the plans, who was also the president and sole shareholder of the sponsoring employer corporation, obtained a series of twenty-three loans from the two plans totaling \$1,150,000, representing ninety-five percent and eighty percent of the total assets of the two pension plans.

6. The 15% and 100% taxes on prohibited transactions are assessed against the disqualified person involved in the transaction, not against the plan. I.R.C. §§4975(a) and (b).

7. The amount involved in a loan for purposes of assessment of the prohibited transaction excise tax is the interest on the loan amount, not the entire amount of the loan. Prohibited transaction penalties are paid with the filing of IRS Form 5330.

8. If a loan fails to satisfy the requirements of IRC §72(p) and the participant is a party in interest, the loan will be deemed to be a prohibited transaction. A deemed distribution under §72(p) does not correct the prohibited transaction. The loan must be actually repaid for the prohibited transaction to be corrected. Treas. Reg. §1.72(p)-1, Q&A-16.

## IV. IMPACT ON LOANS BY THE RETIREMENT EQUITY ACT—SPOUSAL CONSENT

### A. Spousal Consent Required.

A plan that is subject to the automatic survivor annuity requirement (e.g., all pension plans and profit-sharing or 401(k) plans containing annuity provisions) must provide that no portion of a participant's accrued benefit may be used as security for a plan loan unless the spouse consents within the ninety-day period ending on the date the security agreement becomes effective. I.R.C. §417(a)(4).

1. Loans made via an electronic medium may still require written notarized spousal consent.

## V. IMPACT ON LOANS BY THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005 ("BAPCPA")

### A. BAPCPA Application to Participant Loans.

1. Automatic Stay Does Not Apply to Qualified Plan Participant Loans.

When a participant files for bankruptcy, an employer may continue to withhold amounts from the employee's wages for the repayment of loans owed to the qualified plan without violating the "automatic stay". BAPCPA provides that an outstanding loan amount owed to a qualified plan is not dischargeable by an individual in bankruptcy, nor may a Chapter 13 individual bankruptcy reorganization plan materially alter the terms of a qualified plan loan.

2. Plan Loans Are Not Discharged in Bankruptcy.

## VI. DEPARTMENT OF LABOR REGULATIONS ON PLAN LOANS. 29 C.F.R. §2550.408b-1

### A. Reasonably Equivalent Basis.

Regulation §2550.408b-1(b) indicates that loans must be made available to all plan participants and beneficiaries without regard to an individual's race, color, religion, sex or national origin.

Limiting loans to a percentage of a participant's account balance or \$50,000 as required under IRC §72(p) complies with this requirement. A minimum loan amount of up to \$1,000 is permitted.

## **B. Highly Compensated Employees.**

Regulation §2550.408b-1(c)(3) notes that Congress intended that a plan may lend the same percentage of a person's vested benefits to participants with both large and small amounts of accrued benefits. Note: for purposes of the loan regulations, highly compensated employees are determined on a facts and circumstances basis, not under the I.R.C. §414(q) definition.

## **C. Specific Plan Provisions or Loan Policy.**

Regulation §2550.408b-1(d)(2) states that participant loans must be governed by provisions in the plan (or loan policy) which include, but need not be limited to:

1. The identity of the person or position authorized to administer the participant loan program;
2. A procedure for applying for loans;
3. The basis on which loans will be approved or denied;
4. Limitations (if any) on the types and amounts of loans offered;
5. The procedure for determining a reasonable rate of interest;
6. The types of collateral which may secure a participant loan; and
7. The events constituting default and the steps that will be taken to preserve plan assets in the event of such default.

#### D. Reasonable Rate of Interest.

Regulation §2550.408b-1(e) provides that a reasonable rate of interest is one which provides the plan with a return commensurate with the prevailing interest rates charged by persons in the business of lending money for loans which would be made under similar circumstances.

#### E. Adequate Security.

Regulation §2550.408b-1(f) states that a loan will be considered to be adequately secured if the security posted for such loan is something in addition to and supporting a promise to pay.

1. ***No more than fifty percent of the present value of a participant's vested accrued benefit may be considered by a plan as security*** for the outstanding balance of all plan loans made to such participant.
2. If a participant borrows more than fifty percent of the participant's vested benefits under the plan (e.g., if the loan is \$10,000 or less) and the loan is secured solely by fifty percent of the participant's vested benefits under the plan, the loan is arguably inadequately secured.

## VIII. LOAN EXAMPLES

### A. Maximum Amount of Second Loan.

Jim, a participant in our retirement plan, has requested a second plan loan. Jim's vested account balance is \$80,000. He borrowed \$27,000 eight months ago and still owes \$18,000 on that loan. How much can he borrow as a second loan? Would it benefit him to repay the first loan before requesting a second loan?

The new loan plus the outstanding balance of all other loans cannot exceed the lesser of:

1. \$50,000, reduced by the excess of the highest outstanding balance of all Jim's loans during the 12-month period ending on the day before the new loan (in this example, \$27,000) over the outstanding balance of Jim's loans from the plan on the date of the new loan (in this example, \$18,000), or
2. The greater of \$10,000 or 1/2 of Jim's vested account balance.



**Maximum second loan if amount still owed on first loan.**

Jim's current loan balance is \$18,000. This amount plus the new loan cannot exceed the lesser of:

1.  $\$50,000 - (\$27,000 - \$18,000) = \$41,000$ , or
2.  $\$80,000 \times 1/2 = \$40,000$

Jim's total permissible balance is \$40,000, of which \$18,000 is an existing loan balance. This leaves a new maximum permissible loan amount of \$22,000 ( $\$40,000 - \$18,000$ ).

**Maximum second loan if first loan repaid.**

Because the law bases Jim's maximum loan on all of his loans during the 12 months prior to the new loan, there isn't a significant advantage for Jim to pay off his first loan before requesting a second. If Jim repaid the \$18,000 before applying for the second loan, he would be limited to the lesser of:

1.  $\$50,000 - (\$27,000 - 0) = \$23,000$ , or
2.  $\$80,000 \times 1/2 = \$40,000$

In this case, the maximum permissible loan amount would be \$23,000.

## B. Deemed Distributions.

### **Example 1.**

- (i) A participant has a nonforfeitable account balance of \$200,000 and receives \$70,000 as a loan repayable in level quarterly installments over five years.
- (ii) Under section 72(p), the participant has a deemed distribution of \$20,000 (the excess of \$70,000 over \$50,000) at the time of the loan, because the loan exceeds the \$50,000 limit in section 72(p)(2)(A)(i). The remaining \$50,000 is not a deemed distribution.

### **Example 2.**

- (i) A participant with a nonforfeitable account balance of \$30,000 borrows \$20,000 as a loan repayable in level monthly installments over five years.
- (ii) Because the amount of the loan is \$5,000 more than 50% of the participant's nonforfeitable account balance, the participant has a deemed distribution of \$5,000 at the time of the loan. The remaining \$15,000 is not a deemed distribution. (Note also that, if the loan is secured solely by the participant's account balance, the loan may be a prohibited transaction under section 4975 because the loan may not satisfy 29 CFR 2550.408b-1(f)(2).)

**Example 3.**

- (i) The nonforfeitable account balance of a participant is \$100,000 and a \$50,000 loan is made to the participant repayable in level quarterly installments over seven years. The loan is not eligible for the section 72(p)(2)(B)(ii) exception for loans used to acquire certain dwelling units.
- (ii) Because the repayment period exceeds the maximum five-year period in section 72(p)(2)(B)(i), the participant has a deemed distribution of \$50,000 at the time the loan is made.

**Example 4.**

- (i) On August 1, 2002, a participant has a nonforfeitable account balance of \$45,000 and borrows \$20,000 from a plan to be repaid over five years in level monthly installments due at the end of each month. After making monthly payments through July 2003, the participant fails to make any of the payments due thereafter.
- (ii) As a result of the failure to satisfy the requirement that the loan be repaid in level monthly installments, the participant has a deemed distribution. See the following section regarding when such a deemed distribution occurs and the amount thereof.

## C. Timing of Deemed Distribution.

### *Example.*

- (i) On August 1, 2002, a participant has a nonforfeitable account balance of \$45,000 and borrows \$20,000 from a plan to be repaid over 5 years in level monthly installments due at the end of each month. After making all monthly payments due through July 31, 2003, the participant fails to make the payment due on August 31, 2003 or any other monthly payments due thereafter. The plan administrator allows a three-month cure period.

- (ii) As a result of the failure to satisfy the requirement that the loan be repaid in level installments pursuant to section 72(p)(2)(C), the participant has a deemed distribution on November 30, 2003, which is the last day of the three-month cure period for the August 31, 2003 installment. The amount of the deemed distribution is \$17,157, which is the outstanding balance on the loan at November 30, 2003. Alternatively, if the plan administrator had allowed a cure period through the end of the next calendar quarter, there would be a deemed distribution on December 31, 2003 equal to \$17,282, which is the outstanding balance of the loan at December 31, 2003.

## D. Refinancing.

**Home Refinancings.** In general, a refinancing cannot qualify as a principal residence plan loan. However, a loan from a qualified employer plan used to repay a loan from a third party will qualify as a principal residence plan loan if the plan loan qualifies as a principal residence plan loan without regard to the loan from the third party.

### **Example.**

- (i) On July 1, 2003, a participant requests a \$50,000 plan loan to be repaid in level monthly installments over 15 years. On August 1, 2003, the participant acquires a principal residence and pays a portion of the purchase price with a \$50,000 bank loan. On September 1, 2003, the plan loans \$50,000 to the participant, which the participant uses to pay the bank loan.
- (ii) Because the plan loan satisfies the requirements to qualify as a principal residence plan loan (taking into account the tracing rules of section 163(h)(3)(B)), the plan loan qualifies for the exception in section 72(p)(2)(B)(ii).