PRECISION

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Things You Might Not Know About Your Retirement Plan

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Twenty Questions – Retirement Plan Loan Style

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So, your plan allows loans. Simple enough, right? Participants borrow money from their accounts and pay it back. What can possibly make that complicated? Funny you should ask - retirement plan loans are actually your ultimate frenemy. They have advantages, but there is that dark side you need to keep your eye on.

Don't believe us? Let's play a game of twenty questions!

What is a participant loan from a retirement plan?

Fundamentally, it is an exception to a rule. The regulations prohibit retirement plans from loaning money to interested parties, including participants. That prohibition, which actually pre-dates the ability of participants to direct the investment of their own accounts, is designed to prevent plan officials from using plan assets for less than honorable purposes.

Participant loans are an exception to that broad prohibition. As long as certain limitations and parameters are satisfied – amount, duration, interest rate, etc. – an otherwise impermissible loan becomes okay.

Do I have any options that can limit the number of loans in the plan?

The IRS has some limitations, but you are able to further restrict availability within your specific plan. Here are the parameters the IRS has set.

- Length: Maximum of five (5) years. May be extended if for the purchase of a primary residence.
- Amount: Maximum of 50% of the participant's vested account balance, subject to an overall cap of $50,000.
- Number: No regulatory limit, though many plans limit a participant to only a single loan at a time.
- Interest rate: Must be commercially reasonable, similar to the rate a bank would charge for a fully secured loan. Many plans base it on the Prime Rate, e.g. Prime + 1%.
- Payment frequency: At least quarterly, though most plans require payments through payroll deduction.

Plans that offer loans must document these provisions either as part of the regular plan document or in a separate written loan policy.

As always, feel free to reach out to your team at DWC to discuss your options.

Can I deny a loan request?

It depends. We know that's a cop-out answer, but it's true. Certainly, if the request is outside the plan's loan rules, it should be denied. Also, if you have actual knowledge that a participant is using the loan option as a way to access his or her account and has no intention of repaying the loan, that could be grounds for a denial. Beyond that, it is difficult to think of a circumstance when it would be appropriate to deny a legitimate request. It is important to note that loans must be offered on a nondiscriminatory basis. In other words, it would be a violation to deny a loan to a non-highly compensated employee but approve a request by an HCE under similar circumstances. As with pretty much all plan-related decisions, keeping documentation as to why a loan is denied is a must.

How and when should the loan be paid back into the plan?

Although the rules offer some flexibility, most plans require participants to repay their loans through payroll deduction. That means when a participant takes a loan, it is amortized assuming a payment will be automatically withheld from each paycheck. If actual payments do not follow that schedule every step of the way, it can create compliance headaches for the plan and trigger tax liabilities for the participant.

The maximum length of time a loan can be taken is five (5) years; however, if the participant uses the loan proceeds to purchase his or her primary residence, the plan can be written to allow the loan to be amortized over a longer period of time.

How do we handle a missed payment?

A payment could be missed for any number of reasons – anything from an hourly employee not having a paycheck from which to withhold a scheduled payment to simple administrative oversight. Regardless of the reason, a missed payment means the loan is in default and steps must be taken to get it back on track as quickly as possible. Options vary but could include doubling up on withholding (plus accrued interest) on the next paycheck to potentially refinancing the loan if the plan allows it. If missed payments are not caught up by the end of the following quarter, the outstanding balance must be treated as a distribution to the participant, resulting in taxes and penalties.

DID YOU KNOW?

If an active employee wants to discontinue their payments, can I say yes?

The short answer is "No." The longer answer is that one of the underlying requirements for a loan to be permitted is that it must be an enforceable agreement, and plan fiduciaries have a legal obligation to enforce a plan's agreements and collect amounts that are owed to the plan. That means once a participant has agreed to repay the entire loan, it becomes a plan fiduciary's duty to make sure that happens. To voluntarily discontinue payments on a participant's request would be a violation of that duty. However, if a participant will be out of work on an approved formal leave of absence, payments can be temporarily suspended. There are a lot of details on how that works. So give us a call if you are facing that situation and we can help you understand the options.

What happens when a participant with an outstanding loan terminates employment?

Most plans include a provision that makes outstanding loans due immediately on termination of employment. Since the participant in question no longer has a paycheck from which to withhold payments, the pay-off is made via personal check or money order. If it is not repaid, it is treated as a taxable distribution to the participant. Early withdrawal penalties may also apply.

You've made a couple of comments about loans being treated as distributions. How does that work?

The so-called "deemed distributions" rules are kind of like falling out of a window. No one has to take any action to make gravity work ... it just does. Same with a loan that is behind and not caught up by the end of the next quarter...it is automatically deemed to be a taxable distribution whether anyone reports it as one or not. Obviously, the plan has a duty to document it, but failure to do so doesn't mean the tax liability isn't there.

The participant must be issued a Form 1099-R, reporting the outstanding balance as a taxable distribution. The deadline for the 1099 is the January 31st immediately following the year of the deemed distribution. Although plan recordkeepers can usually provide this service quite easily, they typically require a plan sponsor to request it for each applicable loan. In other words, recordkeepers often do not issue 1099s for deemed distributed loans automatically.

Although this should primarily involve terminated employees, it is possible that an active employee could end up with a deemed distribution as well. However, since payments should not be voluntarily discontinued for an active employee, please call us if this situation arises so we can make sure there are not any other compliance issues that need to be addressed.

What happens when an employee wants to pay off their loan early? Can they?

It's possible, if the plan allows for pre-payment of the loan. However, the pay-off should be recalculated to adjust for the interest due through the shorter time period. Just let us know if you have any participant inquiries and we can help evaluate their options.

Argh! Should I even allow loans in the plan?

While loans may seem like they are more trouble than they're worth, think about the alternative. An employee may instead take a distribution, which will never be repaid. The money is gone. With a loan, the funds are eventually returned to the plan and available to the participant as a retirement benefit, which is the primary purpose for the plan.

What do I do if/when I have more questions about loans?

Ok, that only makes 11 questions, but this is the easiest one to answer. Call DWC!

Additional reading

Retirement Topics – Plan Loans

http://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics-Loans

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