



If and when to borrow from a qualified retirement plan

By: **Vorris J. Blankenship**

July 2018

Copyright 2018. Association of International Certified Professional Accountants.
All rights reserved. Reprinted with permission from The Tax Adviser.

The Tax Adviser

This article analyzes how an employee should decide whether to borrow from his or her qualified retirement plan. This analysis first requires a little background on plan loans.¹ Generally, a loan to an employee from a qualified plan is taxable as a plan distribution and is also subject to the 10% additional tax on premature distributions (if none of the statutory exceptions apply).² Nevertheless, an employee may treat certain five-year loans, or certain loans used to purchase a principal residence, as true loans that are not taxable as plan distributions.³

To qualify as a true loan, a loan must be enforceable, in writing, and nondiscriminatory. It must provide for

a reasonable rate of interest and substantially equal repayments quarterly or more frequently. It cannot be payable on demand.⁴ Nevertheless, even a loan that meets those requirements is taxable as a distribution to the extent the loan amount exceeds the *smallest* of the following.⁵

1. \$50,000 less previous plan loans unpaid immediately before the new loan was issued;⁶
2. \$50,000 less the highest outstanding loan balance during the one-year period immediately preceding the new loan's issuance;⁷ or
3. An amount equal to (a) one-half of the value of the nonforfeitable interest in the plan, less (b) the amount of previous plan loans unpaid immediately before the new loan was issued. (However, if the nonforfeitable

interest in the plan is less than \$20,000, the limitation is instead \$10,000 less previous plan loans unpaid immediately before the new loan was issued.)⁸

In applying items (1) through (3) above, an employee must treat as a single plan all of the employer's qualified retirement plans (and formerly qualifying plans), including all plans of certain closely related employers. If the employer is a governmental entity, the employee must treat all the employer's plans as a single plan (whether or not they are qualified retirement plans).⁹

Plan loans as alternatives to loans from outside lenders

An employee about to borrow money for a financial need might consider a loan from his or her qualified defined

Loan comparison assuming 3% plan growth rate

	Nonplan loan at 7%	Plan loan at 5%	Net worth increase (or reduction)
Total interest paid by employee over five years	\$ 9,404	\$ 6,614	\$2,790
Initial qualified plan balance	100,000	100,000	
Total interest earned on loan over five years	-	6,614	
Earnings at 3% on plan funds not loaned	16,162	8,081	
Earnings at 3% on monthly loan repayments	-	4,384	
Ending qualified plan balance	\$116,162	\$119,079	\$2,917
Total amount saved by choosing a plan loan			\$5,707

1. For this purpose, qualified plans include formerly qualified plans, tax-sheltered annuities under Sec. 403(b), and government plans whether or not otherwise qualified (Sec. 72(p)(4)).

2. Secs. 72(p)(1)(A) and (t)(1); Regs. Sec. 1.72(p)-1, Q&A 11(b).

3. Sec. 72(p)(2).

4. Secs. 72(p)(2) and 4975(d); Regs. Sec. 1.72(p)-1, Q&A 3(b); *Estate of Gray*, T.C. Memo. 1995-421.

5. Regs. Sec. 1.72(p)-1, Q&A 4(a). The following three limitations listed in the text are derived from the somewhat convoluted statutory language in Sec. 72(p)(2)(A).

6. Sec. 72(p)(2)(A).

7. Sec. 72(p)(2)(A)(i).

8. Sec. 72(p)(2)(A)(ii).

9. Sec. 72(p)(2)(D).

Loan comparison assuming 9% plan growth rate

	Nonplan loan at 7%	Plan loan at 5%	Net worth increase (or reduction)
Total interest paid by employee over five years	\$ 9,404	\$ 6,614	\$ 2,790
Initial qualified plan balance	100,000	100,000	
Total interest earned on loan over five years	-	6,614	
Earnings at 9% on plan funds not loaned	56,568	28,284	
Earnings at 9% on monthly loan repayments	-	14,554	
Ending qualified plan balance	\$156,568	\$149,452	(7,116)
Total amount lost by choosing a plan loan			<u>\$(4,326)</u>

contribution plan (hereafter “qualified plan”) as a possible alternative to a loan from a commercial or other outside lender. The interest rate on the plan loan is usually lower than on a commercial loan, and the interest paid on the plan loan goes back into the employee’s account. However, the employee must

also consider the effect of liquidating some of the plan assets to fund the plan loan.

Example 1: An employee must borrow \$50,000 for the purchase of an automobile for his personal use. He can borrow that amount at 7%

interest from a third-party lender, with monthly repayments of \$990 over a five-year term. Alternatively, he may borrow that amount at 5% interest from the \$100,000 balance in his qualified plan. He must repay the plan loan by making monthly payments of \$944 over the five-year

EXECUTIVE SUMMARY

- Loans from qualified plans will be considered taxable distributions from the plans unless certain requirements are met. The maximum plan loan an employee may take is \$50,000, but the loan amount may be limited based on the amount of previous plan loans taken by the employee.
- In general, a qualified plan loan is better from an overall perspective than an outside loan if the growth rate of the plan assets is lower than the interest rate on the plan loan and the interest rate on an equivalent outside loan.

- In general, an outside loan is better if the growth rate of the plan assets is greater than the interest rate on the outside loan and the interest rate on an equivalent plan loan. However, if the growth rate on the plan assets is greater than the interest rate on a plan loan but less than the interest rate on an outside loan, a plan loan will generally be better, but possibly not significantly better.
- Whether the interest on the prospective loan will be deductible does not significantly affect the determination of whether a plan loan or an outside loan is more desirable. However, if the interest

on an outside loan is deductible, but the interest on a plan loan is not (e.g., because the loan is to a key employee), the plan loan becomes less desirable.

- A downside to plan loans is that they may terminate on the occurrence of certain events, such as a severance from employment, that will not affect an outside loan.
- Taking an unneeded plan loan to boost the growth rate of an employee’s qualified plan account could possibly result in a prohibited transaction subject to substantial penalties.

term. Assume the loan from the plan will satisfy the requirements described above for a qualified plan loan.

Also assume the balance of the employee's account in his qualified plan grows at an average annual rate of 3%. Under these facts, the employee would normally choose to borrow from the plan. The employee will pay less interest on the plan loan because of its lower interest rate. In addition, the balance of the employee's account in his plan should grow faster because the loan interest rate is higher than the plan growth rate of 3%, as shown in the table "Loan Comparison Assuming 3% Plan Growth Rate" on p. 437.

Example 2: Assume the same facts as Example 1, except that the balance of the employee's account in his qualified plan grows at an average annual rate of 9%. The results will be as

shown in the table "Loan Comparison Assuming 9% Plan Growth Rate" on p. 438.

In Example 2, the employee would normally choose to borrow from the outside lender. It is true the employee would pay less interest on the plan loan because of its lower interest rate. However, that benefit is more than offset by the substantial reduction in the plan's growth rate (from 9% to 5%) on the amount of the \$50,000 loan.¹⁰

Example 3: Assume the same facts as Example 2, except that the balance of the employee's account in his qualified plan grows at an average annual rate of 6%. The results are shown in the table "Loan Comparison Assuming 6% Plan Growth Rate" below.

In Example 3, a plan loan would be only minimally beneficial. It is true the employee would pay less interest on the

plan loan because of its lower interest rate. However, that benefit is partially offset by the reduction in the plan's growth rate (from 6% to 5%) on the amount of the \$50,000 loan. Thus, the ending plan balance would be slightly lower than it would have been without the plan loan.

Guidance derived from Examples 1–3

The first three examples reflect the reality that the interest rate on a plan loan will normally be lower than the interest rate charged by a commercial or other outside lender. Further, those examples are consistent with the following propositions. If the interest rate on a plan loan exceeds the growth rate of the qualified plan (and the interest rate on an outside loan exceeds the rate on a plan loan), the employee should normally choose to borrow from the plan and not from an outside lender. The plan loan will not only reduce the cost

Loan comparison assuming 6% plan growth rate

	Nonplan loan at 7%	Plan loan at 5%	Net worth increase (or reduction)
Total interest paid by employee over five years	\$ 9,404	\$ 6,614	\$ 2,790
Initial qualified plan balance	100,000	100,000	
Total interest earned on loan over five years	-	6,614	
Earnings at 6% on plan funds not loaned	34,885	17,442	
Earnings at 6% on monthly loan repayments	-	9,219	
Ending qualified plan balance	\$134,885	\$133,275	(1,610)
Total amount saved by choosing a plan loan			\$1,180

10. In situations similar to Example 2, an outside loan is always more favorable than a plan loan regardless of the interest rates for the plan loan and the

outside loan provided the plan growth rate is greater than the interest rate on the outside loan.

of borrowing, but the loan will enhance the growth rate of the plan during the term of the loan.

If the growth rate of the qualified plan exceeds the interest rate on an outside loan, the employee should normally choose to borrow from the outside lender. Although a plan loan may reduce the cost of borrowing, the reduction in cost is more than offset by a reduction in the plan's growth rate.

If the plan's growth rate is more than the interest rate on a plan loan but less than the interest rate on a nonplan loan, the results are mixed. A plan loan will reduce borrowing costs, but that reduction is at least partially offset by a lower plan growth rate.

Of course, plan growth rates are difficult to predict, so the employee needs to be realistic. The growth rate of a plan will not often fall substantially below the interest rate charged on a plan loan as in Example 1. Nor will the growth rate often be substantially above the plan interest rate as in Example 2. There will be outliers, of course, but most often the plan growth rate will not be much different from the interest rate on a plan loan. In that case, the plan loan will have little effect on the plan balance. However, the employee will still usually benefit from an interest rate that is significantly lower than the rate an outside lender would charge.

Deductibility of interest and choice of loan

Note that, in the above examples, interest the employee paid on the loans was not deductible because he or she used the borrowed funds for personal expenditures.¹¹ If the employee instead borrowed funds to purchase a principal residence or to make investments, the interest on borrowings might be deductible.¹² But that should not significantly affect the analysis.

Example 4: Assume the same facts as Example 1, in which the plan's growth rate was 3%. However, assume that interest on both the plan loan and the nonplan loan is

Loan comparison when interest on both loans is deductible

	Nonplan loan at 7%	Plan loan at 5%	Net worth increase (or reduction)
Total interest paid by employee over five years	\$ 9,404	\$ 6,614	
Less tax benefit from interest deduction at combined marginal tax rate of 25%	2,351	1,654	
After-tax interest paid by employee over five years	7,053	4,960	\$2,093
Initial qualified plan balance	100,000	100,000	
Total interest earned on loan over five years	-	6,614	
Earnings at 3% on plan funds not loaned	16,162	8,081	
Earnings at 3% on monthly loan repayments	-	4,384	
Ending qualified plan balance	\$116,162	\$119,079	2,917
Total amount saved by choosing a plan loan			\$5,010

11. Sec. 163(h)(1); Temp. Regs. Sec. 1.163-8T(a)(4)(i)(D).

12. Secs. 163(a), (d), and (h)(3). The regulations allocate interest among deductible and nondeductible categories by tracing the related loan proceeds to specific expenditures. Temp. Regs. Sec. 1.163-8T provides detailed tracing

rules. The regulations also provide special rules for interest on debt secured by a residence or used to purchase or improve a residence (Temp. Regs. Sec. 1.163-8T(m)(3); Regs. Sec. 1.72(p)-1, Q&A 7; Notice 88-74).

deductible. The results will be as shown in the table “Loan Comparison When Interest on Both Loans Is Deductible” on p. 440.

Note that the employee’s interest deduction would have no effect on the plan’s growth rate. Second, assuming interest is deductible on both a plan loan and a nonplan loan (as in Example 4), the deduction’s tax benefit would only proportionately affect the relative cost of borrowing from the plan or an outside lender. Thus, after-tax interest paid on a plan loan would still normally be lower than after-tax interest paid to an outside lender.

Interest is normally deductible on either a plan loan or a nonplan loan if the loan proceeds are used in a trade or business (other than as an employee or as a passive activity).¹³ If loan proceeds are used in a passive activity, interest paid becomes a part of total passive income or loss.¹⁴ Thus, the limitation on deductibility of passive losses is substantially the same whether the interest expense component is paid on a plan loan or a nonplan loan.¹⁵ Either way, nondeductible passive losses may be carried over to future years.¹⁶

If interest paid on a loan is investment interest, it is also potentially subject to a statutory limitation on deductibility.¹⁷ However, the limitation would affect the interest in substantially the same way whether the interest is paid on a plan loan or a nonplan loan. In either case, interest that is nondeductible because of the limitation may be carried over to future years.¹⁸ If the current deduction of investment interest is not

limited, the interest becomes an itemized deduction that could be supplanted by the standard deduction. However, the interest would be supplanted by the standard deduction whether paid on a plan loan or a nonplan loan.¹⁹

Similarly, the tax treatments of plan interest and nonplan interest appear to be substantially the same for purposes of the at-risk deduction limitations,²⁰ the disallowance of interest related to tax-exempt income,²¹ and the alternative minimum tax.²²

Nevertheless, as explained below, a significant interest deduction limitation applies to plan loans, but not to other loans.

Disallowance of deductions for interest paid to a plan

Otherwise deductible interest paid to the plan generally becomes nondeductible if the employee is a key employee or the loan is secured by plan amounts attributable to elective deferrals in a 401(k) plan or a 403(b) tax-sheltered annuity.²³ When this limitation applies, the lack of a deduction reduces the relative desirability of a plan loan.

Example 5: Assume the same facts as Example 4, except that the borrower was a key employee who could not deduct interest on the plan loan but could deduct interest on the nonplan loan. The results are shown in the table “Loan Comparison When Interest on Plan Loan Is Not Deductible” on p. 442.

Note that the amount saved by borrowing from the plan rather than from

an outside lender is substantially reduced from \$5,010 to \$3,357, after taking into account the lost tax benefit of \$1,654 (\$6,614 of interest expense multiplied by an assumed 25% combined federal and state marginal tax rate).

Effect of plan loans on ability to make contributions to the plan

Some plans provide that all payments received from an employee will be applied to a plan loan until it is completely repaid. Not only would such a provision prevent an employee from making contributions during the term of the loan, it would also eliminate the possibility of receiving matching contributions from the employer while the loan is outstanding.²⁴ That circumstance alone might persuade an employee to avoid a plan loan.

However, if the plan does allow employee contributions during the term of the loan, there is no reason the employee should not increase plan funds both by making maximum contributions and by choosing a plan loan to enhance the plan’s growth rate.

Note that an inability to make contributions is irrelevant if the employee is unable or ineligible to make contributions, e.g., if the employee is retired.

Termination of a plan loan on the occurrence of certain events

Another downside of a plan loan is that it may terminate on the occurrence of certain events that would not affect an outside loan. For example, the terms of a plan may provide that a loan will be

13. Secs. 162(a) and 163(h)(2)(A); Temp. Regs. Sec. 1.163-8T(a)(4)(i)(A). The limitation on business interest deductions is highly unlikely to apply to a borrowing employee. Taxpayers are generally not subject to the limitation if their average gross receipts are less than \$25 million (Secs. 163(j) and 448(c)).

14. Sec. 469(d)(1); Temp. Regs. Sec. 1.163-8T(a)(4)(i)(B).

15. Sec. 469(a)(1).

16. Sec. 469(b).

17. Sec. 163(d).

18. Sec. 163(d)(2).

19. Sec. 63(b).

20. Sec. 465(a).

21. Secs. 265(a)(1)–(3).

22. Sec. 56(b)(1)(C).

23. Sec. 72(p)(3). Note that the definition of “key employee” excludes officers or employees of governmental units (Sec. 416(i)(1)(A)).

24. Sec. 401(m)(4)(A).

offset with plan funds upon severance of employment or termination of the plan. In either event, the offset of the loan with plan funds is treated as a taxable distribution.

The employee could normally roll over the loan-offset distribution to another plan or IRA, but he or she would have to fund the rollover from other sources (since presumably the employee would have already expended the original loan proceeds).²⁵ Finding rollover funds could be very difficult for an employee if he or she had found it necessary to borrow from the plan in the first place.

Plan basis is unaffected by qualified plan loans

Investment (basis) in the plan is irrelevant. Under all of the above scenarios, the employee's investment in the plan is unchanged by the borrowings (whether the loan is from the plan or from an outside lender). That is, the plan loans discussed above are all treated as true loans for tax purposes. Thus, the disbursement of the loan proceeds is not treated as a plan distribution carrying out employee investment, and repayments are not treated as contributions to the plan.²⁶ Further, any loans to the employee from outside lenders are not

related to the plans and thus cannot affect investment in the plans.

Unneeded plan loans to increase the plan's growth rate

Some tax practitioners have suggested that it might be beneficial to take out a qualified plan loan as a strategy to increase the earnings rate of the plan, even though the employee does not need the loan. Assume, for example, that an employee, who has no need to borrow money, nevertheless borrows \$50,000 from a qualified plan in which the employee has a \$100,000 balance. The loan bears interest

Loan comparison when interest on plan loan is not deductible

	Nonplan loan at 7%	Plan loan at 5%	Net worth increase (or reduction)
Total interest paid by employee over five years	\$ 9,404	\$ 6,614	
Less tax benefit from interest deduction at combined marginal tax rate of 25%	2,351	-	
After-tax interest paid by employee over five years	7,053	6,614	\$ 439
Initial qualified plan balance	100,000	100,000	
Total interest earned on loan over five years	-	6,614	
Earnings at 3% on plan funds not loaned	16,162	8,081	
Earnings at 3% on monthly loan repayments	-	4,384	
Ending qualified plan balance	\$116,162	\$119,079	2,917
Total amount saved by choosing a plan loan			\$3,356

25. Regs. Sec. 1.402(c)-2, Q&A 9. Normally, a participant has only 60 days after a loan-offset distribution to roll it over to another plan or IRA. In some circumstances though, a participant may roll over the loan-offset distribution any time before the due date (including extensions) of the tax return for the year of the distribution. This extended rollover period is available only for

loan-offset distributions after the year 2017, and only if the distribution is due to termination of the distributing plan or failure to satisfy repayment terms because of severance of the participant's employment (Sec. 402(c)(3)(C); Tax Cuts and Jobs Act, P.L. 115-97, §13613).

26. Sec. 72(p)(2).

at 5%. The employee must repay the plan loan by making monthly payments of \$944 per month over a five-year term. Assume the loan from the plan will satisfy the requirements for a qualified loan.

The balance of the employee's account in her qualified plan has been growing at an average annual rate of 3%. Thus, the balance of the employee's account in her plan should grow faster because the loan interest rate of 5% is higher than the plan growth rate of 3%. To recoup the loan repayments to the plan, the employee loans the \$50,000 received from the plan to a third-party borrower on the same terms as the borrowing from the plan (back-to-back identical loans).²⁷

Under the foregoing arrangement, the plan would accumulate an additional \$2,918 over the five-year term of the loan. Further, the employee's interest receipts and payments would exactly offset to produce a zero cash flow, and the employee would not owe any additional tax if the interest payments to the plan were deductible.

Of course, there are some potential problems with this scenario. First, interest paid to the plan might be non-deductible because the employee is a key employee or the loan is secured by plan amounts attributable to elective deferrals in a 401(k) plan or a 403(b) tax-sheltered annuity.²⁸ Second, interest

paid on the loan may not fall within the statutory limitation on deductibility of investment interest. If it does not, the excess interest must be carried over in whole or in part for deduction in a future year when the requirements for deduction are satisfied.²⁹ Third, if the deduction is an itemized deduction, it might be lost forever because it is supplanted by the standard deduction.³⁰

Any of these circumstances could make the increase in the plan balance very expensive indeed. As the table "Taking an Unneeded Plan Loan" below demonstrates, the increase in the plan balance of \$2,918 could be accompanied by a potentially permanent tax cost of

Taking an unneeded plan loan

	<u>No loans</u>	<u>Plan loan at 5%</u>	<u>Plan increase vs. employee tax</u>
Initial qualified plan balance	<u>\$100,000</u>	<u>\$100,000</u>	
Total interest earned on loan over five years	-	6,614	
Earnings at 3% on plan funds not loaned	16,162	8,081	
Earnings at 3% on monthly loan repayments	<u>-</u>	<u>4,384</u>	
Ending qualified plan balance	<u>\$116,162</u>	<u>\$119,079</u>	<u>\$2,917</u>
Total interest received by employee over five years			6,614
Total interest paid by employee over five years			<u>(6,614)</u>
Net cash flow from interest income and expense			<u>-</u>
Tax on interest received at assumed marginal 25% rate (without interest deduction offset)			<u>\$1,654</u>

27. Assume the loan to the third-party borrower is an arm's-length transaction that is not a below-market loan (Sec. 7872(e)(1)).

28. Sec. 72(p)(3).

29. Sec. 163(d).

30. Sec. 63(b).

\$1,654 (in addition to any future tax on distribution of the plan funds).

Note that plan loans are not subject to the penalties imposed on “prohibited transactions.”³¹ However, the IRS could try to use the substance-over-form doctrine to recharacterize the back-to-back transactions as a direct loan from the qualified plan to the third-party borrower.³² Then, if the third-party borrower is a “disqualified person,” the IRS could treat the loan as a prohibited transaction.³³ A disqualified person who participates in a prohibited transaction is subject to a 15% penalty for each year the transaction continues uncorrected, and a 100% penalty if the transaction is not corrected before an IRS notice or assessment.³⁴

The back-to-back loan example above is provided as a simple benchmark. In fact, an employee who borrows unneeded amounts from his or her qualified plan is more likely to use the loan proceeds to make traditional investments. Nevertheless, the difficulties encountered in deducting interest paid on the plan loan remain essentially the same. On the other hand, application of the substance-over-form doctrine and prohibited transaction penalties appears less likely because of the independent investment risks borne by the employee, particularly if the employee genuinely believes he or she can derive a greater return from the investments than the interest paid on the plan loan.

Plan loan from a designated Roth account within a qualified plan

The above analysis applies equally well to a qualified plan loan made from a designated Roth account within a

qualified plan. Thus, if a plan loan will increase the balance of a qualified plan, an employee should generally take the loan from a designated Roth account, if available, rather than from a non-Roth account. The increase in funds in the Roth account will likely never be taxed, unlike an increase in funds in the non-Roth account.³⁵ Note, though, that an employee must repay a qualified loan from a Roth account directly to the Roth account that made the loan.³⁶

Which is better?

An employee who must borrow funds for personal consumption or investment will likely pay less interest by borrowing from the qualified defined contribution plan (rather than from an outside lender). However, the growth rate of the plan ultimately determines whether the plan loan is beneficial to the plan and the employee. The lower the plan's growth rate, the more likely the plan loan will be beneficial. If loan proceeds are used for personal consumption, interest on the loan is not deductible whether the loan is a plan loan or a third-party loan. If loan proceeds are used instead for investment, deduction of interest on a plan loan faces more obstacles than deduction of interest on a nonplan loan. ■

Contributor

Vorris J. Blankenship is a retired attorney and CPA. He is the author of *Tax Planning for Retirees*, published by LexisNexis. For more information about this article, please contact thetaxadviser@aicpa.org.

31. Secs. 401(a)(13)(A) and 4975(d)(1).

32. *Gregory v. Helvering*, 293 U.S. 465 (1935). For analyses of the application of the substance-over-form doctrines to IRAs and Roth IRAs, see Blankenship, “Rollovers to Roth IRAs Are Complicated by Substance-Over-Form Doctrines,” 93 *Taxes* — *The Tax Magazine* 43

(September 2015); Blankenship, “Using DISCs to Avoid Roth IRA Limits: An Overlooked Fact in *Summa*,” 157 *Tax Notes* 973 (Nov. 27, 2017).

33. Secs. 4975(c)(1)(B) and (e)(2).

34. Secs. 4975(a), (b), and (f)(2).

35. Sec. 402A(d).

36. Regs. Sec. 1.402A-1, Q&A 12.