

Plan Loans & Hardship Distributions Compliance

By Stephanie Reagan

Presented to
WPBC

February 3, 2009



Qualified Plan Loan Compliance

Exemptions for Loans

- Participant loans provide a means for participants to access their 401(k) account balances without incurring tax liability
- There are two sets of rules that must be complied with when designing and implementing a participant loan program
 - The Department of Labor (DOL) loan provisions to avoid treatment as a prohibited transaction
 - The Internal Revenue Code (Code) dictates how loans must be structured to avoid treatment as a taxable distribution
- **Consequences of failing to satisfy the DOL/Code loan rules**
 - The loan will be considered a prohibited transaction.
 - The fiduciary responsible for plan investments may be held personally liable to the plan for the loss.
 - A disqualifying loan may also disqualify the plan by violating the anti-alienation rule
 - Taxation to the Participant

Plan Loan Rules

In general, Section 408(b)(1) of ERISA exempts loans by a plan to parties in interest who are participants or beneficiaries of the plan, provided that such loans:

- Are available to all such participants and beneficiaries on a reasonably equivalent basis;
- Are not made available to highly compensated employees, officers or shareholders in an amount greater than the amount made available to other employees;
- Are made in accordance with specific provisions regarding such loans set forth in the plan;
- Bear a reasonable rate of interest; and
- Are adequately secured.

Plan Provisions & Policies

The plan provisions regarding such loans must contain:

- An explicit authorization for the plan fiduciary responsible for investing plan assets to establish a participant loan program; and
- The participant loan program which is contained in the plan or in a written document forming part of the plan includes, but need not be limited to, the following:
 - (i) The identity of the person or positions authorized to administer the participant loan program;
 - (ii) A procedure for applying for loans;
 - (iii) The basis on which loans will be approved or denied;
 - (iv) Limitations (if any) on the types and amount of loans offered;
 - (v) The procedure under the program for determining a reasonable rate of interest;
 - (vi) The types of collateral which may secure a participant loan; and
 - (vii) The events constituting default and the steps that will be taken to preserve plan assets in the event of such default.

Reasonable Rate of Interest

A loan will be considered to bear a reasonable rate of interest if such loan provides the plan with a return commensurate with the interest rates charged by persons in the business of lending money for loans which would be made under similar circumstances

Plans commonly use a "prime + " standard

Adequate Security

No more than 50% of the participant's vested account balance may be considered by a plan as security for the outstanding balance of all plan loans made to that participant

Account balance is determined at the time the loan is made

Loan Rules

The following three conditions must be met in order to avoid taxation of a participant loan at the time the loan is made:

1. The loan must be paid in full within five years, unless the loan is used to acquire a principal residence of the participant [I.R.C. § 72(p)(2)(B)]
2. The loan must require substantially level amortization of principal and interest, with payments required at least quarterly. For example, a loan for a five-year term that requires payments of interest only until the end of the term, and a balloon payment at the end, does not qualify. [I.R.C. § 72(p)(2)(C)]
1. The loan is evidenced by a legally enforceable agreement and the loan is limited to a dollar limit equal to the lesser of (a) or (b):
 - a) \$50,000, reduced by the highest outstanding balance of loans during the one-year period ending on the day before the date a loan is to be made less The outstanding balance of loans on the date the loan is to be made.
 - b) (b) The greater of $\frac{1}{2}$ of a participant's vested accrued benefit; or \$10,000. [I.R.C. § 72(p)(2)(A)]

Deemed Distribution vs. a Loan Offset

Plan loans can give rise to two types of taxable distributions: (1) a loan offset and (2) a deemed distribution under Code Section 72(p).

- Loan offset
 - The plan reduces the participant's account balance by the amount of the outstanding loan balance. This theoretical distribution is treated as a repayment of the loan and the loan is eliminated.
 - Offsetting a participant's account balance is considered an actual distribution under the Code, not a deemed distribution under Code Section 72(p); thus, any distribution of salary deferrals that occurs for reasons other than separation of service, hardship, disability, or attainment of age 59½ disqualifies the plan. Therefore, in a 401(k) plan, if the participant's non-salary deferral dollars are insufficient to offset the loan, the plan must typically wait until a distribution event occurs before it can offset salary deferral dollars.
- Deemed distribution
 - Treated as a distribution for tax purposes only. Consequently, the plan will not violate any prohibition against in-service withdrawals by deeming a loan distributed because, although a loan deemed distributed constitutes a distribution for tax purposes, the participant's account balance is not reduced by the amount of the loan and the loan remains an asset of the plan. [Treas. Reg. § 1.72(p)-1, Q&A 13]
 - Interest continues to accrue

Special Rules for Loans From Roth Accounts

A plan can permit participant loans from Roth accounts. Roth amounts can be used to calculate the maximum loan limit and as a money source for a participant loan. IRS final regulations provide the following additional guidance applicable to loans from Roth accounts:

1. Loan repayments must be proportionally credited to Roth and non-Roth accounts
2. A deemed distribution of a loan from a Roth account is a **nonqualified distribution** for tax purposes even if the deemed distribution occurs after the employee attains age 59½ and the five-taxable-year period of participation was satisfied. [Treas. Reg. § 1.402A-1, Q&A 11]
3. A separate Form 1099-R is required for reporting amounts distributed from a Roth account, including the taxable portion of such a distribution

The extent to which Roth accounts are available for loans should be covered in the plan's loan policy and will impact how loan repayments must be credited to participant accounts and the taxation of deemed loans

Principal Residence Loan

A principal residence plan loan:

- Must be repaid within a reasonable period of time to acquire a principal residence of the participant;
- Need not be secured by the participant's principal residence to satisfy the requirements.
- Refinancing generally cannot qualify as a principal residence plan loan. However, a loan from a plan used to repay a loan from a third party will qualify as a principal residence loan. [Treas. Reg. § 1.72(p)-1, Q&As 5, 6, 7, 8]

There is no clear guidance as to what level of proof is required to extend the five-year term.

Can rely on a signed statement from the participant that the loan proceeds will be used to purchase a principal residence within a stated short period of time or repay a loan from a 3rd party.

Leave of Absence

- A plan may permit a participant to suspend loan payments during a leave of absence
- The level amortization requirement does not apply for a period, not to exceed one year
- The leave of absence must be either without pay from the employer or at a rate of pay (after employment tax withholdings) that is less than the amount of the installment payments required under the terms of the loan
- The loan, including accrued interest, must be repaid by the latest date permitted under the rules (i.e., five years) and the amount of the installments must not be less than the amount required under the terms of the original loan [Treas. Reg. § 1.72(p)-1, Q&A 9]

Military Leave of Absence

- A plan may permit a participant to suspend loan payments during a military leave of absence
- The loan, including accrued interest, must be repaid by the latest date permitted under the rules (i.e., five years) plus the period of military service
- A maximum rate of 6% interest may be charged on a loan during a period of military service

Bankruptcy

- Participant loans are not discharged in bankruptcy, and ongoing loan repayments by payroll deduction are permitted to avoid a loan default and resulting taxation
- The rules concerning the taxability of participant loans continue to apply in bankruptcy
- If a required payment is not made by the end of the cure period, the entire principal and interest will be deemed distributed for tax purposes

Truth in Lending Disclosure

If a plan makes 25 or more plan loans in the current or prior calendar year (or 5 or more loans secured by a dwelling), it must make federal truth-in-lending disclosures

Participant Loan Corrections

- Self-correction of loan - taxable income in year of default, any subsequent repayments give basis in plan
- Correction made through VCP - IRS may postpone income recognition until year of correction or waive it altogether
- Rev Proc 2008-50 EPCRS liberalized the correction requirements
- General Fees under VCP:

<u># of Participants</u>	<u>\$\$</u>
20 or fewer	\$750
21 to 50	\$1,000
51 to 100	\$2,500
101 to 500	\$5,000
501 to 1,000	\$8,000
1,001 to 5,000	\$15,000
5,001 to 10,000	\$20,000
Over 10,000	\$25,000

Loan corrections that do not affect more than 25% of participants in any of the years of the failure and only failure in the submission, the fee is reduced by 50%

Plan Loan Corrections

Rev Proc 2008-50 Appendix F, Sch. 5

- Loans in excess of maximum loan corrective repayment by participant. Choice of previous loan repayment applications as follows (not available to Key Employees):
 - To only reduce the portion of the loan that did not exceed the maximum amount. The corrective repayment = the excess amount + interest.
 - To reduce the excess loan interest only. The corrective payment = to excess loan amount.
 - To reduce pro rata excess loan & max loan amount. Corrective amount = to excess loan amount.
- Loan payments schedule does not meet the requirements. Two possible corrections (not available to Key Employees):
 - Repaid under original sch. As long as paid within the maximum period.
 - Reformed to amortize the remaining principal balance over the remaining period. Substantially level basis made at least quarterly over a period that does not extend beyond 5 years from original date

Plan Loan Corrections

Rev Proc 2008-50 Appendix F, Sch. 5

Correction of defaulted loans that schedules complied with the requirements - correction alternatives (not available to Key Employees)

- Lump sum repayment of missed payments plus interest accrued
- Outstanding balance will be reamortized over the remaining period of 5 years
- Use a combo of the above methods

Determination of interest accrued

- Plan loan rate,
- Rate of return on investments (if exceeds plan loan rate), or
- Actual rate used

The IRS may determine that the plan sponsor should pay all or a portion of the interest.

Plan Loan Corrections

Rev Proc 2008-50 Appendix F, Sch. 5

- Deemed distributions in the year of correction (available for Key Employees)
 - Sponsor not eligible or will not correct loans as stated above
 - Sponsor pays any income tax w/h
 - Report under Form 1099 R
- Loan provision not in plan document-retroactive Plan Amendment Correction Method under VCP (not in App. F)

Hardship Distribution Compliance

Hardship Withdrawals of Elective Contributions

Hardship withdrawals of elective contributions must have an

- Immediate and heavy financial need (the *events test*), and
- Must be necessary to satisfy that need (the *needs test*). [Treas. Reg. § 1.401(k)-1(d)(3)]

The regulation provides two different standards for determining whether these tests are satisfied:

- The *general standard* (also called the facts-and-circumstances standard) and
- The *safe harbor standard*.

The advantage to using the safe harbor standard rather than the general standard is that the employer avoids needing to dig into and police a participant's personal financial situation.

The disadvantage is that it is less flexible in terms of when hardship distributions will be available, making the plan less attractive to employees.

Can not make salary deferral contributions for six months following a hardship withdrawal.

Plan administrators should obtain and file documentation supporting the type and amount of each hardship distribution. [I.R.C. § 6001]

Limit on Maximum Distributable Amount

- The maximum distributable amount is equal to the employee's total elective contributions as of the date of distribution, reduced by the amount of previous distributions of elective contributions
- The maximum distributable amount does not include earnings, QNECs or QMACs, unless grandfathered (generally - EE's account as of 12/31/1988)

Employer Nonelective Hardship Contributions

- Although not specified in the regulations, the IRS has allowed a plan provision permitting withdrawal of employer contributions on account of hardship
- According to the IRS, the term *hardship* must be defined, the rules relating to hardship distributions must be uniformly and consistently applied, and the portion distributed cannot exceed the participant's vested account. [Rev. Rul. 71-224, 1971-1 C.B. 124]
- There is no limit on hardship distributions from profit sharing and matching contribution accounts

Safe Harbor

A distribution is deemed to be on account of an immediate and heavy financial need of the employee if the distribution is for:

- (1) Expenses for (or necessary to obtain) medical care
- (2) Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);
- (3) Payment of tuition, related educational fees, and room and board expenses, for up to the next 12 months of post-secondary education for the employee, or the employee's spouse, children, or dependents;
- (4) Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;
- (5) Payments for burial or funeral expenses for the employee's deceased parent, spouse, children or dependents; or
- (6) Expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction.

Heavy Financial Need

- The amount of the distribution can not be in excess of the amount required to satisfy the financial need.
- The amount required to satisfy the financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.
- A distribution is *not* treated as necessary to satisfy an immediate and heavy financial need of an employee to the extent the need may be relieved from other resources that are reasonably available to the employee.
 - Facts and circumstances test
 - Employee's resources are deemed to include those assets of the employee's spouse and minor children that are reasonably available to the employee

Employer Reliance on Employee Representation

The employer may rely upon the employee's representation (made in writing or such other form as may be prescribed by the Commissioner), unless the employer has actual knowledge to the contrary, that the need cannot reasonably be relieved -

- (1) Through reimbursement or compensation by insurance or otherwise;
- (2) By liquidation of the employee's assets;
- (3) By cessation of elective contributions or employee contributions under the plan;
- (4) By other currently available distributions (including distribution of ESOP dividends under section 404(k)) and nontaxable (at the time of the loan) loans, under plans maintained by the employer or by any other employer
 - Includes all qualified and nonqualified plans of deferred compensation including stock option, stock purchase or similar plans, or a cash or deferred arrangement that is part of a Section 125 cafeteria plan
 - Does not include defined benefit plans or health and welfare benefit plans to which participants make mandatory contributions. [Treas. Reg. § 1.401(k)-1(d)(3)(iv)(F)]; or
- (5) By borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

Tax Consequences Applicable to Hardship Withdrawals of Elective Contributions

- Hardship distributions are subject to ordinary income tax and to the 10 percent additional income tax on distributions prior to age 59 1/2.
- Any distribution on account of hardship --whether it consists of elective contributions and/or employer contributions --is not subject to the 20 percent withholding and direct rollover rules. [I.R.C. § 402(c)(4)(C)]
- Distributees can elect out of the 10 percent withholding that applies to taxable distributions not eligible for rollover.

Hardship Withdrawals From Roth 401(k) Accounts

- Roth 401(k) accounts are subject to the same distribution restrictions as pre-tax elective deferral accounts.
- IRS final regulations provide additional guidance in the event a participant chooses to take a hardship withdrawal from his or her Roth accounts:
 1. Although earnings on Roth contributions are not available for hardship, a pro rata portion of a hardship withdrawal taken from a Roth account must be treated as earnings for tax purposes. [Treas. Reg. § 1.402A-1, Q&As 7 & 8]
 2. When a participant applies for a future hardship withdrawal from a Roth account, both earnings and Roth contributions will be used to limit the maximum amount available for a hardship withdrawal. [Treas. Reg. § 1.402A-1, Q&A 8]

Compliance Issues

- 6-month elective deferral suspension violated
- Hardship provision not in plan document-retroactive Plan Amendment Correction Method under VCP
- Hardship distributions not documented
- Limit exceeded
- Impermissible hardship withdrawal