Why Some Retirement Plans Do Not Offer Loans to Participants

We are occasionally asked why some retirement plans do not allow loans to participants. Some employers consider allowing loans when the plan is established. Although many plans do allow participant loans and have employees who use that option wisely and responsibly, some employers have concerns about allowing loans from the retirement plan. After weighing all the advantages and disadvantages, and further discussing it with their advisors, many employers decide not to allow loans for several reasons:

1) If the loan is used to purchase a home, the interest is usually not deductible, while the interest paid on a home mortgage or a home equity loan may be deductible. (IRS Publication 936 states that interest paid on a loan for a mortgage is only deductible if the loan is secured by the home. Typically a loan from the plan is secured by the plan account balance, NOT by the home itself, even if the loan is used to purchase a home).

2) The interest that a participant "pays himself" through a loan from the plan is most often tied to the prime rate, usually prime plus 1% or prime plus 2%. So, with prime rate currently at 5.5%, a plan loan might charge interest of 6.5% - 7.5%. Most retirement plan investments include some stocks, so it is possible that there may be years in which the rate of return on investments in the plan would earn more than the 6.5%-7.5% that the participant is paying in loan interest, causing the participant to lose out on potential market gains while the money is out of the stock market. Of course, there may also be years in which the loan rate of return is greater than the stock market rate of return, so this is something that needs to be considered, either way.

3) With a commercial loan, payment schedules can sometimes be adjusted without creating a tax problem. However, plan loans are normally paid with regular payroll withholding, through level principal and interest payments, over a period not exceeding five years. If these rules are broken or there is a default on the loan, the participant is deemed to have incurred a distribution subject to state and federal income tax, as well as a 10% penalty if the participant is under age 59 ½. A 2014 study from the Pension Research Council at the Wharton School of the University of Pennsylvania found that 86% of workers who left their jobs with an outstanding loan end up defaulting on the loan. *Note that under new rules, a participant has until the tax return filing due date for that tax year, including extensions, to repay the outstanding balance of the loan, or roll it over to another account. For example, an employee who terminates in June, 2019 has until April 15, 2020 (or later, if an extension is filed) to rollover or repay the loan.*

4) Commercial lending institutions work with such a large volume of business that their service charges can typically be much less than what retirement plan custodians, attorneys, and Administrators charge to handle a relatively small number of loans.

5) A termination of employment often results in a default on the loan if the terminated employee cannot come up with the cash to pay off the loan. Although some plan recordkeepers do allow for loan repayments to continue directly to the recordkeeper even after the employee separates from employment, not all recordkeepers provide this functionality.

6) If the plan is terminated, the employee may be forced to either come up with the cash to pay off the loan before the benefit is rolled over into an IRA, or else pay taxes and penalties.

7) Loan payments are made with after-tax dollars. However, when these same dollars are later taken out of the plan and used in retirement, the participant may pay taxes on those dollars a second time.

8) Participants who take out one loan will often take out other loans. We often see situations where participants constantly churn loans, taking out multiple loans at once (when allowed) or immediately taking out a new loan once the old loan is repaid. Over time, this constant activity has the effect of eroding the plan account balance, in part because participants with an outstanding loan are more likely to reduce their contributions to the plan while they are repaying the loan.

9) Many employers cite that they do not want the plan to become the “bank” for their participants.

10) Like other plan provisions, a loan feature in a plan creates fiduciary responsibility. Loan repayments must be monitored for timeliness and accuracy during the course of the loan. Repayments must be posted within a prescribed time limit after they are deducted from the payroll and there needs to be oversight in the payroll system and at the recordkeeper to be sure that payments are being posted to the correct participant, or in the case of a participant with multiple loans, to the correct outstanding loan account. Some employers make the decision that they do not want to add a loan feature which may create more opportunity for errors in the plan administration that will have to be addressed and corrected.

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