Benefit Insights

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Keeping Abreast of Plan Loan Rules

If you have a 401(k) plan, you've likely had participants ask about taking loans from their accounts. If you haven't yet, it is only a matter of time. While the concept of taking a loan is pretty straightforward—you borrow money, you repay it with interest—there are some pretty detailed rules that govern loans in the retirement plan world.

Background

One of the advantages that qualified retirement plans provide is that there are strict rules designed to protect plan assets from misuse, either accidental or intentional, by plan fiduciaries or other interested parties. One of those rules is a prohibition against the plan loaning money to pretty much anyone except in very limited situations.

One such situation is a loan to a plan participant, but only if a series of detailed requirements are met. In other words, all participant loans start out prohibited and only become allowable if all of the regulatory hoops are jumped through. It's an "all or nothing" proposition, so even the slightest misstep—no matter how picky or insignificant it might seem—can invalidate the loan, subject the participant to taxes and penalties and jeopardize the plan's compliance. Have no fear, however. Most of the loan rules are reasonably easy to follow once you are aware of what they are and how they are applied.

Loan Requirements

Most of the loan rules are written as "bookends" of sorts in that they describe the outside limitations and allow flexibility within those parameters.

Plan Document

For starters, the plan document must specifically authorize participant loans. This might be as simple as checking the appropriate box in the adoption agreement or adding a few sentences to an individually-drafted-type document. Unlike many plan provisions that require adoption before they can be offered/applied to participants, a participant loan feature can often be implemented at any time during the year as long as the plan document or amendment formally adopting it is signed no later than the last day of the plan year of implementation.

With that said, it is important to ensure that loan availability is adequately communicated to all participants (and not just the highly compensated employees, owners, officers, etc.) so that it is not indirectly discriminatory.

If, for some reason, loan availability does not make it into the plan document on time, the IRS has a correction program that makes it relatively easy to retroactively amend.

Loan Policy

In addition to specifically authorizing loans, the plan must also have a written policy that details all of the parameters that will govern those loans. The rest of this article will explore those parameters in more detail, but examples include maximum and minimum amounts, interest rate, processing fees, repayments terms, etc.

Some plans incorporate these details into the plan document itself, while others have a separate administrative policy that spells out the parameters. Once documented, those details must also be communicated to participants, usually by including them in the plan's Summary Plan Description or providing a copy of the administrative loan policy.

There is a fair amount of flexibility in modifying loan parameters; however, it does require a formal written update, usually subject to the same timing requirements described above. If the updated parameters are not formally adopted within the necessary time frame, retroactive correction—if available at all—requires an application to the IRS to request approval.

Because loans start out prohibited and only become allowable if they fall within all of the regulatory limitations, issuing a loan outside those criteria and not seeking IRS approval to correct means that those problem loans are deficient from inception and can taint the plan's compliance for years to come. So, even though a misstep might seem insignificant in the grand scheme of things, voluntarily correcting it is usually going to be far less troublesome and expensive than what would happen if the IRS discovers it in an audit.

Maximum and Minimum Amounts

First, let's take a look at the maximums imposed by the regulations. Participants can only take loans totaling up to 50% of their vested balances. The determination is made when the loan is issued, so it is not a problem if a participant takes the maximum loan and a subsequent market decline causes the loan to exceed half of the remaining balance. If a plan allows multiple loans, then the balance of any existing loans must be added to the new loan amount to ensure the total is within the 50% limit.

Even if a participant has more than $100,000 in his or her account, the maximum combined loan balance cannot exceed $50,000. The $50,000 maximum must be reduced by the highest outstanding loan balance a participant had in the 12 months ending on the date a new loan is issued. So, if someone takes a $30,000 loan on January 1st and repays it June 30th of the same year, he or she is limited to only $20,000 in additional loans until December 31st (12 months after the initial loan was taken) and continues to be limited until June 30th of the following year (12 months from the date the initial loan was repaid).

Although it is possible for a plan to impose smaller caps than these regulatory limits, it is somewhat unusual to do so.

On the other end of the spectrum is a loan minimum, the most common of which is $1,000. Because of the vested balance limitation, imposing a minimum of $1,000 means that a participant must have a vested balance of at least $2,000 to take a loan. For that reason, setting a minimum threshold that is higher than $1,000 is generally considered discriminatory, because it impacts lower paid employees more than higher paid ones. It is not uncommon for a plan to set a lower minimum of maybe $500; however, a lower threshold usually means more loans.

Number of Loans

The law does not impose a maximum beyond the amounts noted in the previous section. That means a plan could allow a participant to have five, ten or an unlimited number of loans at one time as long as the total remains within the amount parameters. In practice, however, many plans limit participants to only one or two loans at a time to minimize the administrative burden or to keep participants from using the plan as a revolving account.

One area where this requirement might not be as straightforward relates to refinancing of existing loans. Similar to mortgages, participant loans can be refinanced if the plan permits. The loan regulations describe refinancing as consisting of two loans at the time of the transaction—the replacement loan and the replaced loan. This means that unless the loan policy has overriding language, a participant with an outstanding loan is prohibited from refinancing that loan if the plan has a one-loan-at-a-time limit.

Interest Rate

Regulations indicate that the interest rate on a participant loan must be similar to what a commercially reasonable rate would be for a loan of similar terms. For convenience, many plans set the interest rate as a factor of the published prime rate, e.g. prime +1% or +2%. The IRS has indicated that this method is not a "safe harbor"; however, if you check with commercial lending institutions, the going rate for a fully secured loan seems to be in that general range.

Even though prevailing interest rates are subject to change over time, participant loans are not variable rate loans. In other words, the interest rate is fixed at the time the loan is issued and remains at that level through the life of the loan.

Amortization

The maximum length of time a participant loan can be outstanding is five years. There is an exception for a loan the participant intends to use to purchase his or her primary residence (not a second home or vacation home). In that case, the duration is sometimes limited to the length of the first mortgage on the home, but many plans limit it to only 10 or 15 years. It is not unusual to stick with the same five-year limitation for all loans so that there is no need to collect further documentation to support the longer amortization.

Other Repayment Terms

There are a few other repayment terms that are important:

Method: The law doesn't really impose any restrictions here, but plans typically require participants to repay their loans through payroll deduction. Since plan fiduciaries are responsible to ensure timely collection of amounts owed to the plan, using payroll deduction helps ensure timely and proper repayment. It is possible to accept other forms of payment such as personal check or certified funds; however, since an insufficient funds issue can create significant administrative headaches, any additional payment flexibility is typically limited only to former employees and only to money order or certified check.

Employment Termination: Speaking of a participant terminating employment with an outstanding loan, each plan can determine the repayment terms in that situation. If payroll deduction is the normal form of payment, a plan may have an "acceleration" clause that requires the participant to repay the entire loan in full. Alternatively, the former employee could, as noted above, be permitted to submit regularly scheduled payments via some other method. Regardless of the option selected, if the former employee does not make timely payments, the entire outstanding balance of the loan is treated as a distribution, subject to regular income tax and an early withdrawal penalty if the individual is younger than age 59½.

Frequency: Regulations say that level payments of principal and interest must be made at least quarterly. Since payments are usually made through payroll deduction, the amortization typically follows the employer's payroll schedule, e.g. biweekly, semi-monthly, etc.

Taxation: Retirement plan contributions receive special tax treatment at the time of deposit. As a result, loan repayments are made on an after-tax basis. This is true regardless of whether the loan proceeds were issued from pre-tax or Roth sources.

Documentation

Participant loans must be documented. It might be via a printed and signed agreement, or it may be via electronic documentation and consent. Either way, the documentation must be in writing. One reason for this is that regulations require participant loans to be enforceable under state law, and state laws generally require any sort of "commercial" loan to be written.

Conclusion

As you can see, there are quite a few moving parts to participant loans. Fortunately, most of them are pretty easy to follow once you are aware of them. It is worth noting that these rules are designed to protect plan assets from misuse and preserve tax-favored retirement benefits. As such, the IRS and DOL both tend to enforce those rules in a rather strict, black-and-white sort of way.

It might be tempting to "help" a participant who needs a little more than what is available or wants to discontinue payroll withholding. But, since following the loan rules is an all-or-nothing prospect (at least from a compliance perspective), what is intended to help a participant could actually result in significant taxes and penalties to him or her as well as the plan. By proactively considering each of these provisions, having a clearly documented loan policy and communicating it to participants, a loan provision can be smooth sailing.

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