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When Good Loans Go Bad

The economic environment of the last few years created financial challenges for individuals and businesses alike. Even though the worst of the recession appears to be behind us now, some of those financial challenges have had a ripple effect that continues to show itself. One area where that is especially true relates to the loans participants took from their 401(k) plans. Economic pressures certainly brought about an increase in loans, but it also caused some participants with loans to have trouble repaying them.

Background

A quick review of the rules that govern qualified plan loans may help to provide some context. The Employee Retirement Income Security Act (ERISA) prohibits plans from loaning money to related parties, including participants, unless certain requirements are satisfied. The Tax Code also has its own rules that parallel and supplement those found in ERISA. In other words, loans start bad and must be made good.

Here is a quick overview of some of the key requirements for making a bad loan good.

- **Amount:** The maximum loan a participant can take is 50% of his or her vested account balance up to $50,000 (reduced by the highest outstanding loan balance in the immediately preceding 12-month period).
- **Duration:** A participant loan cannot be amortized for more than five years. There is an exception, however. If the participant will use the loan to purchase his or her primary residence, the plan can allow the loan to be amortized for longer than five years.
- **Payments:** Loans must have a level amortization with payments of principal and interest made at least quarterly.
- **Interest:** Loans must use an interest rate that is reasonable in light of what a commercial lender would charge for a similar loan.
- **Enforcement:** A participant loan must be an enforceable agreement under state law. This translates into a requirement that the loan be in writing.
- **Documentation:** The plan document must specifically authorize participant loans. It must also include (either within the document or through a separate written policy) the above parameters and require that all loans remain within those parameters.

The above rules are “bookends” of sorts. A company may choose to further limit its loan provisions but it cannot go outside of the bookends. For example, many plans limit a participant to only one loan at a time or establish a minimum loan amount of $1,000. Another common provision is to require loans to be amortized according to the company’s payroll schedule and

payments to be through payroll deduction. A plan that chooses to impose restrictions must follow those limitations even if the bookends would allow more liberal treatment.

In order for a bad loan to go good, it must satisfy all of these rules.

Going to the Dark Side

Just as bad loans can be made good, good loans can go bad if, at any time during their duration, they fail to satisfy any one of the rules…no matter how insignificant or well-intentioned the oversight might seem. This can lead to taxes, penalties and administrative burdens for both the plan and the participant.

Before delving into some of the ways loans can go bad, let's define a few terms.

Default

When a participant misses a regularly scheduled loan payment, the loan goes into default. This is almost like loan purgatory; some sort of correction is required but the loan has not yet reached the point of no return.

Cure Period

The loan regulations provide for a "cure period" for making up a missed loan payment. It extends through the end of the calendar quarter following the quarter in which the default occurs. In other words, once a participant misses one or more payments, he or she has until the end of the following quarter to make up the shortfall along with accrued interest to cure the default and prevent a deemed distribution.

Deemed Distribution

This is when some or all of the outstanding balance of a loan is treated as a taxable distribution to the participant. This can occur either when a defaulted loan is not cured by the end of the cure period or when a loan is otherwise defective in some way.

There are two aspects of deemed distributions that are often overlooked.

- There is no action required to trigger the tax liability. Just like a person's paycheck is subject to income tax regardless of whether they get a W-2 at the end of the year, a deemed distributed loan is taxable even if no one takes steps to report it on a Form 1099-R. If the participant does not report the amount in question on his or her income tax return, it could generate additional penalties and interest for underpayment of income tax.
- A deemed distribution does not extinguish the participant's obligation to repay the loan. In other words, a deemed distributed loan is taxable (and may include a 10% early withdrawal penalty), but the participant must still repay it. To make matters worse, those post-deemed-distribution loan payments create tax basis in the plan and must be tracked as a separate money source on the recordkeeping system.

Offset

A deemed distributed loan continues to be included as a plan asset until the participant in question has a distributable event, usually termination of employment. At that time, the outstanding balance is offset and reported on the plan's financial statements as an actual distribution.

Examples of Good Loans Gone Bad

Now that we have reviewed the rules and defined some key terms, it is time to review some of the more common situations that can cause a good loan to go bad.

Loans Not Permitted

Plans are not required to offer loans but those that wish to allow loans must be sure the appropriate provisions are included in the plan document and/or separate written loan policy. Plan sponsors may believe they are helping a participant in need of cash by approving a loan request without going to the formality of amending the plan document; however, issuing a loan when the plan does not allow it results in a loan that never becomes good. The full amount of the loan is immediately deemed distributed.

Generally, a plan can offer loans at any point during the year as long as an amendment is adopted by the end of that year to add the necessary language to the plan document. However, once the year closes, there are fewer options for correction.

Refinancing Not Permitted

When homeowners wish to change their mortgage to get a lower interest rate or borrow additional money, they do so by refinancing their mortgage. Participant loans operate the same way. In order to change the terms of a loan, the participant must refinance it. The trick is that not all plans permit refinancing. Furthermore, inability to refinance is not always crystal clear.

Consider a plan that permits loans but restricts participants to only one loan at a time. IRS regulations (and the U.S. Tax Court) look at certain refinancing transactions as consisting of two loans—the replacement loan (the new one) and the replaced loan (the old one). Therefore, the refinance transaction violates the one loan at a time limit, and the replacement loan is a deemed distribution. This can be addressed by amending the loan provisions to specifically permit refinancing or to allow multiple loans.

Loan Term Too Long

If a loan is amortized for longer than permitted, it is defective from the moment it is issued and the entire amount is a deemed distribution. A common example of this is when a plan issues a general purpose loan for longer than five years. Since that is a regulatory limit, this type of defect cannot be remedied by amending the plan to allow a longer amortization.

On the other hand, if a particular plan elects to limit all loans to only five years but issues a residential loan with a longer amortization period, it may be possible to amend the plan within the time frame described above.

Payments Never Started

Sometimes a participant takes a loan that is to be repaid by payroll deduction, but the payroll system does not get set up to begin withholding payments. Although there is some latitude, payments should begin within one or two pay periods following issuance of the loan. If that does not occur, the loan goes into default. Unlike the previous examples, this does not cause the entire loan to be defective. Rather, the participant has until the end of the cure period to get principal and accrued interest payments up to date and avoid a deemed distribution.

Payments Voluntarily Suspended or Discontinued

In other circumstances, a participant with a loan determines that he or she can no longer afford to make payments and asks the company to stop withholding on a temporary or permanent basis. Some employers may be inclined to help an employee in that situation by agreeing to the request. Unfortunately, doing so causes the loan to default (and maybe become a deemed distribution), and it also subjects plan fiduciaries to liability for breaching their responsibility.

Even though the participant is borrowing from his or her own account balance, the loan is still considered an asset of the plan. By voluntarily discontinuing the withholding of payments, the plan sponsor fails to enforce a legal agreement between the plan and the participant and allows a plan asset to decrease in value.

Coming Back to the Light

Fortunately, many loans that have crossed over can be brought back to the light. The IRS Employee Plans Compliance Resolution System (EPCRS) includes a series of voluntary correction mechanisms, including several for participant loans. Generally, defective loans are corrected by reforming them so that they comply with the applicable rules. Depending on the circumstances, other correction options may also be available. This could include retroactively amending a plan (effective in a previous year) to permit a loan that was issued in error.

Unlike other types of oversights, EPCRS does not permit self-correction. In other words, bringing a bad loan back from the dark side requires submitting documentation of the correction to the IRS for their approval.

Conclusion

As you can see, the participant loan rules can be challenging even in good economic times. With all of the potential missteps that can occur, it is important to work with knowledgeable service providers that have strong checks and balances designed to properly administer participant loans. By also implementing similar controls internally, plan sponsors can make sure that good loans don't go bad.

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