Qualified Plan Participant Loans

Most transactions between a qualified plan and its participants are prohibited transactions. One exception to the prohibited transaction rules concerns the granting of a loan to a plan participant.

Rules for Plan Loans

In order for the exception to apply, certain rules must be followed:

- The maximum loan must not exceed the lesser of 50% of the vested benefit of the participant or $50,000. The largest outstanding balance of any participant loan outstanding during the prior 12 months further reduces this amount.
- The loan must be fully amortized over a period not to exceed five years. In addition, the repayment must be on at least a quarterly basis. More commonly this will be done on a monthly or semi-monthly basis through payroll deduction.[1]
- The loan must bear a reasonable rate of interest. While the government does not give a specific guideline as to what is reasonable, a rule of thumb that has served through the years and has stood the test of time is that reasonable is prime plus 1% or 2%. The plan could also check with local banks for their rates on secured loans.
- If the participant borrowing from the plan is married, then that participant's spouse must also consent to the loan, if the plan or law so requires.
- If the loan is renegotiated during its term, it is considered a new loan. This will often cause additional problems with either the $50,000 maximum limit or the five-year repayment period requirement.
- The plan must have a loan policy and qualification process for granting loans, including a reasonable effort to determine credit worthiness.

[1] If the participant goes on active military duty, the loan repayments are suspended.

If these rules are not followed, then the participant loan falls outside of the exception and serious results can occur. The outstanding principal and any unpaid interest will be a deemed distribution[1] to the borrower and taxable as ordinary income to that participant in the year during which one or more of the rules are broken. It is entirely possible that the IRS could seek to disqualify the plan in an egregious situation. If this were to occur, the vested benefits of all participants could be immediately taxable to them.

[1] While interest will continue to accrue on the defaulted loan, it will not create additional deemed income.