401(k) Plan Loans

Is a 401(k) plan loan a liability that should be considered in a property division upon martial dissolution?

To answer that question correctly, one has to examine how a 401(k) plan loan actually works. When a participant requests a plan loan, the trustee of the plan sells enough of the participant's plan assets to fund the loan and then distributes the funds to the participant. In essence, the participant is "borrowing" his own money. For example, if a participant has shares in a mutual fund, the trustee sells some of those mutual funds and distributes the cash. If the 401(k) has money market assets, the trustee simply distributes the cash. The trustee then creates a notional plan loan account for the funding of the "loan" and the repayments.

Example:

Before loan is funded:	
Marketable securities	$150,000
Value	150,000
After loan is funded:	
Marketable securities	$ 100,000
Plan Loan Account	50,000

The value of the account is now $100,000. The loan account has no value because those assets have been distributed and are no longer part of the plan balance.

As the loan is paid back, the assets in the plan account increase, and the loan account decreases.

Example:

Before loan re-payments begin:	
Marketable securities	$ 100,000
Plan Loan Account	50,000
After loan is paid back:	
Marketable securities	$ 125,000
Plan Loan Account	25,000

The value of the account is now $125,000 because $25,000 of the loan was repaid (increasing the marketable securities), and $25,000 remains unpaid.

The above example assumes no interest was paid on the loan. However, all 401(k) plan loans are subject to interest, usually at rate equal to the prime interest rate on the date of the plan loan plus 1 or 2 percent.

A plan loan is nothing more than a distribution disguised as a loan, pursuant to the Internal Revenue Code, to avoid the distribution from being taxed in the year of distribution. But it has no value and is neither an asset nor a liability. Plan loans are notional accounts. They are an illusion. They are imaginary. They do not exist, except by name. There is no third party liability. How do you borrow your own money and create an actual liability?

So you can see that a plan loan is not a liability that should be considered in the division of marital property upon divorce.

The only things that have value in 401(k) plan are the marketable securities.

Now consider the following actual Texas case.

The participant has $200,000 in his 401(k) plan account just a few days before he is married. He receives a $50,000 plan loan prior to the date of his marriage, all of which would have come from his separate property assets in the plan. He enters the marriage with $150,000 in marketable securities and $50,000 of a plan loan account.

During the course of his marriage, the loan, plus interest, is repaid using community property funds.

Is it possible that the repayment of a plan loan could give rise to a valid claim for reimbursement?

Does the repayment of a plan loan by the community estate give rise to a valid reimbursement claim?

Let’s first examine the concept of reimbursement in Texas cases. A claim for reimbursement is an equitable right, not necessarily a legal right. Therefore equitable principles govern.

A claim for reimbursement arises when one estate expends funds that benefits the other estate and in turn, receives something less in exchange, i.e., no *quid pro quo*. Examples would be for the re-payment of a debt, improvements to property, and life insurance premiums. If the community estate pays for a separate property debt, that would give rise a valid reimbursement claim (TFC §3.402). If the community estate pays for improvements on a separate property building, that would give rise to a valid reimbursement claim (TFC §3.402). If the community estate pays for premiums on a separate property life insurance policy, where there was no benefit to the community estate, could also give rise a valid reimbursement claim (Case law).

TFC §3.402 also provides that a claim for reimbursement would include the payment by one marital estate of the unsecured liabilities of another marital estate.

So where does the re-payment of a plan loan fit in. The answer is, it doesn't. When a pre-date of marriage plan loan is repaid using community property funds, there is no separate liability that is extinguished, so the separate estate is not benefited by a reduction in the liability. Remember, plan loans do not really exist. When the plan loan is repaid using community property funds, the assets acquired are considered community property. The repayment of the plan loan is nothing more than making additional contributions to the plan which increases the community property balance.

We can all agree that community property salary deferrals into a 401(k) plan create a community property interest in the resulting assets. There is no difference in these deferrals and the re-payment of a plan loan. The repayment of a plan loan with community property funds does not increase the separate property assets. The funds used to "repay the loan" are community property and so are the resulting securities.

So if the pre-date of marriage plan loan is paid back using community funds, what detriment does the community property suffer and how is the separate estate benefited? Other than tax considerations, the simple answer is (i) there is no detriment to the community estate and (ii) no benefit to the separate estate.

Other than possible tax considerations, would it be equitable to find that a claim for reimbursement exists where the community estate expended funds to repay a plan loan that originated prior to the date of marriage, keeping mind that the payments actually increased the community interest in the plan dollar for dollar and there was no benefit to the separate estate?

Tax considerations:

When a plan "loan" is funded and then paid back according to the terms of the loan, no tax is due (including IRC Section 72(t) additional tax due on early withdrawal, if applicable) on the distribution.

When a plan loan is funded, the distribution of the funds to the participant is made tax free. When the loan is paid back, it is paid back with after-tax funds. If the plan loan is a pre-date of marriage loan, then the community estate would pay an additional amount equal to the tax on the loan payments (principal and interest) at the marginal tax rates of the community estate. What would be a legitimate claim for reimbursement is the amount of additional tax the community estate paid based on those loan repayments. Likewise, when a plan loan is made post-date of marriage, the distribution is likewise made tax free. If plan loan balance exists on the date of divorce, the payments will be made post-date of divorce by the participant with after-tax funds. In this case, you would have a deferred liability equal to the amount of additional tax that the participant's separate estate would be responsible for.

The tax that the community estate actually paid can be calculated easily. The tax that the separate estate will pay can likewise be estimated easily.

For example, if a plan loan is equal to $50,000, carries an interest rate of 6%, and the loan is payable over 60 months, the monthly payments would be $ 966.64 or $ 11,599.68 annually. Assume a marginal 25% tax rate, and the additional tax would $ 2,899.92 each full year.

Note: This article applies to any kind of defined contribution plan that allows for plan loans, such as federal and military Thrift Savings Plan, governmental section 457 plans, profit sharing plan, etc.

Definition –

Notional. adj.

1. Of, containing, or being a notion; mental or imaginary.
2. Speculative or theoretical.
3. Not evident in reality; hypothetical.
4. Something that is notional exists only in theory or as a suggestion or idea, but not in reality.