Refinancing 401(k) Plan Loans Has Benefits, But Learn the Pitfalls

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Refinancing a 401(k) plan loan presents a number of benefits and potential pitfalls to plan participants. A refinancing occurs when a new 401(k) plan loan replaces an existing loan or multiple existing loans. The existing loan, or "replaced loan," is considered repaid upon completion of the transaction. The resulting new loan is known as the "replacement loan."

Here is a summary of the benefits and potential pitfalls associated with refinancing 401(k) plan loans.

The Benefits

Loan refinancing can enable participants to borrow additional funds, extend the term of their loans or even reduce the interest rate in some cases. Refinancing can be particularly helpful when the plan allows for only one outstanding loan at a time. By refinancing, a participant can renegotiate a more affordable repayment schedule, or borrow the additional funds needed to complete a project, without taking out multiple loans or providing proof of hardship.

Pitfalls to Avoid

If the amount and term of the new loan are not carefully calculated and administered, however, refinancing a participant's loan can trigger unintended tax consequences — a deemed distribution. A participant who has an outstanding loan may refinance that loan or borrow additional amounts if the loans collectively satisfy the dollar-amount limitation (generally the lesser of $50,000 or 50 percent of the vested account balance) and the existing loan and the new loan each satisfy the maximum repayment period requirement (generally five years, but it may be longer for a principal residence loan).

If the repayment period of the replacement loan ends on or before the maximum permissible term of the existing loan — no later than five years from the existing loan's origination date — only the replacement loan is treated as outstanding to determine if that loan exceeds the maximum dollar limit. A replacement loan that is paid off within the existing loan's maximum permissible term will be taxed as a deemed distribution only if the loan's outstanding balance exceeds the maximum dollar limit.

Where the term of the replacement loan ends beyond the maximum permissible term of the existing loan — the replacement loan's payment ending date is more than five years from the existing loan's origination date — both loans are treated as outstanding on the date of the replacement loan. That determines whether the replacement loan violates the dollar-amount limitation, even though the replacement loan itself satisfies the maximum repayment period (five years from the date of the replacement loan) and is actually "paying off" the existing loan. So, in that case, if the sum of the outstanding balance of the existing loan and the amount of the replacement loan exceeds the maximum dollar limit, the excess is taxed as a deemed distribution, even if the replacement loan satisfies the maximum permissible term requirement.

There is an exception, however, to the requirement that the existing and replacement

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loan amounts both be counted to determine if the replacement loan violates the dollar limitation. To determine if the exception applies, the replacement loan is analyzed as if it were two separate loans: one replacing the existing loan and one representing the difference between the amount of the replacement loan and the amount of the existing loan. If the portion attributable to the existing loan is paid off within the maximum repayment period for that loan, then the existing loan does not have to be combined with the replacement loan to determine whether the maximum dollar limit has been violated. A deemed distribution is avoided if the replacement loan does not exceed its maximum dollar limit and maximum repayment period.

> If the amount and term of the new loan are not carefully calculated and administered, refinancing a participant's loan can trigger unintended tax consequences — a deemed distribution.

Here are some examples of how refinancing works:

Replaced Loan with a Term of Less Than 5 Years

The participant borrows $10,000 on Jan. 1, 2012, with a Dec. 31, 2014, loan end date (that is, the loan has a three-year repayment period). The latest permissible term for the loan would be Dec. 31, 2016 (or a five-year repayment period). One year later, the participant refinances the loan, borrowing an additional $10,000, with a Dec. 31, 2016, loan end date. The principal of the new loan (the replacement loan) is $16,666.67, which represents the additional $10,000 plus the $6,666.67 outstanding balance on the original loan (that is, the replaced loan).

Because the repayment period of the replacement loan does not end later than the latest permissible term of the replaced loan, only the replacement loan is taken into account to determine if the maximum dollar amount limit is exceeded. As of the date of the replacement loan, the participant's vested account balance is $100,000, so the loan amount limit is $50,000. Because the amount of the replacement loan ($16,666.67) is less than $50,000, the replacement loan satisfies the IRS requirements.

Replacement Loan with Later Repayment Date

A participant borrows $15,000 on Jan, 1, 2012, with a Dec. 31, 2016, loan end date (in other words, the five-year maximum permissible term). On Jan. 1, 2013, the participant refinances the loan, borrowing an additional $15,000, with a new five-year repayment term ending on Dec. 31, 2017. The principal of the new loan (the replacement loan) is $27,000, which represents the additional $15,000 plus the $12,000 outstanding balance on the original loan (or the replaced loan).

Because the repayment term of the replacement loan ends after the term of the replaced loan, both loans must be treated as outstanding as of the date of the replacement loan (Jan. 1, 2013) to determine if the maximum dollar-amount limit is exceeded. The sum of both loans on that date is $39,000 (the $12,000 outstanding balance on the replaced loan plus the $27,000 replacement loan). As of the date of the replacement loan, the participant's vested account balance is $100,000, so the loan amount limit is $50,000. Because the sum of the replaced loan and the replacement loan ($39,000) is less than $50,000, the replacement loan satisfies the IRS requirements.

Replacement Loan Term Satisfying the Exception

If the facts in the prior example are changed slightly so that the participant's vested account balance as of the date of the replacement loan is $75,000 instead of $100,000, the participant could not have two loans outstanding that total $39,000 — because his maximum loan limit would now only be $37,500. Under the exception, the repayment schedule for the replacement loan is structured so that at least $12,000 of the principal (the loan balance of the original loan at the time of the refinancing) is repaid by Dec. 31, 2016, (the loan end date for the original, replaced loan) and the difference is repaid by Dec. 31, 2017, (the loan end date for the new, replacement loan).

So, through Dec. 31, 2016, the payments would equal the payments under the replaced loan plus an additional amount needed to amortize the additional $15,000 over a five-year period beginning Jan. 1, 2013, and the payments from Jan. 1, 2017 through Dec. 31, 2017, would equal only the amount needed to finish amortizing the additional $15,000. Because the outstanding balance of the replaced loan is still being repaid by Dec. 31, 2016, (the five-year maximum permissible term), the replaced loan is not treated as outstanding at the time of the replacement loan for purposes of the maximum dollar-amount limit. Only the replacement loan is taken into account to determine if that limit has been exceeded. Because the amount of the replacement loan ($27,000) is less than the dollar limit ($37,500), the replacement loan satisfies the IRS requirements.

Finding out More

For more information about establishing a plan loan program, see ¶460 in the *Handbook.* ❖