

## **WHY SOME RETIREMENT PLANS DO NOT OFFER LOANS TO PARTICIPANTS**

June, 2007

We are occasionally asked why some retirement plans do not allow loans to participants. Some employers consider that option when the plan is established. However, 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) The interest on a qualified plan loan is usually not deductible, while the interest paid on a home mortgage or a home equity loan may be deductible.
- 2) The interest that a participant would "pay himself" through a loan from the plan is required to be comparable to that of similar loans with local financial institutions. However, most retirement plan investments include some stocks. Consequently, in the long run one would expect retirement plan yields to exceed loan rates. Consider the example of a plan that could obtain a yield of 8%, while either a plan loan or a bank loan required 6% interest. In this case, the participant would be lowering his retirement fund yield by 2% (on the portion he "lends to himself") for every year that he borrows from the plan instead of from the bank.
- 3) Plan loans are subject to much more restrictive rules than other commercial loans. For example, plan loans would be 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, you could be deemed to have incurred a distribution subject to state and federal income tax, as well as a 10% penalty for using retirement funds prior to age 59 ½. With a commercial loan, payment schedules can sometimes be adjusted without creating a tax problem.
- 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 recordkeepers would charge to handle a relatively small number of loans.
- 5) Participants can contribute to 401(k) and 403(b) plans only through regular and limited payroll withholdings. Consequently, if a participant defaults on a loan, it could take him months or even years to get the value of his retirement account back to what it was before the default.
- 6) If making a hardship withdrawal from a 401(k) plan that also allows participant loans, then the employee must first apply for, and be denied, a plan loan, before a hardship withdrawal request can be considered.