Retirement Plan Loans- Complicated and Dangerous

Take-Away: Plan loans to participants are highly regulated, and the requirements for a valid plan loan are very complex. While a plan loan may be the only option that a plan participant has to access needed funds, a plan loan should be a decision of 'last resort.'

Background: The words 'recession' and 'stagflation' seem too often appear in headlines these days. Both inflation and unemployment are up, and many market prognosticators are saying we will be in a recession sometime in 2026. If that is the case, with costs rising and employment layoffs increasing, we might see an uptick in qualified plan participants taking loans from their retirement accounts. For context, surprising recent Fidelity survey indicates that the number of plan participants who have taken loans from their qualified plan accounts has increased in the last few years, increasing from 6.5% in 2021 to 9.2% in 2025. That struck me as a large number of outstanding loans from qualified plans, with the prospect of an even larger number if indeed we are headed into a recession. Unfortunately, the rules surrounding a loan from a qualified plan account are complex and they pose some 'traps' that could make the borrower's situation even worse.

Plan Loan Drawbacks: The first obvious drawback is that the funds borrowed from a 401(k) account are not available for investment growth within the qualified plan. And a plan loan could be taxable and subject to penalties if all of the Tax Code's technical rules are not followed. Then there is the reality that the interest that is repaid by the borrower to the plan is going to be taxed twice; the participant repays the interest on the plan loan using after-tax dollars, and that interest is taxed again when the 401(k) funds are later received on a plan (or rollover IRA) distribution. Retirement or a job change can also trigger income taxes if the outstanding loan on either event is not promptly repaid.

Plan Loan Basics: To get started, not all qualified plans permit plan loans. A recent 2022 survey number indicates that about 52% of 401(k) plans expressly permit plan loans. As an important reminder, an individual cannot take a loan from his/her traditional IRA, nor from their SIMPLE or SEP IRAs. Loans can only be taken from qualified plans like 401(k) and 403(b) plans.

Tax-Free: While a plan loan is considered to be a distribution, it will not be taxable to the borrower if four requirements identified in the Tax Code are satisfied.

(1) **Written Enforceable Agreement:** The loan terms must be set forth in a legally enforceable agreement, like a promissory note with an amortization schedule.

(2) **Maximum Loan Amount:** The loan cannot exceed a maximum amount, which is limited to the ***lesser of 50% of the vested account balance or $50,000.*** However, there are three exceptions to this loan limit amount rule.

Exceptions: The first exception is that if 50% of the vested account balance is less than $10,000, the participant can borrow up to $10,000. The second exception is for plans that permit more than one loan while the first loan is still outstanding; the second loan cannot exceed the lesser of $50,000 reduced by the difference between the highest outstanding balance in the previous 12- month period and the current outstanding loan balance, or the greater of $10,000 or 50% of the participant's current vested account balance, minus the current outstanding loan. (Head spinning yet?) The third exception is for loans taken in a federally declared disaster area; in this limited situation the plan can increase the dollar limit for the loan to the lesser of 100% (not the customary 50% limit) of the participant's vested account balance or $100,000 (not the customary $50,000 dollar limit.)

Example: Brad is a participant in his employer's 401(k) plan. The plan permits participant loans. The balance of Brad's 401(k) account is $100,000 but only $80,000 of that balance is fully vested. The maximum loan that Brad can take from his 401(k) account is $40,000. [50% of Brad's *vested* $80,000 account balance = $40,000 available loan]

Example- Exception 1: Harvey has a $15,000 vested account balance and his employer's 401(k) plan allows the exception to the 50% rule. Since 50% of $15,000 ($7,500) is less than $10,000, Harvey's maximum available loan amount from his 401(k) account is $10,000.

Example -Exception 2: In June 2025, Cindy took a $40,000 loan from her 401(k) account. The 401(k) plan allows for two plan loans to be outstanding at any one time. In August 2025, Cindy wants to take a second loan from her 401(k) account. On the date of her request, Cindy's vested account balance is $80,000; and she owes $30,000 on her first loan. In the prior 12-month period Cindy's highest loan balance was $38,000. Step One: take the **lesser** of $50,000 – ($38,000- $30,000= $42,000) or the **greater** of $10,000 or 50% of $80,000 = $40,000. Step 2: $40,000 - $30,000 = $10,000. Cindy can borrow up to $10,000 as a second loan from her 401(k) account.

(3) **5-Year Loan Repayment:** The plan loan repayment term cannot exceed a maximum period. Most plan loans must be amortized over a 5-year repayment period. However, a loan that is used to acquire a primary residence can be expanded to 10 or 15 years depending on the terms of the plan document and what it permits.

(4) **Loans Amortized Quarterly:** The plan loan must be amortized by level installment payments made no less frequently than quarterly. Most repayments are through a payroll deduction, but some plans permit a payment through the use of 'coupon' payments using the borrower's own funds. Some plans also permit a 'cure' period, but any cure period cannot extend beyond the end of the calendar quarter that follows the calendar quarter in which the missed repayment occurred.

Deemed Distributions: If the borrower fails to satisfy the loan requirements described above, there is a deemed distribution from the qualified plan account to the borrower. A deemed distribution is taxable and may also subject the borrower to the 10% excise tax for an early distribution. A deemed distribution cannot be rolled over. A deemed distribution makes the loan taxable, but the loan remains on the plan's books. To the extent the borrower ultimately repays the plan loan, the borrower's loan repayments are 'basis;' they will not be taxed again when a later distribution from the retirement account occurs.

Loan Offset: A loan offset does not result from a violation of the Tax Code's loan requirements, like a deemed distribution does. Rather, a loan offset occurs when a plan loan becomes immediately due under the plan's rules, e.g., when the participant terminates employment with the plan sponsor, if the outstanding loan balance is not immediately paid. Then, the plan will offset that amount of the unpaid loan against the former participant's vested account balance. The loan offset amount is not paid to the former participant but is still taxable (maybe, too, with the early distribution 10% excise tax) in the year of the offset, unless the former participant comes up with separate funds to roll over that offset amount. The rollover deadline is the tax-filing due date, including extensions, for the year in which the loan offset occurred. Consequently, the offset amount can be rolled over even as late as six months beyond the normal income tax return due date, e.g., October 15, and even if the former participant does not request an extension in which to file his/her tax return.

Example: Kim is age 53. Kim borrowed $10,000 from her 401(k) plan in 2023. In 2025, Kim terminates her employment from the sponsor of her 401(k) account. At the time of Kim's termination, the outstanding loan balance is $6,500. Under the terms of the 401(k) plan document, Kim's outstanding loan becomes immediately due. Kim will have until October 15, 2026, in which to come up with all or some of the $6,500 funds to roll over, even if Kim does not formally extend her 2025 tax return deadline. If Kim does not complete a rollover by October 15, 2026, she will have $6,500 additional taxable income and possibly owe the $650 excise tax for 2025.

Prohibited Transaction Trap: If an employee who owns 10% or more of the qualified plan sponsor takes a loan from his/her 401(k) account, that is a loan to a *disqualified person.* A loan between a qualified plan and a *disqualified person* is usually a prohibited transaction unless several conditions are met. One condition is that the loan must bear a reasonable rate of interest. As a generalization, the IRS will view the prime rate + 2% as a reasonable rate for plan loans. Another condition is that the loan must be made in accordance with specific provisions contained in the qualified plan document, meet the four Tax Code requirements that were identified earlier. The point is that a plan loan to a *disqualified person* could constitute *both* a deemed distribution and a prohibited transaction. The deemed distribution is taxable and possibly subject to the 10% early distribution excise tax. The prohibited transaction is subject to an initial excise tax equal to 15% of the interest paid on the loan imposed for each year the loan is not completely repaid; that tax is cumulative. If the loan is not completely repaid before the IRS issues a Deficiency Notice, or the IRS assesses the 15% excise tax, this excise tax increases to 100% of the interest paid. As such, extreme caution needs to be taken if an owner of the qualified plan sponsor takes a loan from his/her 401(k) account.

Conclusion: Taking a loan from a 401(k) account may not be a good decision if the participant's access to other funds is a viable option. If a plan loan is ultimately taken by the participant, there are plenty of technical rules to navigate, along with the continuing risk of a *deemed distribution* and possible excise taxes for an early distribution if the loan is not timely repaid. In short, there are plenty of traps that go along with taking a loan from a 401(k) account.

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