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webcast

Plan Sponsor Basics

Webinar 5 of 6

Plan Loan Administration

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Overview

- Loan basics (advantages/disadvantages, regulatory framework)
- Loan requirements (including limits, documentation, etc.)
- Repayment requirements
- Leaves of absence
- Loan default and distributions
- Administrative issues and correction options

Loan Basics – Advantages and Disadvantages

- Availability of loans is a significant plan feature since early withdrawals are restricted by law
  - Advantages of a loan program
    - *Provides participants with a critical source of funds*
    - *Encourages participation in the plan by lower-paid employees (helps the plan pass nondiscrimination tests)*
  - Disadvantages of a loan program
    - *Complex administrative and compliance duties*
    - *Plan loans are subject to many regulatory constraints, including rules issued separately by the DOL and IRS*

Loan Basics – Regulatory Framework

- Both ERISA (§ 408(b)(1)) and the Internal Revenue Code (Code) (§ 4975(d)(1)) treat loans by a plan to participants or beneficiaries as prohibited transactions unless the loans meet certain requirements

- The Code (§ 72(p)) treats loans by a plan to participants or beneficiaries as taxable distributions unless the loans meet an additional set of requirements

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Why Are Loan Rules Important?

- IRS includes loans as an audit priority in the event of a plan audit

- Failure to follow loan rules can result in the following:
  – Prohibited transaction (DOL)
  – Taxable distribution to participants and beneficiaries
  – Plan disqualification/penalties

Loan Requirements – Prohibited Transaction Exception

- Must be available on a reasonably equivalent basis
  - Parties in interest
  - Officers and directors may be excluded
- Must not be made available to highly compensated employees (HCEs) in amounts greater than those available to other participants
- Must be made in accordance with specific provisions of the plan
  - Plan document may refer to a loan policy maintained outside of the plan (incorporated by reference)

Loan Requirements – Prohibited Transaction Exception (cont'd)

- Must bear a reasonable rate of interest
  - Commensurate with interest rate charged by persons in business of lending money for loans made under similar circumstances
  - Maximum 6% rate for military service members
- Must be adequately secured
  - 50% limit on security provided through vested account benefit
  - Spousal consent may be required

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Prohibited Transaction

- Failure to meet prohibited transaction exemption requirements may result in:
  - 15% excise tax on the participant or beneficiary who is a disqualified individual (up to 100% if not timely corrected)
    - *Officers, directors, certain shareholders and HCEs*
  - Plan disqualification for failure to comply with anti-alienation provisions of Code § 401(a)(13) (and failure to operate in accordance with plan terms)

Loan Requirements – Deemed Distribution Exception

- Loans must be evidenced by a legally enforceable agreement that sets forth the amount, date, and repayment schedule of the loan
- Amount of loan may not exceed the lesser of 50% of a participant's vested account balance or $50,000
  - Exception for loans up to $10,000 that may exceed 50% of the participant's account balance; however, such loans must be secured by something other than only the plan account balance
  - Multiple loans are permitted so long as any plan limits are maintained

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Loan Requirements – Deemed Distribution Exception (cont'd)

- All plans in controlled group aggregated for purposes of determining loan amounts
- Loans from all plan accounts included (Pretax, Match, Roth, etc.)
- Adjusted loan limit where two or more loans are taken in a 12-month period
  - *Take highest outstanding loan balance in the 12-month period and subtract the current outstanding loan balance at the time of the new loan to determine the adjusted maximum loan limit*

Loan Requirements – Deemed Distribution Exception (cont'd)

- Loan Term
  - May not exceed five years (60 months) for general purpose loans
  - Longer term permitted to purchase primary residence
    - *Does not apply to participant's family or loans to construct, reconstruct or substantially rehabilitate participant's existing primary residence*

Loan Repayment Requirements

- To maintain nontaxable status, a participant loan must be repaid within five years (60 months) unless it is a principal residence loan
  - The date of the loan has informally been indicated by the IRS to be the date the participant receives the check
- Payments (principal and interest) must be amortized in substantially level payments that must be made at least quarterly

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Loan Repayment Requirements (cont'd)

- Refinancing available in some circumstances
  - An existing loan is replaced by a new loan
  - Helpful in situations when the plan's loan program limits number of loans
  - Specific requirements to refinance if amortization period is extended and/or the principal amount of the loan is increased

Loan Repayment Requirements (cont'd)

- Missed Payments
  - A missed payment violates amortization requirement – deemed distribution is entire outstanding loan balance at time of failure
  - Participant may cure missed payments within "cure period"
    - *Cure period should be designated in plan document or loan policy*
    - *Latest cure period is end of quarter following quarter in which first payment is missed (cure period may be shorter)*
    - *All loan payments must be made and loan must be current by end of cure period*

Deemed Distributions

- If loan fails to satisfy deemed distribution exception requirements under Code § 72(p), deemed distribution will occur at first time those requirements are not satisfied
- Entire amount is deemed distribution if does not satisfy enforceable agreement, repayment term or level amortization requirements
- Excess amount is deemed distribution if loan exceeds statutory amount limit (but meets all other requirements)

Leaves of Absence

- Suspension of loan payments due to a leave of absence (LOA)
  - Loan payments may be suspended for up to one year because of an LOA
    - *Participant must be on LOA without pay or paid at a rate that is less than the loan installment payment amount*
    - *Exception for an LOA due to military leave*
  - Participants that satisfy LOA requirements will avoid loan default

Leaves of Absence (cont'd)

– Upon return from LOA (or after one year, if earlier), payments must resume

- *Loan term may be extended by LOA and reamortized, but cannot be extended to be longer than maximum loan period (generally five years)*
  - General rule is that installment payments under reamortized loan may not be less than the amount of the installment payments under the original loan
- *Loan with five-year term may be refinanced to take into account missed payments*
- *Instead of refinancing, a balloon payment may be made at the end of the loan term to make up for missed payments*

Leaves of Absence (cont'd)

- LOA due to military service
  - Suspension due to LOA for military service does not need to meet the other LOA requirements
    - *Loan suspension may exceed one year*
    - *Payments must resume upon completion of military service*
    - *Period of military service may be added on to loan term, even if the addition of the military service period will cause the loan term to exceed five years*
    - *Loan must be reamortized over new term (IRS has stated informally that balloon payments are not permitted for military LOA loans)*

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Loan Default

- Loan default results in “deemed distribution” or “loan offset”
  - Deemed distribution occurs when a participant is not otherwise entitled to a plan distribution (i.e., the participant remains actively employed following loan default)
  - Loan offset occurs when the participant is otherwise entitled to a distribution under the plan (i.e., the participant terminates employment)

Loan Default (cont'd)

- Deemed distributions
  - Amount deemed to be distributed is included in gross income and reported on IRS Form 1099-R in year default occurs
    - *Deemed distributions of Roth amounts are not treated as qualified distributions under Roth rules, even if the amounts otherwise satisfy the Roth requirements*
  - No automatic withholding
  - 10% penalty tax may apply
  - Loan remains part of account balance until distributable event occurs

Loan Default (cont'd)

– Repayments are permitted on a defaulted loan

– Interest should continue to accrue on the defaulted loan

  - *Accrued interest is not taxed*
  - *Limits the amount of subsequent loans*

Loan Default (cont’d)

- Loan Offset
  - Loans may be offset upon a distributable event
    - *Plan provisions should clearly state when offset occurs*
  - No participant consent required for loan offset

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Loan Rollover

- Loans may be rolled over to another qualified plan
  - Common in business transactions
  - Plan terms must accept loan rollovers in order to permit rollover
  - Loans must be rolled over and payments must resume within cure period

Loan Documentation

- Review loan paperwork
  - Loan paperwork may be paper or electronic
- Beneficial if loan note and other paperwork contain language to permit makeup of any missed payments
  - If participant consent can be obtained at the time the loan is initiated, it can save administrative problems later if payments are missed due to payroll or other issues
  - Standard recordkeeping loan documentation varies

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Common Loan Administration Issues

- Missed payments or defaulted loans due to payroll errors
- Loans exceeding maximum permissible amount
- Leave of absence administration
- Amortization of new loans
- Failure to follow the terms of the plan or loan policy
- Request for voluntary loan default from participant

Common Loan Administration Issues (cont'd)

- Avoid errors through proactive steps
  - Update plan document provisions and/or loan policy to conform to loan administration
  - Review loan delinquency or error reports created by plan recordkeepers
  - Work with payroll to ensure that payments for new loans are timely remitted
  - Perform an internal audit of loans to find and correct problems

Correction Options

- Self-Correction
  - Plan loans may be self-corrected if missed payments are contributed within the plan's cure period
    - *Ensure that the cure period being administered matches the cure period in the plan document or loan policy*
  - If default occurs, an IRS Form 1099-R should generally be issued for the year of default

Correction Options (cont'd)

- Voluntary Correction Program (VCP)
  - Filing under VCP can provide expanded relief
  - May permit:
    - *Defaulting a loan in the current tax year (instead of the tax year in which the default actually occurred, if a prior year)*
    - *Reamortizing missed payments over the remaining term of the loan or the maximum loan term (five years), if longer*
    - *Permitting a lump-sum payment of any missed amounts*

Correction Options (cont'd)

- VCP Filing Fee
  - Under Revenue Procedure 2008-50
    - *If (a) a VCP submission involves the failure of participant loans to comply with the requirements of § 72(p)(2), (b) the failure does not affect more than 25% of the plan sponsor's participants in any year(s) in which the failure occurred, and (c) the failure is the only failure of the submission, the applicable fee for a VCP submission is reduced by 50%.*

Correction Options (cont'd)

- Certain loan failures create prohibited transactions
  - Failure to timely remit loan repayments creates an impermissible loan between the company and the plan
  - Correction requires:
    - *Filing IRS Form 5330 and paying 15% excise tax on "amount involved" of prohibited transaction*
    - *Remitting late contribution to the plan, plus earnings*
    - *Reporting failure on IRS Form 5500*
    - *DOL's Voluntary Fiduciary Correction Program*

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Questions?

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