Participant Loans from A to Z

Making Retirement Plans Work

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Robert M. Kaplan, CPC, QPA, CFP, APA
National Training Consultant
Voya Financial

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Agenda

- Basic Rules
- Bankruptcy
- Depositing Repayments
- $10,000 Rule
- Leave of Absence
- Deemed Distributions
- Offsets
- Refinancing
- Procedure Issues
- Loan Debit Cards
- Questions??

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Basic Rules

- Plan provision and loan program
  - Check the document for terms
  - This session will discuss the regulations but the plan can be more restrictive
- Must be operated in a nondiscriminatory manner
- Must be secured by a loan note and an amortization schedule provided

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Advantages

- Encouragement to defer?
- Repay amounts to plan (not so with hardships or other distributions)
- No tax impact if loan is repaid
- For any reason – easier than getting loans from commercial lenders

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Disadvantages

- Taxable if not repaid (no withholding like other distributions)
- Plan termination
- Lower take-home pay

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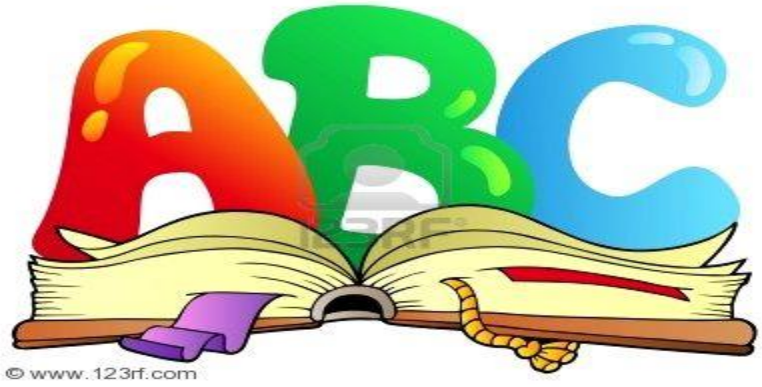
Basic Rules

- Minimum – cannot be higher than $1,000
- Maximum – Lesser of 50 percent of vested account balance or $50,000 (offset by highest outstanding loan amount in prior 12 months)
- Two questions:
  - Are you getting adequate information in takeover situations?
  - Does your plan limit the number of loans allowed?



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Basic Rules

- Duration – maximum of five years (60 months) unless for principal residence
- Plan can set duration to be less than 60 months
  – Many do to avoid taxable event if loan goes over 60 months
  – Many set at 54, 56, or 58 months
- Principal residence can set limit to "reasonable"
  – Is it reasonable to expect employee to be here past retirement date or for 15 or 30 years?
  – Many plans don't offer these types of loans as a practical matter

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Basic Rules

- Interest rate – general prevailing rate
- Prime plus one or two percentage points?

Basic Rules

- Source
  - Documents should indicate from WHERE the loan is being distributed
    - Deferrals, match, non-elective, rollover?
    - Pro-rata?
  - This could be important if the loan is defaulted and want to offset (to be discussed later)

Basic Rules

- Optional plan provision
  - One industry study I read mentioned that about 88 percent of 401(k) plans have a loan provision
  - It is not a protected benefit and thus can be amended out of plan
  - It's a good idea in annual plan reviews with client to see if they want to consider elimination -- they probably won't but they may not be aware of the possibility
  - Takeovers or during mergers/acquisitions is a good time to review also

Basic Rules

- Failure to follow repayment terms may be a taxable event to participant
- Failure to follow plan document may be a disqualifying event for plan sponsor
  - Can be fixed under EPCRS

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Bankruptcy

- If a participant declares personal bankruptcy – do the participant loan repayments continue?

Bankruptcy

- If a participant declares personal bankruptcy – do the participant loan repayments continue?
- "Yes"
  - The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

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Bankruptcy

- Can I take a participant loan, place it all in a bank account, declare bankruptcy, and have it protected?

Bankruptcy

- Can I take a participant loan, place it all in a bank account, declare bankruptcy and have it protected?
- "No" – per California court case Friedman versus Broach

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Bankruptcy

- What if the participant wants to stop repaying loan (they understand the tax consequences) – can they ask to have salary reduction repayments stopped?

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Bankruptcy

- What if the participant, who declares bankruptcy, wants to stop repaying loan (they understand tax consequences) – can they ask to have salary reduction repayments stopped?
- "No" – Section 523(a)(18) of 2005 bankruptcy law does not discharge the obligation of a participant to a retirement plan

Depositing Repayments

- Salary reduction repayments for participant loans (as well as elective deferrals) must be made “as soon as administratively feasible”
- Small plans (under 100 lives) may rely on the regulations for elective deferrals that have a seven-business-day safe harbor

$10,000 Rule

- Maximum loan amount
- $50,000 or 50 percent
- Don’t forget to look at the document to see if $10,000 rule applies
- Loan can be greater than 50 percent and up to $10,000 if vested account balance is enough
- But only 50 percent of vested account balance may be used as collateral

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$10,000 Rule: Example

- Vested Account Balance = $12,000
- Loan can be up to $10,000
- But, collateral can only be 50 percent of the vested account balance
  - $6,000
  - Therefore, $4,000 in collateral would have to be from other assets

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Leave of Absence

- Suspensions
  - Plan may allow a suspension of repayments for up to 12 months as long as it does not go beyond original five-year period
    - Approved leave (maternity for example)
      - Strikes do not count as approved leave
    - Layoff
    - Note: interest still accrues

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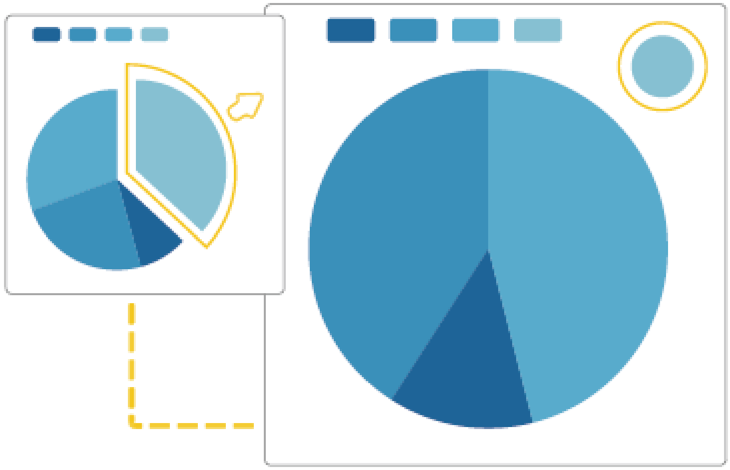
Leave of Absence

- Suspension Example
  - Five-year loan taken on 7/1/13
  - Final payment 6/30/2018
  - Suspended 7/12/16
  - Reinstated 7/12/17
  - Must recalculate interest from 7/12/16 – because no payments made
  - Either balloon payment on 7/12/17 for missed payments plus interest, or
  - Re-amortize from 7/12/17 to 6/30/18



Leave of Absence: USERRA

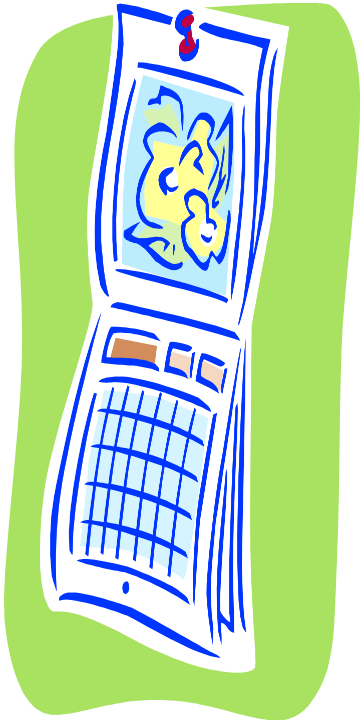
- Suspensions
  - USERRA – may extend beyond five-year period for the time on active duty
  - Interest still accrues
  - Interest rate may be capped at six percent during military duty <u>if requested by participant</u>

Leave of Absence: USERRA

- Example
- Loan taken 7/1/13
- Final payment due 6/30/18
- Activated on 7/1/16 for two-year commitment
- Loan recommences on 7/1/18 and is not payable until 7/1/2020
- Note: option to continue payments and not extend time (no additional interest accrues)

Deemed Distributions

- Cure period for missed payments – last day of the calendar quarter following the missed payment
  - Payment due – April 28, 2016
  - Cure period ends September 30, 2016
- Plan could default payment sooner – see loan policy



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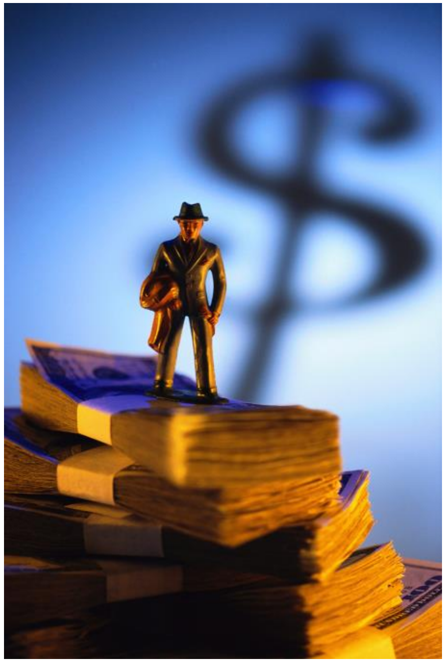
Deemed Distributions

- Deemed distribution for tax purposes = principal and interest until the <u>default</u> date
  - Therefore total taxable amount is more than just the total of the missed payments
  - In example on prior slide, the default date is September 30th not April 28th
- Included as ordinary income in year defaulted
- Ten percent penalty under age 59½



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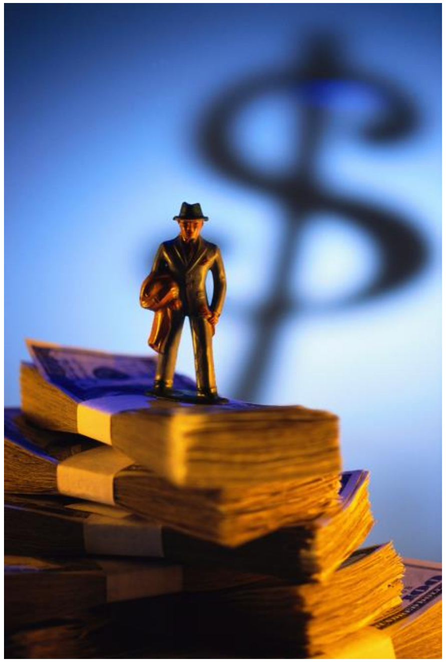
Deemed Distributions: Form 1099R

1099R – From 2016 Instructions

Deemed distribution. If a loan is treated as a deemed distribution, it is reportable on Form 1099-R using the normal taxation rules of section 72, including tax basis rules. The distribution also may be subject to the ten percent early distribution tax under section 72(t). It is not eligible to be rolled over to an eligible retirement plan nor is it eligible for the ten-year tax option. On Form 1099-R, complete the appropriate boxes, including boxes 1 and 2a, and enter Code L in box 7. Also, enter Code 1 or Code B, if applicable.



Deemed Distributions

- Most plans use payroll withholding to simplify the procedures and ensure that the payments will be made timely
  - Is there a conflict with state labor laws?
- If the payroll department fails to set up the withholding – it can still be a problem for participant (Leonard versus IRS)
  - There is an EPCRS correction

Deemed Distributions

- Defaulted loans
- Don't accrue interest, except
  - To calculate loan maximums for additional loan
  - To repay with after-tax dollars
  - Yes, loans are still due and payable even after a taxable event
  - But 5500 reports the default amount until it is offset

Deemed Distributions: Roth

- Roth defaults will never be considered a “qualified distribution,” thus the earnings will be taxable and subject to a ten-percent penalty, if applicable

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Offsets

- Loan is offset from the participant account only at the time that a participant has a distributable event
- Depends on source
  - Age 59½
  - Termination of service
  - Termination of plan
  - Two-year rule or five-year rule for employer $
  - Rollover

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Default or Offset

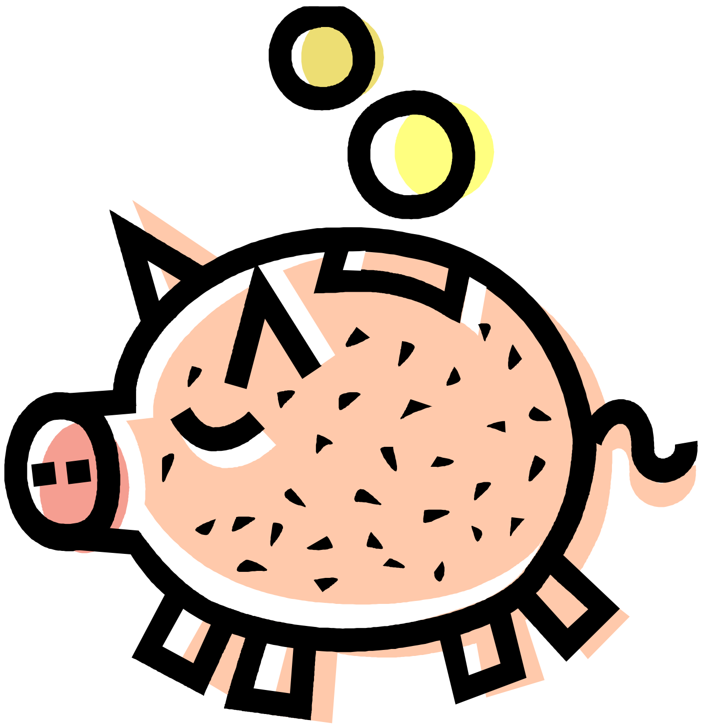
- Same participant who defaulted takes another participant loan
  - Require payroll withholding, or
  - Require additional collateral

Refinancing

- Only if allowed by plan
- Reasons
  - Interest rate
  - Frequency of payments
  - Extend loan to statutory allowable (three-year loan extended to full five years)
  - Additional funds

Refinancing

- Replacement loan is treated as a new loan for
  - Re-determine interest rate and maximum limits

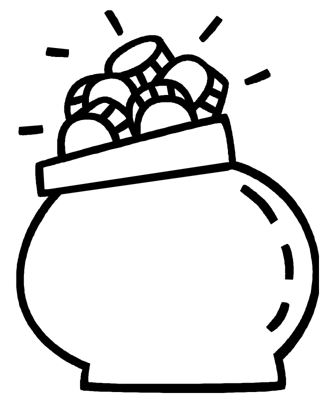


Refinancing

- If new loan repayments extend beyond original five-year payment period, then both the new and old loans will need to be taken into account for the maximum loan amounts

Refinancing: Example 1

- Old loan = $11,000
- New loan = $18,000
  - Repay old loan and receive additional $7,000
  - New loan payable over a five-year period <u>re-starting now</u>
- Total loans = $11,000 plus $18,000 = $29,000



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Refinancing: Example 2

- Old loan = $11,000
- New loan = $18,000
  - Repay old loan and receive additional $7,000
  - New loan will be repaid within the original five-year period of the old loan
- Total loans = $18,000
  - You do not have to combine the two limits

Refinancing: Example 3

- Old loan = $11,000
- New loan = $18,000
  - Repay old loan and receive additional $7,000
  - New loan will be not repaid within the original five-year period of the old loan
  - Same result as taking a separate loan
- However, repayments will reflect $18,000 amortization until old loan five-year period is up and based on $7,000 loan until new five-year period is up
  - Result is same as taking a new $7,000 loan, but it is accomplished in one loan and not two

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Procedural Issues

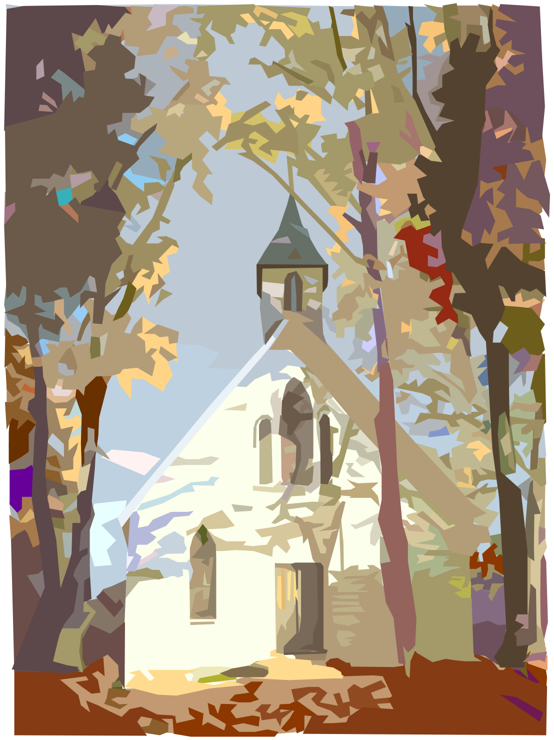
- Spousal consent – required when plan is subject J&S rules
- QDRO – loan is not assigned to alternate payee – it remains in entirety to the participant

Procedural Issues

- Rollovers of loans allowed if:
  - Distributing plan allows and in-kind distribution
  - Receiving plan allows loans
  - Receiving plan allows rollovers
  - Receiving plan allows rollovers of loans
  - Note: Loans may not be rolled to IRAs (including SIMPLE or SEP IRAs)

Redemption
Revenue Procedure 2013-12

- Must file under VCP for correction of loan operational errors
  - No self-correction
- Corrections must come within original five-year period of the affected loan



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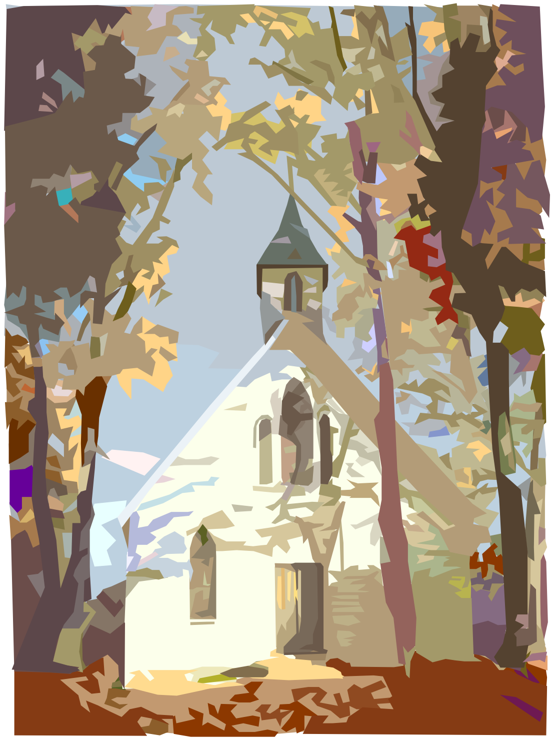
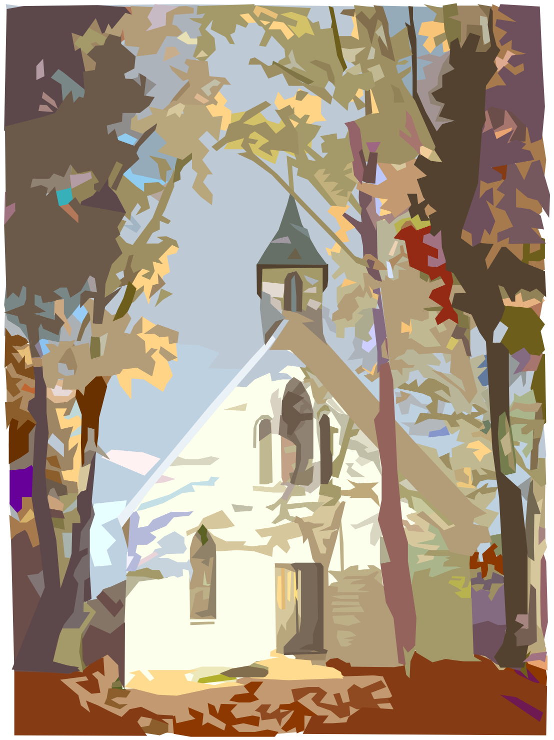
Redemption
Revenue Procedure 2013-12

- Corrections:
- Duration longer than five years
  - Re-amortization to correct amounts to reflect the correct period



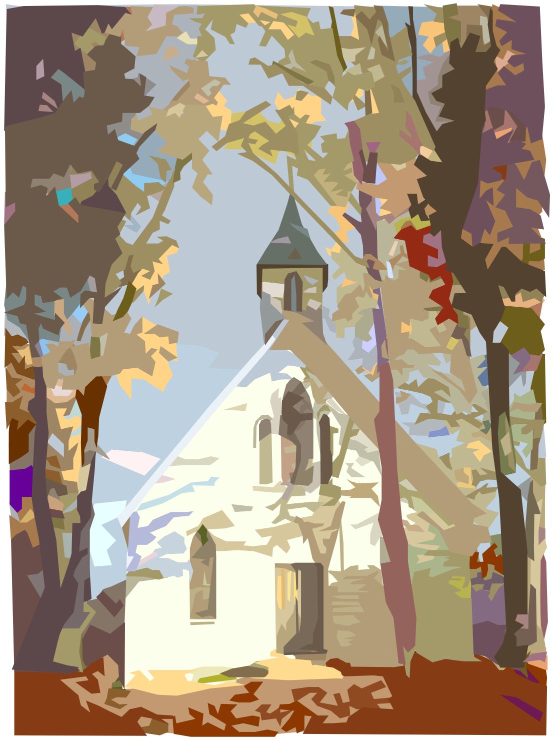
Redemption
Revenue Procedure 2013-12

- Corrections:
- Default on loan
  - Balloon amount for missed payment or
  - Re-amortize remaining payments



Redemption
Revenue Procedure 2013-12

- Corrections:
- Exceed maximum
  - Repay excess
  - All payments go to pay off corrected loan amount and interest on excess



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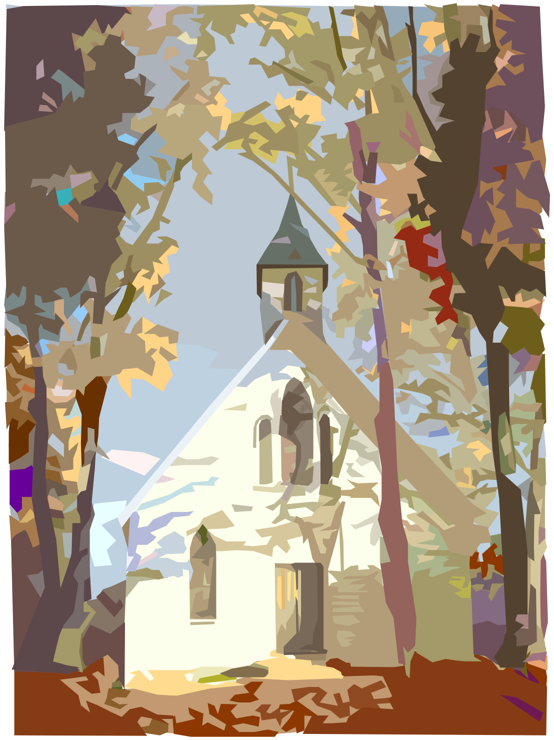
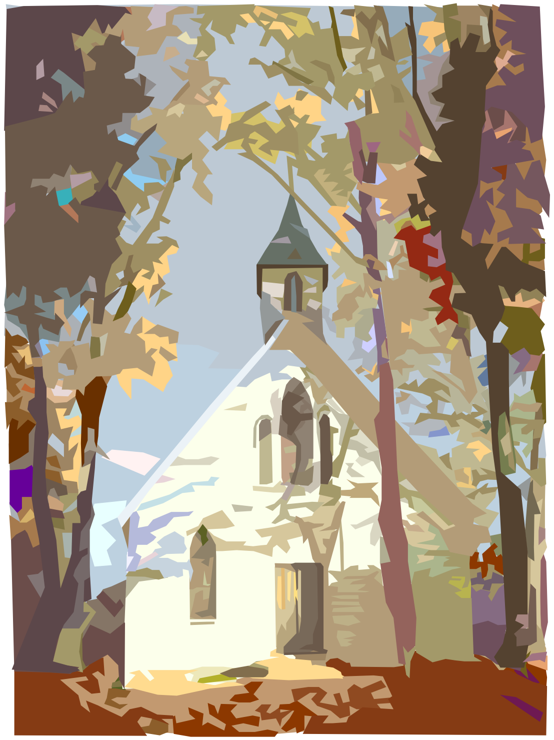
Redemption
Revenue Procedure 2013-12

- Corrections:
- Document failure
  - VCP
  - Maybe SCP for amendment
  - Check with ERISA counsel



Redemption: Fee for VCP Revenue Procedure 2015-27

- Number of participants with loan failures and compliance fee
- 13 or fewer: $ 300
- 14 to 50: $ 600
- 51 to 100: $1,000
- 101 to 150: $2,000
- Over 150: $3,000



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Questions?

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50 YEARS OF MAKING RETIREMENT PLANS WORK

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