Eight Key Requirements for 401(k) Loans

By Christine Brueser, CPA
(480) 839-4900 ~ ChristineB@hhcpa.com

A 401(k) plan is a well-established retirement savings vehicle. But can an employee tap into the 401(k) plan account if he or she needs to do so before retirement? It depends.

A typical plan may permit employees to make hardship withdrawals. However, IRS regulations allow hardship withdrawals only if a participant has an immediate and heavy financial need and lacks other resources. In addition, such distributions may be subject to income tax and a 10% early withdrawal penalty.

Possible solution: A plan can address these shortcomings by including a loan feature. If it is warranted, an employee may borrow the greater of (a) $10,000 or (b) up to one-half of the first $100,000 in the account without paying any tax or penalty.

As with other retirement plan features, loan programs must meet regulatory requirements of the Department of Labor and the IRS. The eight key requirements are:

1. Availability: Loans must be available to all participants on a reasonably equivalent basis. To satisfy this requirement, loans must be available without regard to race, color, religion, sex or national origin. Also, when considering whether to make loans, plans can consider only such factors as commercial lenders would take into account, such as creditworthiness and financial need.

2. Nondiscrimination rules: A loan cannot be made available to highly compensated employees, officers or shareholders in amounts greater than those made available to other employees. This condition will not be violated merely because the loans do not exceed a maximum amount or a maximum percentage of a participant's vested account balance.

3. Specific plan provisions: Loans must be made under specific provisions contained in the plan. The plan must state the procedure to apply for loans, the basis on which loans are approved or denied, the limitations on types and amounts of loans, the procedure to determine a reasonable rate of interest, the collateral that may secure loans, and an explanation of default and how the plan will deal with it.

4. Reasonable rate of interest: A loan must bear a reasonable rate of interest. This test is met if the rate charged is similar to what banks or other commercial lenders would charge under similar circumstances.

5. Adequate security: Loans must be adequately secured. In other words, you need more than just a promise to pay—there must be security that could be sold so that the plan would suffer no loss of interest or principal. The regulations allow plans to permit the participant to use up to one-half of his or her account balance to secure loans. In other words, if loans are limited to 50% of a participant's account balance, the plan can avoid the need to acquire additional security.

6. Amortization: There must be level amortization.

7. Length of term: Loans must be repayable within five years, except where the loan is used to acquire the principal residence of the participant.

8. Frequency of payments: Payments must be made in quarterly installments or at more frequent intervals (e.g., monthly, weekly, etc.).

Remember, however, that 401(k) plans are intended for retirement saving. Typically, borrowing from the account should not be the first option to examine.

This is a technical area of the law. Whether you are an employer or an employee, obtain expert assistance.

Christine Brueser, CPA, is a Partner at Henry & Horne. Her area of expertise is employee benefit plan audits. Contact Christine at (480) 839–4900 or ChristineB@hhcpa.com.

HENRY & HORNE, LLP
Certified Public Accountants

Tempe
2055 E. Warner Road
Suite 101
Tempe, AZ 85284
(480) 839-4900

Scottsdale
7098 E. Cochise
Suite 100
Scottsdale, AZ 85253
(480) 483-1170

Casa Grande
1115 E. Cottonwood
Suite 100
Casa Grande, AZ 85122
(520) 836-8201