Do 401(k) Loans Impact a Participant's Credit Score?

Facts

Our 401(k) plan allows participants to take loans from their accounts. We have a written policy that describes how the loans work and spells out the requirements that the plan and participants must follow. Among other details, the loan policy indicates that payments must be made via payroll deduction.

Question

Since loan payments are withheld via payroll deduction, are they treated the same as deferrals? Also, do loans impact a participant's credit score?

Answer

Participant loans…for all the convenience they offer to participants, they are also the source of many questions just like these. Let's start with the second one first since it has a shorter answer.

Participant Loans and Credit Scores

We used to see loan policies that suggested employers would assess the creditworthiness of a participant seeking a plan loan, which would presumably entail things like credit checks. In practice, however, we do not recall hearing of any employers that actually went through that process, and most of the loan policies we see now specifically indicate that there will be no such review. Some policies do include a provision that a participant will not be granted a loan if he or she already has a loan from the plan that is in default. Even if there is not that type of overt prohibition, the outstanding balance of a defaulted loan does count against the maximum amount a participant can take as a subsequent loan. Beyond that and the tax ramifications, there generally are not any additional punitive actions (such as a negative mark on a credit report) taken against the participant in the case of a loan default.

Treatment of Loan Payments

Now, back to your first question. You are correct that participant loan payments may appear similar to deferrals in that they are both withheld from payroll and remitted to the plan, but that is where the similarities end. There are several critical differences.

- **Taxation:** Salary deferrals enjoy special tax treatment, but loan payments do not. Depending on whether deferrals are pre-tax or Roth, participants are able to either take a current year tax deduction or may be eligible for tax-free distributions on retirement, respectively. Loan payments, on the other hand, do not carry any special tax treatment. They must be withheld from payroll on an after-tax basis and are taxed to the participant the same as the rest of his or her account on eventual withdrawal.

- **Flexibility:** Participants are allowed to change the amounts they defer (including discontinuing deferral altogether) on a periodic basis with some plans allowing such changes as often as each pay period. When it comes to loan payments, the participant is more or less stuck with the periodic payment amount shown on the loan amortization schedule until the loan is paid in full. With very few exceptions, plan sponsors are not able to act on a participant's request to reduce or discontinue loan payments until the terms of the loan are completely satisfied.

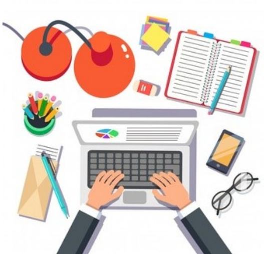
- **Contribution Limits:** While deferrals do count toward the various contribution limits that apply to retirement plans, loan payments do not. So, even if a participant is making loan payments throughout the year, he or she is still able to make deferrals of up to $19,500 or $26,000 if age 50 or older (2020 limits, indexed for inflation).

- **Nondiscrimination Testing:** Unlike salary deferrals which must be included in certain annual nondiscrimination testing, participant loan payments are not counted for those purposes.

Fortunately, once you know them, both of these answers are relatively straight-forward to apply. Most payroll systems are setup to properly handle loan payments with regard to taxation and application of the limits as long as the key details are added at the time the loan is setup. Also, loan payments should not be included with deferrals or other contributions on the year-end census that you submit to your TPA. Of course, if you're not sure how to proceed in a specific situation, give us a call. We are glad to work through it with you and point you in the right direction.

Related Resources

- Retirement Plan Loan Questions
- Feeling Defeated in the Battle of Plan Loans? We've Got a Fix for That!
- DWC 401(k) Q&A Topic Archive: Participant Loans



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