Participant Loans in Retirement Plans – Part 2

The first installment of this series outlined the rules that apply to loans from qualified retirement plans, and identified pros and cons associated with allowing this feature in a retirement plan. As a plan administrator, you need to be aware of the more technical aspects related to participant loans, such as recent tax law changes affecting terminated participants with an outstanding loan balance, suspension of loan repayments, and suggested best practices to avoid mistakes.

Tax Cuts and Jobs Act

Prior to the passage of the Tax Cuts and Jobs Act, an employee who terminated employment with an outstanding loan balance generally had three repayment options:

- Pay back the loan,
- Offset the loan balance with a taxable distribution from their account, or
- "Roll over" the loan by contributing the amount of the unpaid loan balance to an IRA within 60 days of termination of employment.

Effective for tax years beginning in 2018, the new tax law now extends the rollover deadline from 60 days to the due date of the individual's tax return, including extensions for the year in which the plan offsets the loan. By allowing additional time to avoid a taxable event, the intended impact of this change is to reduce the number of defaulted loans.

For example, assume an employee with an outstanding loan balance terminates employment on May 1, 2018. Prior to the new law, the employee had a 60-day deadline, or July 2, 2018, to accomplish the rollover of the loan balance. Now, the employee could deposit the offset funds as late as April 15, 2019 (or October 15, 2019, if an extension is filed).

Suspension of Loan Payments

There are just two scenarios under which the IRS will allow a plan to suspend loan repayments of a participant with an outstanding loan:

1. For an approved non-military leave of absence of up to one year, or
2. For the period during which an employee is performing United States military service.

When the leave of absence ends, the participant must make up the missed payments by the latest date permitted by IRS regulations (i.e., generally five years from the date of the original loan). When payments resume, the amount may be adjusted for the remaining term to cover the missed payments or the participant can make a lump-sum payment at the end.

For participants who incur a leave of absence for military service, the loan will avoid default provided that repayments resume at the end of the service, the payment amount is not less than required under original terms of the loan, and the loan is repaid in full by the end of the maximum loan term ***plus*** the period of military service.

Be sure to check the terms of the plan document and loan policy for specific procedures and requirements related to the suspension of loan payments.

How to Avoid Costly Mistakes

A participant loan must meet several rules to prevent the IRS from treating it as a taxable distribution:

1. The loan must be a legally enforceable agreement,
2. The amount cannot exceed 50% of the vested account balance up to a maximum of $50,000, and
3. The loan terms must require level, amortized payments on at least a quarterly basis not exceeding five years (exceptions apply when the loan is for purchase of a primary residence).

It is important that plans have a process to ensure that the terms of a participant loan and its repayments follow the federal law to avoid taxation to the participant. The plan administrator should develop and implement loan procedures, including:

- A system for determining the maximum available loan amount.
- A written policy to determine loan terms (e.g., criteria used to determine the loan's interest rate).
- Written, enforceable loan agreements.
- Procedures to provide for a "cure" period to correct missed payments.
- Documentation for exceptions to general rules (e.g., loans exceeding five years for a primary residence).
- Procedures for ensuring timely repayment (e.g., automatic payroll deductions).

Conclusion

Retirement plan loans are popular for many reasons. They can often be the quickest, simplest, lowest-cost way to get the cash a participant needs while avoiding a taxable event with no impact on the participant's credit rating. However, loans are also subject to strict rules that can result in painful taxes or penalties, affecting employees and plan sponsors alike, when violated.

If you would like additional information on your plan's existing loan policy, the implementation of loan provisions, or consultation on potential mistakes requiring correction, please contact your relationship manager or First American Bank's Retirement Plan Services Group at 847-392-2999 or RSAdmin@firstambank.com.

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