FAQs REGARDING PARTICIPANT LOANS

These frequently asked questions and answers are provided for general information only and should not be cited as any type of legal authority. They are designed to provide the user with information required to respond to general inquiries. Due to the uniqueness and complexities of Federal tax law, it is imperative to ensure a full understanding of the specific question presented, and to perform the requisite research to ensure a correct response is provided.

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1. Can a loan be taken from an IRA?

Loans are not permitted from IRAs or from IRA-based plans such as SEPs, SARSEPs and SIMPLE IRA plans. Loans are only possible from qualified plans that satisfy the requirements of §401(a), from annuity plans that satisfy the requirements of §403(a) or 403(b), and from governmental plans. (Code §72(p)(4); Reg. § 1.72(p)-1, Q&A-2)

2. What happens if a loan is taken from an IRA?

If the owner of an IRA borrows from the IRA, the IRA is no longer an IRA, and the value of the entire IRA is included in the owner's income. (Code § 408(e)(2) and (3))

If the owner of an IRA pledges part of the IRA as collateral, the part of the IRA that is pledged is treated as distributed. (Code § 408(e)(4))

3. Under what circumstances can a loan be taken from a qualified plan?

A qualified plan may, but is not required to provide for loans. If a plan provides for loans, the plan may limit the amount that can be taken as a loan. The maximum amount that the plan can permit as a loan is (1) the greater of $10,000 or 50% of your vested account balance, or (2) $50,000, whichever is less.
For example, if a participant has an account balance of $40,000, the maximum amount that he or she can borrow from the account is $20,000.

A participant may have more than one outstanding loan from the plan at a time. However, any new loan, when added to the outstanding balance of all of the participant's loans from the plan, cannot be more than the plan maximum amount. In determining the plan maximum amount in that case, the $50,000 is reduced by the difference between the highest outstanding balance of all of the participant's loans during the 12-month period ending on the day before the new loan and the outstanding balance of the participant's loans from the plan on the date of the new loan.

For example, assume Participant A has a vested account balance of $100,000 and took a plan loan of $40,000 on January 1, 2005, to be paid in 20 quarterly installments of $2,491. On January 1, 2006, when the outstanding balance is $33,322, Participant A wants to take another plan loan. The difference between the highest outstanding loan balance for the preceding year ($40,000) and the outstanding balance on the day of the loan ($33,322) is $6,678. Since the new loan plus the outstanding loan cannot be more than $43,322 ($50,000 - $6,678), the maximum amount that the new loan can be is $10,000 ($43,322 - $33,322).

A plan may require the spouse of a married participant to consent to a plan loan. (Code section 417(a)(4))

A plan that provides for loans must specify the procedures for applying for a loan and the repayment terms for the loan. Repayment of the loan must occur within 5 years, and payments must be made in substantially equal

payments that include principal and interest and that are paid at least quarterly. Loan repayments are not plan contributions. (Reg. § 1.72(p)-1, Q&A-3)

A loan that is taken for the purpose of purchasing the employee's principal residence may be able to be paid back over a period of more than 5 years. (Code § 72(p)(2)(B)(ii); Reg. § 1.72(p)-1, Q&A-5,-6, -7, and -8)

A plan may suspend loan repayments for employees performing military service. (Reg. § 1.72(p)-1, Q&A-9(b))

A plan also may suspend loan repayments during a leave of absence of up to one year. However, upon return, the participant must make up the missed payments either by increasing the amount of each monthly payment or by paying a lump sum at the end, so that the term of the loan does not exceed the original 5-year term. (Reg. § 1.72(p)-1, Q&A-9(a))

Loans are not dependent upon hardship. Some plans may provide for hardship withdrawals, however. See FAQs on hardship distributions.

As long as a plan provides for loans, the purpose of the loan or the participant's ability to borrow the same amount elsewhere is irrelevant in determining whether the loan is permitted, unlike hardship withdrawals, which require a demonstration of need. See FAQs on hardship distributions.

The participant's relationship to the plan (e.g., being an owner of the plan sponsor) does not affect the participant's ability to take a loan, as long as all participants are equally able to take loans under the plan's loan provisions.

Loans are not taxable distributions unless they fail to satisfy the plan loan rules of the regulations with respect to amount, duration and repayment terms, as described above. In addition, a loan that is not paid back according to the repayment terms is treated as a distribution from the plan and is taxable as such. (Code § 72(p); Reg. § 1.72(p)-1, Q&A-1)

4. What happens if a plan loan is not repaid according to its terms?

A loan that is in default is generally treated as a taxable distribution from the plan of the entire outstanding balance of the loan (a "deemed distribution"). The plan's terms will generally specify how the plan handles a default. A plan may provide that a loan does not become a "deemed distribution" until the end of the calendar quarter following the quarter in which the repayment was missed. For example, if the quarterly payments were due March 31, June 30, September 30 and December 31, and the participant made the March payment but missed the June payment, the loan would be in default as of the end of June, and the loan would be treated as a distribution at the end of September. (Reg. § 1.72(p)-1, Q&A-10(a))

5. Is a deemed distribution treated like an actual distribution for all purposes?

No, a deemed distribution is treated as an actual distribution for purposes of determining the tax on the distribution, including any early distribution tax. A deemed distribution is not treated as an actual distribution for purposes of determining whether a plan satisfies the restrictions on in-service distributions applicable to certain plans. In addition, a deemed distribution is not eligible to be rolled over into an eligible retirement plan. (Reg. § 1.72(p)-1, Q&A-11 and -12)

6. What can be done to remedy a default after there has been a deemed distribution?

If a participant failed to make payments on a plan loan, the missed payments can still be made even after a deemed distribution has occurred. In that case, the participant's or beneficiary's tax basis under the plan is increased by the amount of the late repayments. (Reg. § 1.72(p)-1, Q&A-21)