

IRS Loan Rules for 403(b) and 457(b) Plans

Many 403(b) and/or 457(b) plan sponsors depend on various vendors to maintain their plans; however, the ultimate responsibility for the operation of the plan, including its loan program, rests with the plan sponsor. It is the plan sponsor's responsibility to ensure that each participant loan adheres to the requirements of the loan program and to enforce loan repayments. Notably, "hold harmless" agreements between a 403(b)/457(b) plan sponsor and its vendors do not lessen the plan sponsor's responsibilities.

Key Considerations for Participant Loans

Participant loans must comply with several rules to avoid being classified as a taxable distribution. There are two main areas of concern:

1. Does the written 403(b)/457(b) plan permit participant loans?
 - The written plan must explicitly state that loans to participants are allowed. Since many 403(b)/457(b) plans coordinate a loan program with various vendors, it is essential to clearly outline the operation of the loan program. This requirement has been applicable since 2009.
2. Do the participant loans meet the Internal Revenue Code Section 72(p) requirements?

To avoid being treated as a taxable distribution, participant loans must meet the following conditions:

- The loan must be based on a legally enforceable agreement:
 - This can take the form of a paper or electronic document.
 - The loan terms must comply with IRC Section 72(p)(2) requirements.
 - The loan agreement must specify the date and amount of the loan, along with a repayment schedule to ensure timely repayment by the participant.
- The plan administrator must cap the loan amount at the lesser of:
 - 50% of the participant's vested account balance at the time of the loan, or
 - \$50,000.
 - An exception allows a participant to borrow up to \$10,000, even if it exceeds 50% of their account balance.
 - If the participant has previously taken out another loan, the plan administrator must reduce the \$50,000 limit by the highest amount owed on other participant loans from the plan (or any related employer plan) during the one-year period ending the day before the loan.
- The participant must repay the loan within five years, unless the loan is used for purchasing their principal residence. If the loan repayment extends beyond five years for this purpose, evidence must be provided to confirm the loan is for purchasing a primary residence.
- Typically, loan terms should require the participant to make substantially level payments, at least quarterly, throughout the loan's duration (with exceptions for leave of absence or military service).