SHDR
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A PRIMER ON PARTICIPANT LOANS FROM QUALIFIED RETIREMENT PLANS

A participant loan program is a common plan provision in today's qualified plan environment. Studies have indicated higher levels of employee participation in 401(k) plans that include the right to borrow. Plan sponsors, plan administrators, and service providers must all take great care to achieve the intended results. Due to complex compliance and tax regulations, it is imperative that all parties involved have an understanding of the rules and the repercussions of noncompliance. Following is a brief overview of the basic requirements, limits, and common pitfalls in the operation of the loan program.

THE BASIC REQUIREMENTS

- Must be written program
- Must be available on an equivalent and nondiscriminatory basis
- Must charge a commercially reasonable interest rate
- Must be adequately secured
- Level Amortization over no more than 5 years (exception for loans used to acquire principal residence)
- Payments made at least quarterly (most plans require payroll deduction)

THE NONTAXABLE LIMITS

The maximum available loan may generally be calculated by determining the results of the following steps:

Step 1:
Determine the lesser of:

1) $50,000 <u>reduced by the difference between</u> a) the highest outstanding loan balance within the last 12 months and b) the current outstanding loan balance, or
2) 50% of the participant's vested account balance

Step 2:
The lesser of 1 or 2 above is reduced by the current outstanding balance

Result: Maximum nontaxable loan available

COMMON PITFALLS

One of the common problems encountered is the failure to establish payroll deduction for the loan repayment. This can lead to the default and taxation of the outstanding balance to the participant. In addition to ordinary income taxes, the participant may be subject to a 10% excise tax if younger than age 59 ½. IRS regulations generally mandate that loans be considered in default as of the end of the calendar quarter that follows the quarter of a missed payment.

A recent Tax Court case involving this issue indicates that the IRS' position is to hold participants primarily responsible as they are in the best situation to monitor their own paychecks. Regardless, all parties involved should take steps to avoid the negative tax implications and conflicts that result from these inadvertent defaults. The plan's loan policy should describe all events that result in default.

Another area of concern is the refinancing transaction. Some plan's loan policies are designed to limit the participant to one outstanding loan. As a means to grant access to additional funds, these plans may allow a refinancing of the existing loan. This transaction involves replacing the existing loan with a new loan of a greater amount. If the term of this replacement loan extends beyond the term of the original loan, both amounts are considered outstanding on the date of the replacement loan. The sum of the existing loan and the replacement loan amounts must be compared to the nontaxable limits describes above.

For example, assume a $25,000 outstanding loan with 3 years remaining on an original 5-year term is replaced by a $30,000 loan with a new 5-year amortization period. In this case, the limit is exceeded by $5,000 since the total of the replacement loan amount and the old loan amount is $55,000. If the nontaxable limit is violated due to this rule, the excess portion is immediately taxable to the participant as a deemed distribution.

If you have questions regarding your loan program, contact your SHDR or BB&T consultant today.