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## **BORROWING FROM RETIREMENT PLAN TO SURVIVE TOUGH TIMES**

By Victor Sy, CPA, MBA

The persistent recession continues to put a squeeze on cash-strapped individuals looking to borrow money for such things as paying for a child's college tuition, financing a much-needed home repair, or simply keeping up mortgage payments while the family goes through a rough patch, like a spouse's unemployment. For some, the only **source of funds** may be a profit-sharing or 401(k) plan, IRA, SEP, SIMPLE IRA, or Roth IRA. But there are **tax and penalties** to contend with. You can **save taxes if the loan is set up correctly and repaid on time**. **Let's learn a few tips to limit damage when you borrow from your retirement plans.**

**1. Getting a loan from a company retirement plan.** Loans from a profit sharing or 401(k) plan, (but not a SEP or SIMPLE IRA) usually is **quick**, can be requested for **any reason**, doesn't affect a person's credit rating, and often will **cost less than a bank loan** (typically the interest rate will be prime plus 1%). The interest paid on your loan will be funneled back into your own plan (instead of a bank) and continue to grow on a tax-deferred basis. Finally, the loan **won't have any tax consequences if it is set up properly**. **Caution:** A plan loan must be timely repaid or there will be unattractive tax consequences.

**2. Keeping the loan tax-free.** A loan to a participant in a qualified employer plan **won't be treated as a deemed (taxable) distribution if it satisfies loan amount, loan term, repayment, and documentation requirements.**

**3. Loan amount.** The loan amount can't exceed the *lesser* of **\$50,000** or **1/2 of the present value of the employee's non-forfeitable accrued benefit** under the plan. But a loan up to \$10,000 is allowed, even if it's more than half the employee's accrued benefit. If a plan loan (when added to outstanding balance of all other plan loans) exceeds these limits, the excess is treated (and taxed) as a plan distribution. You may have more than one outstanding plan loan at a time; however, any new loan, when added to the outstanding balance of **all** loans, can't exceed the plan maximum amount.

**4. Loan term and repayment.** The plan loan generally must be **repaid within five years** in **substantially level payments**, made **at least quarterly**, over the term of the loan. The five-year repayment limit **doesn't apply** to a plan loan used to buy a dwelling unit which, within a reasonable amount of time, is to be used as the participant's **principal residence**. The level amortization requirement doesn't apply while the borrower is on a leave of absence not lasting more than one year (longer, if for military service, see below), and either not receiving pay or receiving pay at a rate that's less than the installments required under the loan. However, the loan (plus the interest that accrues during the leave) still must be repaid by the end of the last permissible loan term. If a plan suspends loan repayments while the borrower is performing **military service, the repayment period is tolled** during that service. When the participant returns, the loan must be repaid over the latest permissible loan term (five years unless it's a home loan) plus the term of the suspension period.

**5. Deductions for interest paid.** For a plan loan which is not treated as a distribution, **no deduction** is allowed for interest paid or accrued during the period: (1) on or after the first day on which the individual to whom the loan is made is a key employee (e.g., an officer making more than \$150,000 for 2008, or a 5% company owner), or (2) the loan is secured by amounts attributable to elective deferrals under a qualified cash or deferred arrangement (CODA) or under a tax-sheltered annuity.

**6. Nonpayment of plan loan.** A plan loan that is in **default** is generally treated as a **deemed distribution**. Where the plan provides for a grace period (e.g., borrower has **until the end of the calendar quarter following the quarter** in which the repayment was missed to make up missed payments), a loan default won't become a deemed distribution until that grace period expires without the default being remedied. **For example**, if the quarterly payments were due at the end of each calendar quarter, 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**.

7. A deemed distribution is treated as an actual distribution for purposes of determining the tax on the distribution, including the 10% premature penalty tax that may apply. For example, a 45-year-old plan participant who defaults when his loan balance is \$30,000 (and hasn't made nondeductible contributions to the plan) would owe tax at ordinary income rates on the \$30,000 deemed distribution plus a \$3,000 penalty tax.

8. Double trouble. IRS regulations make it clear that if a plan loan isn't repaid, the participant could face **two** different taxable events: a **deemed distribution** under Code Sec. 72 , and a **regular taxable distribution** of a plan loan offset amount. A distribution of a plan loan offset amount is a distribution that occurs when, under the plan terms governing a plan loan, the participant's accrued benefit is reduced (offset) in order to repay the loan. A distribution of a loan can occur if the plan requires that the loan be repaid immediately.