WRMarketplace

An AALU Washington Report

The *WRMarketplace* is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led by Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca Manicone. *WRMarketplace* #17-46 was written by Greenberg Traurig Shareholder Ian A. Herbert.

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TOPIC: 401(k) Plan Loans: Considering a Loan Program – Better Know the Basics

MARKET TREND: Allowing participants to borrow from their 401(k) accounts encourages participation because it assures employees that they can access their money before retirement, if needed.

SYNOPSIS: To establish an effective 401(k) loan program, the plan sponsor must ensure that the loans comply with requirements under the Internal Revenue Code ("Code"), along with making other important design decisions. Specifically, plan sponsors must ensure that loans are: (1) made on commercially reasonable terms, (2) adequately secured and documented in writing, (3) paid off within a specified period pursuant to a level amortization schedule, and (4) not in excess of specified amounts. In addition, employers should decide how many loans they wish to allow participants to take, the manner in which loans are to be repaid, and how to determine when a participant has defaulted on a loan.

TAKE AWAYS: Loan programs are prevalent and effective features of 401(k) plans and are useful in encouraging plan participation by non-highly compensated employees. However, plan sponsors must comply with several rules and fulfill numerous administrative responsibilities in creating and maintaining these programs. Further, plan loans are not the most efficient investment of plan assets and can subject accounts to depletion before a participant's retirement. Accordingly, the best loan programs limit the extent to which funds are available for borrowing.

The overwhelming majority of 401(k) plans allow participants to borrow from their plan accounts. While plans may allow participants to borrow only from their own plan contributions or from both employee contributions and employer contributions (e.g., matching or profit sharing contributions), typically the borrowing is limited to amounts in which the participant is vested. An effective loan program must meet a number of requirements to ensure plan loans are permissible, are not treated as taxable distributions from the plan, and comply with the terms governing plan operations. The following summarizes these requirements, as well as certain design options employers can select to craft a suitable plan loan program for their participating employees.

LEGALLY REQUIRED FEATURES

Plan loans are governed by Code §72(p) and the underlying Treasury Regulations, which set forth the following six elements of a permissible plan loan.

1. Loans Must Be Made on Commercially Reasonable Terms. The Treasury Regulations assume that the loans described in its examples are made on commercially reasonable terms and bear a reasonable rate of interest. This requirement is satisfied based on the relevant facts and circumstances of any individual loan, but it is useful to note that the most prevalent rate of interest charged on plan loans is equal to the prime rate plus 1%.

2. Loans Must Be Adequately Secured. Generally, plan loans are secured by the participant's account balance under the plan.

3. There Must Be an Enforceable Agreement. Any plan loan must be documented in writing, in a form that is enforceable under applicable law. The agreement can be in a single document or multiple documents, and it can be prepared on paper or electronically.

4. Loans Must Not Exceed a Specified Amount. To avoid having a portion of a loan treated as a taxable distribution, the maximum amount that a participant can borrow from his or her account at one time (*i.e.,* counting the amount outstanding under any existing loans) is equal to the lesser of: (a) $50,000, reduced by the highest outstanding loan balance during the one-year period ending on the day before the date the loan is made; and (b) the greater of (i) one-half (½) the participant's vested account balance under the employer's plans, and (ii) $10,000.

> ***Example:*** Assume Bob has a vested account balance of $80,000 and a loan outstanding for $20,000 during the previous year, which he has paid off. The maximum amount he can borrow now is $30,000 (*i.e.¸* the lesser of ($50,000 - $20,000) and ½ of $80,000).

5. Loans Must Be Paid Off Within a Specified Period. Generally, a plan loan must be repaid in full within five years. A longer term is allowed, however, for loans that are used to acquire a principal residence of the participant. In that case, the loan needs to be paid off within a "reasonable period"; many plans specify that these loans must be repaid within 15 or 30 years.

6. Loan Repayment Schedules Must Be Based on a Level Amortization Schedule. Typically, a loan must be repaid pursuant to a level amortization schedule with payments made no less frequently than quarterly. Accordingly, each scheduled repayment should be in the same amount and include principal and interest. A schedule that provides for smaller periodic payment (*e.g.*, interest only) and a balloon payment at the end of the term would **not** be permitted.

OTHER DESIGN OPTIONS

In addition to the legally required provisions, a plan and its loan policy should address certain design features of the plan loan program.

1. How Will the Loan be Repaid? The overwhelming majority of plans provide that loan repayments will be made by payroll deductions. This approach goes a long way to ensuring that loans get repaid and do not fall into default. However, the question remains as to how to handle the repayment of outstanding plan loan balances when a participant terminates employment with the sponsoring employer. A large percentage of plans provide that the outstanding balance becomes due and payable upon termination, resulting in treatment of any unpaid amount as a taxable distribution from the plan. Many other plans with loan programs provide for periodic payments to continue after termination of employment, either through the use of a coupon book issued by the plan trustee or through direct debit from the participant's bank or other account.

2. How Many Loans Can a Participant Have Outstanding at Any Time? Plan loan programs may provide an incentive for employees to contribute to plans (*i.e.*, because they realize they can access their money if needed before retirement). Most employers, however, still prefer to limit usage of the program, because, for example, the taking and repaying of a loan is not a particularly good investment of plan assets for the participants and defaulting on a loan will deplete the assets available for retirement. A prevalent limitation is to restrict the number of loans a participant can have outstanding at any time – e.g., the participant can have two outstanding loans at a time, often with a further condition that one loan can be a "general purpose" loan but the second loan is available only for the purpose of obtaining a principal residence.

3. When Will a Loan Be Considered to Be in Default? Generally, a failure to repay a loan in a timely fashion (*i.e.*, in accordance with the terms of the loan agreement) will cause the loan to be in default and likely trigger a deemed distribution for tax purposes. Under the Code, however, a plan may provide participants with a grace period for making missed loan repayments. Specifically, a plan can provide that a loan will not be considered in default until the end of the calendar quarter following the calendar quarter in which the last loan repayment was made (a common grace period among plan sponsors). Regardless, the loan must still be repaid within five years from its initiation. Failure to repay by that date also will result in a deemed distribution.

CONSEQUENCES OF DEFAULTING ON A PLAN LOAN

As noted, if a participant defaults on a plan loan, the outstanding loan balance is deemed a distribution from the plan and is includible in the participant's taxable income at the time of the deemed distribution (and subject to the 10% tax on early distributions if the participant is not yet 59½ years old).

The default, however, **<u>will not give rise to an actual distribution</u>** that is offset against the participant's account balance if the participant is not otherwise entitled to receive a distribution under the law and the terms of the plan.

For example, there is no reduction of the participant's account balance for the value of the defaulted loan if (1) the loan was made from the participant's elective deferrals account under the plan and (2) the participant has not (a) had a separation from service, (b) died, (c) become disabled, (d) experienced a financial hardship, or (e) attained age 59½. Instead, the defaulted loan balance is considered a part of the participant's account balance until an actual distribution can be made, and the account balance is reduced by the amount of the defaulted loan – **plus** accrued interest from the time of the default – at that time.

If the plan allows a participant who has defaulted on a loan to take another loan, the subsequent loan will be deemed a distribution unless the loan will be paid through payroll withholding or the plan receives adequate security from the participant in addition to the participant's account balance under the plan.

TAKE AWAYS

Loan programs are prevalent and effective features of 401(k) plans and are useful in encouraging plan participation by non-highly compensated employees. However, plan sponsors must comply with several rules and fulfill numerous administrative responsibilities in creating and maintaining these programs. Further, plan loans are not the most efficient investment of plan assets and can subject accounts to depletion before a participant's retirement. Accordingly, the best loan programs limit the extent to which funds are available for borrowing.