Retirement Plan Loans and Other In-Service Distributions: Do You Really Want to be Your Employee's Banker?

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Retirement Plan Loans and Other In-Service Distributions: Do You Really Want to be Your Employee's Banker?

- Other than terminating employment, how can a participant get access to their retirement account:
  - In-service distributions
  - Hardship distributions
  - Loans

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- What is an in-service distribution?
  - It is a distribution that a participant receives from a retirement plan while still employed
  - Distributions may be available after the participant reaches their retirement age or even before, if certain conditions are met
  - It is an optional feature – plans need not allow them

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- Can there be in-service distributions from a pension plan?
  - Generally not allowed because they are inconsistent with the purpose of the plan – providing retirement benefits
  - The IRS will allow in-service distributions if the participant has attained age 62

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- Can there be in-service distributions from a profit sharing plan or the employer contribution component of a 401(k) plan?
  - With regard to employer contributions in-service distributions are permitted if the participant meets the specified conditions

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- The plan can not merely allow participants the right to request distributions at any time
- Employers must balance the purpose the plan was established for against facilitating participant needs/desires

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- What are the common conditions established for in-service distributions?
  - Attaining normal retirement age, but continuing to work
  - Attaining a specified age (before the normal retirement age) – i.e. age 59 ½

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- The participant encountering a situation that meets the 401(k) hardship distribution rules
- The participant encountering an "emergency" – much lower standard than a hardship
- Other conditions such as completing "X number of years of participation" or "amounts that have been in the plan for at least Y number of years"

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- Other considerations for in-service distributions
  - Amounts can be rolled to other plans or IRAs – may give the participant other investment options
  - Amounts not rolled are taxed, subject to withholding and possible penalties
  - If partial in-service distributions are allowed, there will be likely be limits on their frequency

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- What's so important about 401(k) plan hardship distributions?
  - Generally there is an absolute prohibition against in-service distributions of employee deferrals in a 401(k) plan prior to age 59 ½
  - The limited exception to this general rule is for "Hardship Distributions"

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- This is a "big casino" issue – if an employer does not administer the hardship distribution rules properly the plan can lose its tax qualified status
- This is an optional provision although most 401(k) plans offer them

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- What are the requirements to qualify for a hardship distribution
  - The distribution must be for a participant's "immediate and heavy financial need"
  - The amount distributed may not exceed the amount needed to satisfy the hardship

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- All other sources must be exhausted before a hardship distribution may be made
- The employer must maintain the necessary documentation

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- What are the situations/events that must exist to qualify as an "immediate and heavy financial need"
  - Unreimbursed medical expenses deductible under Internal Revenue Code Section 213(d) for the participant or the participant's spouse, dependents, or beneficiaries
  - The purchase of a principal residence

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- Tuition and related educational fees and room and board expenses for up to the next 12 months of post-secondary education for the participant or the participant's spouse, children, dependents, or beneficiaries
- To prevent eviction from or foreclosure on the principal residence

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- Funeral expenses for the participant or the participant's spouse, dependents or beneficiaries
- Expenses for the repair of a principal residence due to hurricane, flood, and other casualty deduction reasons

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- Amount that may be distributed for a hardship distribution
  - Limited to employee deferrals, but not the earnings on those employee deferrals
  - The hardship distribution may also include the taxes and penalties (if applicable) on the distribution

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- What other sources must be exhausted before a hardship distribution is available
  - Insurance or other methods of reimbursement
  - Personal savings
  - Plan loans (unless it prevents a third party loan or the take home pay would be lowered too much
  - Other in-service distributions available under the 401(k) plan or other plans

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- What has been the IRS' position regarding the documentation that is needed by an employer for a hardship distribution
  - Regulations have suggested that the employer must obtain the underlying legal and financial documents before the distribution is made
  - Medical bills, tuition statements, eviction or foreclosure notices

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- Other employers have believed that a participant may simply self certify the hardship
- Without the proper documentation the plan could lose its tax qualified status

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- What has the IRS done recently to help clarify what documentation is needed
  - The IRS earlier this year issued a memorandum to its auditors confirming that self certification is acceptable if the requirements are met
  - While the memorandum doesn't have the effect of law it should give comfort to employers and third party administrators

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- The first requirement is for the self certification to contain certain specified information
  - Participant's name
  - The total cost of the event causing the hardship
  - The amount of the distribution request
  - Certification that the information is true and correct

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- Certain additional information specified in the memorandum based on the type of hardship (i.e. address and purchase price for purchasing a principal residence)
- If more than 2 hardship distributions are requested in a plan year, the employee must also explain why multiple distributions were requested

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- Note that if the auditor determines that the summary is inadequate they may still request the underlying documents
  - Participants are required to maintain the underlying documents
  - Participants must provide them to the employer or TPA on request

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- Retirement plans are not required to provide for plan loans
  - Optional for most plans
  - Generally permitted in 401(k) and 403(b) plans
  - Not permitted in SEPs, SIMPLE-IRAs

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- Both IRS and DOL have jurisdiction
  - IRS rules deal with taxability
  - DOL rules deal with prohibited transaction

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- Where are the rules governing plan loans found?
  - The plan document
  - The summary plan description
  - The loan procedure

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- What is the maximum loan available?
  - Lesser of $50,000 or 50% of vested account balance
  - Employers may set lower limits

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- What is the maximum repayment term?
  - Generally no more than 5 years
  - A reasonable period if used to acquire a principal residence

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- How must the loan be repaid?
  - Amortized ratably over the term
  - Installments must be made at least quarterly

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- What constitutes "adequate security"?
  - Most 401(k) plans use 50% of vested account balance
  - Other assets could be used instead

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- What constitutes a reasonable interest rate?
  - Comparable to the rate charged on a commercial loan
  - As a practical matter, it is generally prime plus 1% or 2%

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- What happens if there is a default in repayment?
  - Maximum grace period ends on the last day of quarter following the quarter of default
  - Form 1099 issued and loan becomes taxable and could be subject to the 10% penalty for early distributions

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- Is interest paid tax deductible?
  - If secured by participant deferrals, no
  - If made to most owners and officers, no

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TOP TEN REASONS WHY

YOU DON'T WANT

***TO* BE YOUR EMPLOYEE'S BANKER**

AND ALLOW PLAN LOANS

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#10

If there is a default, the loan becomes taxable and possibly subject to a 10% excise tax on early distributions.

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#9

If employer terminates the plan, the loan likely becomes taxable and possibly subject to a 10% excise tax on early distributions.

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#8

If the participant terminates employment, the loan likely becomes taxable and possibly subject to a 10% excise tax on early distributions.

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#7

Borrowing against retirement benefits often creates leakage (reduction of benefits) due to the inability to repay the loan.

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#6

The interest that a participant pays on a plan loan will likely be "double taxed." Since it is not deductible, it is taxed when earned and taxed a second time when distributed from the plan.

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#5

Other loan sources available to employees (an equity line of credit) may be deductible.

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#4

Many plans suspend future deferrals until the loan is repaid.

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#3

The interest rate credited to a participant's account is often less than they would have earned if their account was fully invested.

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#2

Participants have a smaller take home pay because of the likely payroll withholding.

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#1

Ready access to retirement benefits may facilitate impulsive spending for the wrong reason (a new boat, a vacation, etc.).

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TOP TEN REASONS WHY

YOU SHOULD BE

WILLING TO BE YOUR EMPLOYEE'S BANKER

AND ALLOW PLAN LOANS

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#10

There is no income tax consequence for a plan loan that gets repaid.

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#9

There is no 10% premature distribution excise tax for a plan loan that gets repaid.

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#8

It's a "cheap benefit" for most employers since the participants usually bear the cost.

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#7

Since most 401(k) plans allow participant loans, an employer may be perceived as taking away an "entitlement" if plan loans aren't offered.

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#6

The costs of borrowing from a retirement plan are often less than from a commercial lender.

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#5

Participants may be uncomfortable attempting to qualify for hardship distributions from 401(k) plans, not wanting to disclose to their employer personal hardship situations.

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#4

If the loans get repaid there is no "leakage" of retirement benefits (thereby maximizing retirement benefits) that may otherwise occur if the plan provides for hardship distributions or other in-service distributions.

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#3

Participants will appreciate the ability to borrow funds without jumping through all of the hoops that a commercial lender may require.

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#2

Without a plan loan opportunity, employers face the prospect of good participants terminating employment simply to get access to their accounts.

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#1

Participants will feel more comfortable deferring amounts in the employer's 401(k) plan if they have a reasonable expectation of those amounts being made available to them in a time of need.