# Managing D

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# C Plan Loans

Plan loans are an optional means of early access to defined contribution account balances, but they come with risks to both plan sponsors and plan participants.

Plan loans are a common provision in many defined contribution (DC) retirement plans, particularly 401(k) plans, with surveys showing that two-thirds to 90% of plan sponsors offer them.[1]

According to the Vanguard *How America Saves 2019* report, 13% of 401(k) plan participants had loans outstanding in 2018 compared with 17% in 2014, and the average loan balance was $9,900.

About 68% of organizations surveyed offer loans in their 401(k) plans, according to the International Foundation of Employee Benefit Plans 2018 *Employee Benefits Survey.* Close to 80% of corporations offer loans, and nearly 35% of multiemployer plans offer them.

While these loans can be attractive for participants who lack other means for borrowing money, they create risks for both the participant and the plan sponsor.

This article will describe the regulations that plan loan provisions must comply with, and it will discuss the pros and cons of offering plan loans.

## Defined Contribution Plans: Another Pillar to Support Retirement

Before diving into the x's and o's of plan loans, it is worth taking a moment to consider how DC plans fit into the retirement landscape. In the earlier days of pension plans, defined benefit (DB) plans largely stood alone as the primary nongovernmental income source upon retirement. Postretirement health care coverage was also commonplace, and it usually came with little to no ongoing costs to the retiring plan participant. However, times have changed.

Today, many people approaching retirement do not have a DB plan. Even amongst those who do, DC plans can serve as a significant additional stream of income at retirement alongside any traditional DB pension and Social Security.

DC plans also offer something else that is unique—options for accessing the account balance prior to reaching retirement age. These options take the form of hardship distributions and plan loans. And while both can be of great value to plan participants, they are not without risk.

Although hardship distributions are not the focus of this article, they can be offered only by 401(k), 403(b) and 457(b) plans and are limited by law for the purpose of "an immediate and heavy financial need." Loans, on the other hand, don't have statutory restrictions for the reason they are used, although plan sponsors may choose to limit allowable reasons.

## How Do DC Plan Loans Work?

A loan provision allows participants to "borrow" up to 50% of their own vested account balance. As a result, there are no credit checks for the member. Technically, DC plan loans are not loans at all, since participants are accessing money in the trust that is attributable to their individual accounts. The loan is repaid (with interest) to members' accounts through payroll deduction. Loan terms are set by the plan document, but these terms (explained below) are governed by the Internal Revenue Code (IRC). The plan sponsor also sets the interest rate—Prime plus 1% is typical. The theory behind charging interest on the loan is that it can make up for lost earnings in the plan investments. Most plans charge loan origination and annual maintenance fees. It is important to note that loan payments and interest are paid with the participant's after-tax dollars.

Plans can allow participants to have multiple loans outstanding at one time. The Plan Sponsor Council of America (PSCA) *61st Annual Survey of Profit Sharing and 401(k) Plans* showed that more than half of plans (about 56%) allow participants to have only one loan outstanding at a time. Larger plans (more than 1,000 employees) are more likely to allow two loans, compared with smaller plans.

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Lawrence R. Beebe. International Foundation. 2017.
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## takeaways

- Plan loans can be attractive for defined contribution (DC) plan participants who lack other means for borrowing money, but they create risks for both the participant and the plan sponsor.
- A loan provision allows participants to "borrow" up to 50% of their own vested account balance. There are statutory limits to the reason for borrowing, but plan sponsors may choose to limit allowable reasons.
- Loans are optional features of DC plans. Both the Internal Revenue Code (IRC) and the Employee Retirement Income Security Act (ERISA) have requirements that loans must adhere to.
- The process of implementing and administering plan loans remains a fiduciary function under ERISA. Plan loans are a plan investment and carry the same fiduciary responsibility as any other investment in the plan under ERISA.
- Loans may be a better option for participants than high-interest loans outside of the plan, but early access to retirement funds can have a significant negative impact on a plan member's account balance and eventual retirement benefit.

## ERISA and IRC Compliance Considerations

Loans, like hardship distributions, are optional features of DC plans. Unfortunately, the compliance obligations that come about once loan programs are put into place are not so optional. Loan programs carry with them a good-sized set of legal baggage since both IRC and the Employee Retirement Income Security Act (ERISA) have requirements that must be adhered to. Specifically, IRC contains the following requirements for DC plan loans.[2]

- Loans must be made based on a legally enforceable loan agreement between the trust and the participant.
- Generally, the loans must be repaid within five years (some exceptions exist, such as loans for a primary residence).
- Repayment must be made in substantially level installments (payable at least quarterly) that include principal and interest.
- The loan amount must not exceed the lesser of (a) $50,000, reduced to the extent that the participant's or beneficiary's highest balance for plan loans outstanding during the preceding 12 months exceeds the current balance for plan loans or (b) 50% of the participant's or beneficiary's vested balance (or $10,000, if greater).

ERISA has similar but distinct requirements for plan loan provisions.[3]

- Loans must be made available to all participants on a reasonably equivalent basis.
- The amount (or percentage) of loans made available to highly compensated employees, officers or shareholders must not be higher than that which is available to other participants.
- Loans must be made in accordance with the plan provision that authorizes them.
- The rate of interest charged must be reasonable.
- The plan must require adequate security for the loan (typically the account balance).

Once a loan is taken out, a limited grace period for repayment can be offered. However, the grace period generally cannot extend beyond the calendar quarter that follows the quarter when the payment was due.[4] In addition, if the participant is married, plan sponsors should ensure that requirements are in place to make sure that the spouse has consented to the loan if the plan pays benefits in an annuity form.

In the event that a plan participant defaults on the loan, there is a "deemed distribution" for tax purposes and assessment of a 10% penalty if the participant has not reached age 59½.[5] The plan must also then issue a Form 1099-R for the tax year in which the default occurs.[6] If the plan allows for more than one loan, each loan must satisfy IRC and ERISA requirements.[7] This can be a tricky process, particularly in the multiemployer setting, since payroll deduction (as a method for loan repayment) is usually not available and plan sponsors preferably want to avoid playing loan collector. Plan sponsors also want to avoid having to venture into the Voluntary Correction Program offered by the Internal Revenue Service (IRS) if mistakes are made in administering a loan program. As a result, plan sponsors that are considering (or that currently allow) multiple loans should consult closely with plan professionals to ensure compliant operation.

As previously mentioned, plan loans can generally be taken out for any reason, unlike hardship withdrawals. But, plan sponsors may wish to craft their policies to allow them only in certain circumstances and may also try to limit their usage by making the loan program more restrictive.

According to the 2020 Callan *Defined Contribution Trends Survey*, 32.9% of DC plan sponsors had restructured loan provisions, such as reducing the number of loans allowed or changing loan frequency to prevent plan *leakage* (preretirement withdrawals), and another 17.9% were considering doing so.

Other provisions include a shorter repayment term than the outer limit of five years or making loans available only if a hardship distribution is not. One common way to discourage casual borrowing from the plan is to charge origination fees and annual maintenance fees. Some plans do not allow participants to contribute to the plan while they are making loan payments. The recently passed Setting Every Community Up for Retirement Enhancement (SECURE) Act also prohibits plans from making plan loans through credit cards.

Plan sponsors that place other restrictions on loans, such as financial hardship requirements, should have written procedures to ensure the policies are fairly applied. They may also consider having their plan administrator or another third party make these determinations to mitigate fiduciary liability and remove trustees from the process.

Accordingly, trustees and plan fiduciaries need to ensure that there are written policies and procedures in place to ensure compliance with plan provisions and applicable regulations. Plans should have standardized procedures for application, approval and administration of approved loans. The policy should further set out detailed procedures for how a loan gets paid back (e.g., check, ACH, etc.), for how participants will be notified in the event of default and for the issuance of the proper tax documents if a loan is found to be in default.

Loan defaults are a growing concern in the retirement industry. According to a 2014 Wharton Pension Research Council study, about 90% of all plan loans are paid off on time.[8] However, among workers who are terminated from their jobs, the default rate soared to 86%. Until the Wharton study, there was little knowledge of this problem. IRS now tracks loan defaults due to job loss on the form 1099-R.

## Fiduciary Duties Under ERISA

The process of implementing and administering plan loans remains a fiduciary function under ERISA.

Plan loans are a plan investment and, as such, carry the same fiduciary responsibility as any other investment in the plan under ERISA.[9] The interest being charged on the loan represents the rate of return for the investment.

ERISA requires plan fiduciaries to regularly monitor the loan program and to consider whether it is prudent and in the best interest of all plan participants—not just those who might now or in the future benefit from the loan program.

In addition, plan fiduciaries and trustees must keep in mind that retirement is the primary purpose of the plan, and ERISA requires that plan loans are allowed only if they do not reduce participant retirement benefits. For example, a plan that has a loan program with a very high default rate and where few repayments are ever made arguably distorts this purpose. In that case, plan fiduciaries might rightfully conclude that the program is no longer in the best interest of the plan and its participants and therefore take action to modify or even eliminate it.


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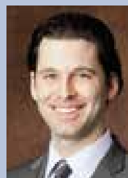

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## Other Considerations for Plan Sponsors

Most benefit programs have advantages and disadvantages, but plan loans carry a unique blend of member and plan sponsor responsibilities. Following are some pros and cons of plan loans.

### *Advantages*

- Plan loans allow members to access money in the plan before retirement, which may encourage participation in the retirement plan. A 2019 study from Custodia Financial and Greenwald Associates found that 91% of participants value their 401(k) loan feature.
- If they are repaid properly and on time, plan loans, notwithstanding the impact they may have on their retirement benefits, may be a better option for a participant than a high-interest loan outside of the plan.
- Plan loans can help members through a difficult financial hardship, such as family illness, without the penalties and taxes associated with a hardship withdrawal. They also may help with the purchase of a home.

### *Disadvantages*

- When participants borrow from the plan, the withdrawn assets are not invested and do not earn returns. This can significantly affect the account balance over time and eventual retirement benefit.
- Loan provisions can be abused. In some cases, early access to retirement funds can make a member's bad financial condition even worse.
- Loans are administratively complex, particularly in a multiemployer environment. As discussed earlier, plan sponsors are ultimately responsible for the correct handling and accounting of loans.
- Plan loan provisions can be difficult to sunset. Some members may view the elimination or alteration of a loan provision as a benefit reduction. In any case, clear, plain-English communications can help participants understand why changes are being made and the reasoning behind them.

## Conclusion

Operating a retirement plan is a complex and multifaceted undertaking. Trustees and plan fiduciaries considering adding a loan program should not rush into the decision but instead take the time to consider both the potential advantages and challenges that plan loans bring. Those that already have a loan program in place may consider conducting a thorough review of the program's design, operation and administration. In addition to identifying any potential areas that need shoring up or corrective action, the process should also provide useful information on the efficacy of the loan program.

## Endnotes

1. Vanguard, *How America Saves 2019:* https://institutional.vanguard.com/VGApp/iip/site/institutional/researchcommentary/article/HowAmericaSaves2019 and International Foundation of Employee Benefit Plans, *Employee Benefits Survey: 2018 Results*: www.ifebp.org/BenefitSurvey2018.
2. IRC Section 72(p)(2)(A); see also Treasury Reg. 26 CFR §1.72(p)-1.
3. 29 CFR 2550.408b-1.
4. Treasury Reg. §1.72(p)-1, Q&A 10.
5. Treasury Reg. §1.72(p)-1, Q&A 11.
6. Treasury Reg. §1.72(p)-1, Q&A 14.
7. Treasury Reg. §1.72(p)-1, Q&A 20.
8. See https://pensionresearchcouncil.wharton.upenn.edu/wp-content/uploads/2015/09/WP2014-01-Lu-OSM-Utkus-Young-2.12.20144.pdf.
9. *Participant Loan Leakage: Protecting Participant Accounts and Reducing Fiduciary Risks,* Bruce Ashton, DrinkerBiddle, 2019.