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Plan Loans—Whose Money Is It Anyway and Why Should You Care?

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Wolters Kluwer

INTRODUCTION

Participant loans from defined contribution retirement plans are popular with both employers and employees. Participant loans can be made from 401(k), 403(b), and governmental 457(b) plans, if the plan terms permit them.[1] A retirement plan is not required to permit participant loans,[2] although loans may entice some employees to participate in the plan who otherwise would not participate. Among 330 employers with defined contribution plans surveyed in 2015, 95 percent permitted loans from their defined contribution plans, and, over the past 15 years, at least 94 percent have permitted plan loans.[3] Often, the sentiment is that it's the participants' money anyway, so why shouldn't they be able to borrow it?[4] Nevertheless, plan sponsors should recognize that improper plan loans are among the most common compliance errors found by the Internal Revenue Service.[5] Permitting plan loans entails a number of additional administrative and legal requirements for which the plan sponsor is generally responsible.

PLAN LOANS NOT TREATED AS TAXABLE DISTRIBUTIONS

A plan loan is not a taxable distribution to the participant receiving the loan, provided that the loan satisfies various requirements under Internal Revenue Code (Code) Section 72(p). Plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) are subject to similar requirements, described later. The requirements of Code Section 72(p) include:

- An enforceable agreement;
- Reasonable rate of interest;
- Adequate security;
- Repayment term requirements;
- Level amortization; and
- Loan amount limitations.[6]

Enforceable Agreement

A plan loan must be documented by a legally enforceable agreement, the terms of which demonstrate compliance with Code

Section 72(p). The document (or documents) must specify the amount and date of the loan and the loan repayment schedule. The agreement must be in writing, either in paper or delivered electronically under IRS rules for electronic notices and elections.[7]

Reasonable Rate of Interest

A plan loan must bear a reasonable rate of interest.[8] What is reasonable is generally considered to be what is commercially reasonable and may depend on particular facts and circumstances. Prime rate plus one percent was the most common interest rate among employers surveyed in 2015 whose defined contribution plans permitted loans (67 percent).[9]

Adequate Security

A plan loan must be adequately secured.[10] Generally, a plan loan is secured by the participant's account balance with repayments made through payroll withholding, although there can be situations in which additional security is required, as discussed further below.

Repayment Term Requirements

A plan loan must be repaid within a term of five years, unless the loan is used to acquire a dwelling that will be used as the principal residence of the participant within a reasonable period from the time the loan is made, in which case a longer term is permitted.[11] The average term for principal residence loans was 15 years among employers surveyed in 2015 whose defined contribution plans permitted such loans.[12]

Level Amortization

Generally, there must be substantially level amortization of a plan loan (*i.e.,* repayments must be made in substantially equal payments that include principal and interest) with repayments made no less frequently than quarterly.[13] But level amortization need not apply, and repayments may be suspended, during a *bona fide* leave of absence from the employer of not more than one year, either without pay or at a rate of pay (after applicable employment tax withholdings) that is less than the rate of repayments required under the terms of the loan. Nevertheless, the loan (including interest that accrues during the leave of absence) must be repaid by the latest permissible term of the loan (*i.e.,* five years from the date of a plan loan that is not for the purpose of acquiring a principal residence) and the amount of the installment payments due after the leave ends must not be less than the amount required under the terms of the original loan.

However, if a plan suspends loan repayments for any part of a period during which the employee performs service in the uniformed services,[14] whether or not qualified military service, the suspension will not cause the loan to be deemed a taxable distribution, even if the suspension exceeds one year and even if the term of the loan is extended. But the loan will not satisfy the repayment term and level amortization requirements, unless (1) loan repayments resume upon the completion of the period of military service, and (2) the loan is then repaid by amortization in substantially level installments over a period that ends not later than the latest permissible term of the loan, as extended by the period the loan repayments were suspended while the employee performed service in the uniformed services.[15] Further, the interest rate of a plan loan taken prior to a period of military service must generally be limited to 6 percent during the period of military service, subject to certain requirements that the participant give notice of the active duty or the participant's voluntary waiver of the interest rate limitation. If the plan provides for suspension of the participant's loan, then the 6 percent interest rate limitation is applied and calculated upon recommencement of payments when the participant returns to employment.[16]

Loan Amount Limitations

If a plan loan exceeds the loan amount limitations, but otherwise satisfies the requirements not to be deemed a taxable distribution, the amount of the loan in excess of the applicable limitation (and only that amount) is deemed a taxable distribution (described further in the next section) at the time the loan is made. A plan loan must not exceed the lesser of−

- $50,000 reduced by the highest outstanding loan balance (aggregating all outstanding loans from the employer's plans) during the one-year period ending on the day before the date the loan is made;[17] or

- The greater of one-half of the employee's vested account balances under the plans or $10,000.[18]

Among the 313 employers with defined contribution plans permitting loans surveyed in 2015, 22 percent did not permit loans from employer contributions.[19] Some employers limit loans to come only from employee contribution accounts, but will permit employer contribution accounts to be considered as well in determining one-half of the employee's vested account balance for purposes of loan amount limitations.

Sponsors of 403(b) plans frequently limit loans to employee pre-tax deferrals and Roth contributions as they seek to align the plan accounts eligible for loans with the plan accounts eligible for hardship distributions to reduce confusion and simplify administration. Whether employer contributions are eligible for hardship distributions under a 403(b) plan depends on whether the employer contributions were ever in a custodial account rather than an annuity contract, in which case those employer contributions are not eligible for hardship distribution.[20]

DEEMED DISTRIBUTIONS

A plan loan is deemed a taxable distribution, referred to as a "deemed distribution," at the first time the requirements described above are not satisfied, whether as documented or administered, including when the loan is first made. If the terms of a loan do not satisfy the repayment term or the level amortization requirements or the loan is not evidenced by an enforceable agreement, the entire amount of the loan is a deemed distribution at the time the loan is made. If the loan satisfies the requirements, except the amount loaned exceeds the loan amount limitations, the amount of the loan in excess of the applicable limitation is a deemed distribution at the time the loan is made.

If the loan initially satisfies the requirements, but repayments are not made in accordance with the terms of the loan, a deemed distribution occurs as a result of the failure to make the repayments.[21] However, the plan administrator may allow a cure period that avoids a deemed distribution, provided the missed installment payment is made not later than the end of the cure period. A cure period cannot continue beyond the last day of the calendar quarter following the calendar quarter in which the required installment payment was due.[22] If repayment is not made within the cure period, the loan will be considered a deemed distribution or else a loan offset (described in the next section) will occur at that time, depending upon circumstances and plan language, but not both. If a participant defaults on a loan when a plan loan offset is possible, the plan will offset the loan rather than treat the loan as a deemed distribution. Otherwise, the loan will be considered a deemed distribution with a later plan loan offset when such an offset is possible.

A deemed distribution is not an actual distribution from the account balance, but a plan loan offset is. A deemed distribution is not treated as an actual distribution for purposes of the qualification requirements of Code Section 401, the distribution provisions of Code Section 402, the distribution restrictions of Code Sections 401(k)(2)(B) or 403(b)(11), or the vesting requirements of Treasury

Regulation section 1.411(a)-7(d)(5), which affects the application of a graded vesting schedule when there is a prior distribution. A deemed distribution is treated as a distribution to the participant only for certain tax purposes, including the 10 percent additional tax on early distribution if an exception to the additional tax does not apply.[23] A deemed distribution is not eligible to be rolled over to an eligible retirement plan.[24]

A loan that is deemed distributed generally ceases to be an outstanding loan, except that a loan deemed distributed that has not been repaid (by a plan loan offset or otherwise) is considered outstanding for purposes of determining the maximum amount of any subsequent loan to the participant.[25] A loan treated as a deemed distribution is reportable on Form 1099-R using the normal taxation rules of Code Section 72, including tax basis rules. The distribution is not eligible for the 10-year tax option.[26] A deemed distribution is reported separately from other plan loans to participants on Form 5500 (for those plans subject to ERISA), unless the participant is repaying the deemed distributed loan as of the end of the plan year for which the Form 5500 is being filed. After such a deemed distributed loan is separately reported, it is no longer to be reported as an asset on Form 5500 unless, in a later year, the participant resumes repayment under the loan.[27]

PLAN LOAN OFFSETS

When a participant's account balance is reduced (offset) to repay a plan loan (including an offset to enforce the plan's security interest in the participant's account balance) in accordance with the plan's loan provisions, the "plan loan offset" is an actual distribution, not a deemed distribution. In essence, a plan loan offset against a participant's account balance can only occur when there is an actual distribution under the plan and not necessarily when there is a deemed distribution under the plan. A plan may be prohibited under the provisions of Code Section 401(a), 401(k)(2)(B), or 403(b)(11) (and, presumably, 457(d)), which prohibit or limit distributions to an active employee, from making a plan loan offset at the time of a deemed distribution. When a deemed distribution precedes a plan loan offset, the plan does not report the later plan loan offset on Form 1099-R (nor, for those plans subject to ERISA, on the Form 5500), but merely adjusts the participant's account to reflect the plan loan offset of the loan. However, a plan loan offset of a plan loan that has not been deemed distributed is reported on Forms 1099-R and 5500.[28]

A distribution of a plan loan offset amount can occur in a variety of circumstances, such as where the plan loan provisions require that the loan be repaid immediately (or else be treated as in default) when the employee requests a distribution, or where the plan loan provisions require that the loan be repaid immediately (or else be treated as in default) when the employee terminates employment. A distribution of a plan loan offset amount also occurs when, under the terms governing the plan loan, the loan is cancelled, accelerated, or treated as if it were in default (*e.g.*, where the plan treats a loan as in default upon an employee's termination of employment or within a specified period thereafter).[29] A plan may provide by its terms that a participant with a loan deemed distributed will have the loan offset as of the earliest date on which the participant is eligible for an actual distribution from the plan or be treated as in default.[30]

A distribution of a plan loan offset amount is an eligible rollover distribution if it otherwise satisfies the requirements to be an eligible rollover distribution. As noted in the prior section, a deemed distribution is not eligible for rollover. Thus, an amount equal to the plan loan offset amount can be rolled over by the employee (or spousal distributee) to an eligible retirement plan within the 60-day period under Code Section 402(c)(3), unless the plan loan offset amount fails to be an eligible rollover distribution for another reason, including because the loan was deemed distributed.[31] Although plan loan offset amounts that are rollover eligible must be included in the amount that is multiplied by 20-percent to determine mandatory federal income tax withholding on an eligible rollover distribution not directly rolled over, the total amount required to be withheld is limited to the sum of the cash and the fair market value of property received (excluding employer securities) by the distributee, excluding any amount of the distribution that is a plan loan offset amount. For example, if the only portion of an eligible rollover distribution that is not paid in a direct rollover consists of a plan loan offset amount, withholding is not required.[32]

INTEREST CONTINUES ON PLAN LOAN DEEMED DISTRIBUTED UNTIL REPAID

Interest continues to accrue on a plan loan that is deemed distributed until the loan is repaid, whether through a plan loan offset or repaid by the participant. This additional interest is not treated as an additional loan and does not result in an additional deemed distribution. However, this additional interest, along with the unpaid loan balance at the time the loan was deemed distributed, is considered outstanding for purposes of loan repayment (whether repaid by the participant or plan loan offset) and determining the maximum amount of any subsequent loan to the participant.[33]

A bona fide plan loan is an investment of plan assets, and both the obligation to repay the loan and the loan repayments with interest are plan assets.[34] Because the loan obligation, including continuing interest, is a plan asset, along with any contributions and earnings amount in the participant's account, the participant's account "value" grows with the continuing interest on a deemed distributed loan that has not been offset or repaid. The "value" of the loan obligation as a plan asset (including continuing interest) is exactly equal to the liability of the loan amount due (including continuing interest). When the loan liability is eliminated through a plan loan offset of the loan obligation subsequent to the loan being deemed distributed, the net result leaves only the contributions and earnings amount in the participant's account, including any loan repayments made prior to the deemed distribution.[35] In contrast, when the loan liability is eliminated through repayment of the deemed distributed loan, the result is an account balance equal to the contributions and earnings amount in the participant's account plus the loan repayment amounts made after the deemed distribution as well, with an adjusted tax basis.

TAX BASIS INCREASED IF PLAN LOAN REPAID AFTER DEEMED DISTRIBUTION

If a plan loan is repaid after a deemed distribution of the loan, then the participant's tax basis ("investment in the contract") under the plan increases by the amount of the cash repayments made on the loan after the deemed distribution. However, loan repayments are not treated as after-tax contributions for other purposes, including actual contribution percentage (ACP) testing under Code Section 401(m) and the limitation on annual additions under Code Section 415(c)(2)(B).[36]

LOAN SUBSEQUENT TO DEEMED DISTRIBUTION MAY REQUIRE ADDITIONAL SECURITY

If a plan loan is deemed distributed and has not been repaid by the participant or through a plan loan offset, a subsequent plan loan will be treated as a taxable distribution unless one of the following conditions is satisfied in addition to the other requirements for a plan loan not to be taxable:

- An arrangement among the plan, the employer, and participant is made for loan repayments to be made by payroll withholding; or

- The plan receives adequate security from the participant that is in addition to the participant's account balance under the plan.

If, before full repayment of the subsequent loan, the applicable condition is no longer satisfied (*e.g.*, if the participant revokes payroll withholding), the outstanding balance on the subsequent loan is also treated as a deemed distribution.[37]

Many, if not most, employers require repayment of a plan loan through payroll withholding. For those employers, the first of the two conditions would be satisfied with respect to subsequent loans. Many other employers do not use payroll withholding and participants repay either by check or automated transfers from an account at a financial institution. To avoid having to provide payroll withholding or require security in addition to the participant's plan account, some of these employers' plans require an outstanding loan be repaid (whether the loan had been deemed distributed or not) before a second plan loan is permitted or prohibit additional plan loans to a participant who has had a plan loan deemed distributed.

BONA FIDE LOAN REQUIREMENT

A plan loan must be a *bona fide* loan. If there is an express or tacit understanding the loan will not be repaid or if, for any reason, the transaction does not create a debtor-creditor relationship or is otherwise not a *bona fide* loan, then the loan amount is treated as an actual distribution from the plan and is not treated as a loan or as a deemed distribution.[38]

MULTIPLE LOANS AND REFINANCING

A plan may permit more than one loan to be outstanding at one time or allow a participant to refinance an existing plan loan. A participant who has an outstanding loan may refinance that loan or borrow additional amounts if, under the facts and circumstances, (1) the loans taken together satisfy the loan amount limitations, and (2) the prior loan(s) and the additional loan(s) each satisfy the repayment term requirements and level amortization requirements. Refinancing a plan loan includes any situation in which one plan loan replaces another plan loan.[39] Among employers whose defined contribution plans offer loans surveyed in 2015, 45 percent permitted only one loan outstanding at a time. Nine percent permitted one general purpose and one principal residence loan. Thirty-eight percent permitted two loans, regardless of type, and only 8 percent permitted more than two loans outstanding at a time.[40]

If a plan loan is refinanced and the term of the replacement loan ends after the latest permissible term of the replaced loan, then both loans are treated as outstanding on the date of the refinancing. The "latest permissible term" of the replaced loan is the latest date permitted (*i.e.,* five years from the original date of the replaced loan, assuming that the replaced loan was not for acquiring a principal residence and that no additional period of suspension applied to the replaced loan due to military service). For example, if the term of the replacement loan ends after the latest permissible term of the replaced loan and the sum of the amount of the replacement loan plus the outstanding balance of all other loans on the date of the refinancing, including the replaced loan, fails to satisfy the loan amount limitations, then the replacement loan results in a deemed distribution. However, this rule does not apply to a replacement loan if the terms of the replacement loan would satisfy the plan loan requirements, determined as if the replacement loan consisted of two separate loans: (1) the replaced loan (amortized in substantially level payments over a period ending not later than the last day of the latest permissible term of the replaced loan), and (2) a new loan, to the extent the amount of the replacement loan exceeds the amount of the replaced loan, that is also amortized in substantially level payments over a period ending not later than the last day of the latest permissible term of the replacement loan.[41] The regulations provide two examples that help clarify the application of these refinancing rules.[42]

PLAN LOAN MAY BE A PROHIBITED TRANSACTION UNDER THE CODE

A loan to a "disqualified person" from a tax-qualified plan under Code Section 401(a), such as a 401(k) plan, that is not a governmental plan or nonelecting church plan[43] may be a prohibited transaction, subject to excise taxes on the disqualified person,[44] unless it is a loan to a participant or beneficiary of the plan and such a loan−

- Is available to all such participants or beneficiaries on a reasonably equivalent basis;
- Is not made available to highly compensated employees (under Code section 414(q)) in an amount greater than the amount made available to other employees;
- Is made in accordance with specific provisions regarding such loans set forth in the plan;
- Bears a reasonable rate of interest; and
- Is adequately secured.[45]

Disqualified persons include officers, directors, 10-percent shareholders, and certain highly compensated employees of the plan sponsor or certain related companies, as well as their family members, fiduciaries, and certain other persons.[46] An initial tax of 15 percent of the amount involved with respect to the prohibited transaction applies for each year until the prohibited transaction is corrected or, if earlier, the tax is assessed. If the prohibited transaction is not corrected after the initial tax is assessed, an additional tax of 100 percent of the amount involved applies. Correction would likely include repaying the outstanding loan amount, including interest, to the plan, rather than simply taxing the loan as a deemed distribution.

Although the likelihood that a plan loan to a participant would be a prohibited transaction under the Code may be small, assuming the plan generally satisfies the requirements outlined above, the tax consequences to the loan recipient could be onerous if the IRS finds the loan to be a prohibited transaction. Also note that a deemed distribution does not constitute a correction of a prohibited transaction under the Code.[47] And, if the plan is also subject to Title I of ERISA, there could be additional penalties for breach of fiduciary duty relating to a prohibited transaction.

LOANS FROM PLANS SUBJECT TO ERISA

Certain nongovernmental 401(k) and 403(b) plans are subject to Title I of ERISA. Governmental plans within the meaning of Code Section 414(d) and nonelecting church plans within the meaning of Code Sections 410(d) and 414(e) are not subject to ERISA. Certain 403(b) plans of Code Section 501(c)(3) tax-exempt organizations that do not provide for employer contributions (including employer matching contributions provided in a separate plan) and meet prescribed limitations on employer involvement are also not subject to ERISA.[48]

PLAN LOAN MAY BE A PROHIBITED TRANSACTION UNDER ERISA

Only plan loans that satisfy certain requirements are exempt from being a prohibited transaction under ERISA.[49] ERISA Section 408(b)(1) provides an exemption from prohibited transactions for the making of a participant loan that is arranged and approved by the fiduciary administering the loan program, is primarily in the interest of the participant, and otherwise satisfies the exemption criteria (similar to the criteria under the Code and described below), determined upon consideration of all the relevant facts and circumstances. For purposes of the exemption, a plan loan includes any renewal or modification of an existing loan agreement, provided that the requirements are met at the time of each such renewal or modification. The presence of a loan document that appears to satisfy the requirements will not be sufficient where the subsequent administration of the loan indicates that the parties to the loan agreement did not intend the loan to be repaid. A program of participant loans, like other plan investments, must be prudently established and administered for the exclusive purpose of providing benefits to participants and beneficiaries of the plan.[50]

The DOL can impose penalties on a "party in interest" to a prohibited transaction, but only with respect to a plan subject to ERISA and not subject to the prohibited transaction penalties under the Code.[51] Therefore, a 403(b) plan subject to ERISA may be subject to the penalties described in this paragraph, even though not subject to the 15 and 100 percent penalties under the Code described earlier. A party in interest is essentially equivalent to "disqualified person" under the prohibited transaction rules of the Code and includes any plan fiduciary (*e.g.,* any plan sponsor, officer, trustee, or custodian), plan counsel, an employer or employee organization with employees covered under the plan, and plan service providers (or a family member or constructive owner of a person who is a party in interest).[52] The DOL civil penalty is 5 percent of the prohibited transaction amount for each year or portion thereof that the prohibited transaction is not corrected and increases to 100 percent of the highest fair market value during the period beginning on the date the prohibited transaction occurs and ending 90 days after a final DOL order, if the prohibited transaction is not corrected within 90 days after notice from the DOL or such later date as the DOL may permit.[53]

PLAN LOAN NOT A PROHIBITED TRANSACTION UNDER ERISA

For plan loans to be exempt from being a prohibited transaction under ERISA, plan loans to parties in interest who are participants or beneficiaries of the plan must−

- Be available to all such participants and beneficiaries on a reasonably equivalent basis;
- Not be made available to highly compensated employees, within the meaning of Code Section 414(q), in an amount greater than the amount made available to other employees;
- Be made in accordance with specific provisions regarding such loans set forth in the plan;

- Bear a reasonable rate of interest; and
- Be adequately secured.[54]

A plan loan is not a prohibited transaction merely because loan repayments are suspended for any part of any period during which the employee is performing service in the uniformed services, whether or not qualified military service.[55] If a plan loan to a participant who is a party in interest with respect to the plan involves a plan fiduciary receiving any consideration for the fiduciary's own account from any party dealing with the plan in connection with a transaction involving plan assets, such an act constitutes a separate transaction that may be a prohibited transaction.[56]

Reasonably Equivalent Basis

Plan loans will not be considered to have been made available to participants and beneficiaries on a reasonably equivalent basis unless each of the following three conditions are satisfied–

- Plan loans are available to all plan participants and beneficiaries without regard to any individual's race, color, religion, sex, age or national origin.
- In making plan loans, consideration has been given only to those factors that would be considered in a normal commercial setting by an entity in the business of making similar types of loans. Such factors may include the applicant's creditworthiness and financial need.
- An evaluation of all relevant facts and circumstances indicates that, in actual practice, plan loans are not unreasonably withheld from any applicant.[57]

A plan loan program will not fail to have made loans on a reasonably equivalent basis, merely because the loan program establishes a minimum loan amount of up to $1,000; provided that the loans granted meet the requirements to be adequately secured.[58]

Loan Amounts Not Greater for Highly Compensated Employees

Loans will not be considered to be made available to highly compensated employees, officers, or shareholders in an amount greater than the amount made available to other employees, if, upon consideration of all relevant facts and circumstances, the program does not operate to exclude large numbers of plan participants from receiving loans under the program. Further, a participant loan program will not fail to meet this requirement merely because the plan documents specifically governing plan loans set forth either a maximum dollar limitation or a maximum percentage of vested accrued benefit which no loan may exceed, even though maximum loan amounts will vary directly with the size of the participant's account balance.[59]

A plan loan program will not have made loans available to highly compensated employees, officers, or shareholders in an amount greater than the amount made available to other employees, merely because the loan program establishes a minimum loan amount of up to $1,000; provided that the loans granted meet the requirements to be adequately secured.[60]

Specific Loan Provisions

Participant loans are considered made in accordance with specific plan provisions if−

- The plan provisions regarding such loans at a minimum contain an explicit authorization for the plan fiduciary responsible for investing plan assets to establish a participant loan program; and

- The participant loan program contained in the plan or in a written document forming part of the plan includes, but need not be limited to, the following:

  1. The identity of the person or positions authorized to administer the participant loan program;

  2. A procedure for applying for loans;

  3. The basis on which loans will be approved or denied;

  4. Limitations (if any) on the types and amount of loans offered;

  5. The procedure under the program for determining a reasonable rate of interest;

  6. The types of collateral which may secure a participant loan; and

7. The events constituting default and the steps that will be taken to preserve plan assets in the event of such default.[61]

Reasonable Rate of Interest

A plan loan will be considered to bear a reasonable rate of interest if the loan provides the plan with a return commensurate with the interest rates charged by persons in the business of lending money for loans that would be made under similar circumstances.[62]

Adequate Security

A plan loan will be considered adequately secured if the security for the loan is something in addition to, and supporting, a promise to pay, which is pledged to the plan such that the security may be sold, foreclosed upon, or otherwise disposed of, upon default of repayment of the loan. The value and liquidity of the security must be such that loss of principal or interest is reasonably anticipated not to result from the loan. The adequacy of the security will be determined considering the type and amount of security that would be required in the case of an otherwise identical transaction in a normal commercial setting between unrelated parties on arm's-length terms.

Importantly, a participant's vested account balance under the plan may be used as security for a participant loan to satisfy the participant's outstanding obligation in the event of default, provided the loan otherwise meets the requirements to be adequately secured. However, no more than 50 percent of a participant's vested account balance may be considered by the plan as security for the outstanding balance of all plan loans made to that participant as of immediately after the origination of each plan loan secured in whole or in part by the participant's vested account balance.[63]

PENALTIES FOR BREACH OF FIDUCIARY DUTY UNDER ERISA

The DOL will impose penalties for any concurrent breach of fiduciary duty in connection with a plan loan by a plan fiduciary or knowing participation in such breach by another person, on such plan fiduciary or other person, equal to 20 percent of the amount recovered (for the plan) due to the breach in fiduciary duty, but reduced by any applicable prohibited transaction penalties imposed, whether under the Code or ERISA.[64] This penalty for breach of fiduciary duty is not limited to 403(b) plans subject to ERISA, but would apply to any plan subject to ERISA. It is possible to petition the DOL, prior to the expiration of the penalty payment period, to waive or reduce the 20 percent penalty on the basis that either the person assessed the penalty acted reasonably and in good faith in engaging in the breach or violation or the person will not be able to restore all losses to the plan or participant or beneficiary of the plan without severe financial hardship unless such waiver or reduction is granted.[65]

CONCLUSION

The primary purpose of retirement plans is to provide employees with retirement income. While offering plan loans may entice some employees to participate in a plan who otherwise might not have participated, a termination of employment or other event causing a plan loan default can result in unexpected tax consequences to the employee. In 2015, although only four percent of employed participants with an outstanding plan loan defaulted on their plan loans, 62 percent of participants who terminated employment with an outstanding plan loan defaulted on their plan loans. The percentage of participants with a plan loan outstanding was 25 percent and the average outstanding loan principal as a percentage of a participant's overall account balance was 20 percent.[66] Given the complexity of properly administering plan loans and the possibility that improper plan loans can result in taxes and penalties for the participant and penalties for the plan sponsor, plan sponsors should carefully review their plan loan processes and documentation[67] with their record keepers and other plan advisors. Plan sponsors should also thoughtfully consider whether they want to offer, or continue to offer, participant loans from their retirement plans.

NOTES

1. *See* Code § 72(p)(4) and Treas. Reg. § 1.72(p)-1, Q&A-2.
2. *See, e.g.,* Treas. Reg. § 1.403(b)-3(b)(3)(i) and IRS Retirement Topics−Plan Loans on the IRS Web site irs.gov at *https://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics-Loans*. Further, the availability of plan loans is not a protected benefit (other than a distribution arising from an execution on an account balance used to secure a loan on which there has been a default) and a plan may be amended to eliminate or change its loan provisions. *See* Treas. Reg. §§ 1.411(d)(6)-4, Q&A-1(d)(4) and 1.411(d)(6)-4, Q&A-2(b)(2)(vii). If a 403(b) plan is subject to the Employee Retirement Income Security Act of 1974 (ERISA), then substantially identical rules apply under ERISA § 204(g). *See* the preamble to the final 403(b) plan regulations (72 Fed. Reg. 41129).
3. *See* Aon Hewitt, "2015 Trends & Experience in Defined Contribution Plans" report.
4. Technically, even employee pre-tax amounts (and even if designated as Roth contributions) contributed to a 401(k) or 403(b) plan are not the employee's money under Treasury regulations, but rather are employer contributions made under a "cash or deferred election" to have

the employee's cash compensation reduced by an amount in exchange for the employer to contribute the same amount to the plan. *See* Treas. Reg. §§ 1.401(k)-1(a)(3); 1.402(g)(3)-1(b); 1.402A-1, Q&A-1; 1.403(b)-3(a); and 1.403(b)-3(c)(1).

5. *See, e.g.,* IRS Publication 4224.
6. *See* Treas. Reg. § 1.72(p)-1, Q&A-3(a). Whether the availability or making of a loan, or the failure to repay a loan, from a governmental 457(b) plan is treated as a distribution (directly or indirectly), or is otherwise a violation of the requirements of Code § 457(b), depends on the relevant facts and circumstances. Among the relevant facts and circumstances is whether the loan has a fixed repayment schedule, bears a reasonable rate of interest, and has repayment safeguards to which a prudent lender would adhere. For example, a loan must bear a reasonable rate of interest in order to satisfy the exclusive benefit requirement of Code § 457(g)(1). Code § 72(p) also applies to a governmental 457(b) plan. *See* Treas. Reg. §§ 1.457-6(f)(2) and 1.457-7(b)(3). Similarly, whether the availability of a loan, the making of a loan, or a failure to repay a loan from a 403(b) plan to a participant is treated as a distribution, or otherwise violates the requirements of Code § 403(b), depends on the facts and circumstances, including whether the loan has a fixed repayment schedule, bears a reasonable rate of interest, and is subject to repayment safeguards to which a prudent lender would adhere. Code § 72(p) also applies to a 403(b) plan. *See* Treas. Reg. § 1.403(b)-6(f).
7. *See* Treas. Reg. §§ 1.72(p)-1, Q&A-3(b) and 1.401(a)-21.
8. The introductory paragraph of Treasury Regulation Section 1.72(p)-1 states that, "The examples included in the questions and answers in this section are based on the assumption that a *bona fide* loan is made to a participant from a qualified defined contribution plan pursuant to an enforceable agreement (in accordance with paragraph (b) of Q&A-3 of this section), with adequate security and with an interest rate and repayment terms that are commercially reasonable." *See also* Treas. Reg. §§ 1.403(b)-6(f) and 1.457-6(f)(2).
9. *See* Aon Hewitt, "2015 Trends & Experience in Defined Contribution Plans" report.
10. *See* endnotes 6 and 8.
11. *See* Code § 72(p)(2)(B). *See* Treas. Reg. §§ 1.72(p)-1, Q&A-5, Q&A-6, Q&A-7, and Q&A-8 for additional rules regarding security for the home loan, refinancing, tracing rules, and defining principal residence.
12. *See* Aon Hewitt, "2015 Trends & Experience in Defined Contribution Plans" report. Coincidently, or perhaps not, the example in Treasury regulations of a principal residence loan uses a repayment period of 15 years. *See* Treas. Reg. § 1.72(p)-1, Q&A-8(b).
13. *See* Code § 72(p)(2)(C).
14. Uniformed services as defined in 38 U.S.C. Chapter 43.
15. *See* Treas. Reg. § 1.72(p)-1, Q&A-9.
16. *See* the Servicemembers Civil Relief Act §§ 101, 107, and 207. Note that "military service" generally means active duty and the participant notice is retroactive.
17. This modified description of the limitation set forth in Code § 72(p)(2)(a) assumes that the loan amount, when added to the outstanding balance of all other loans from the plan whether made on, before, or after August 13, 1982, is an identical amount as the outstanding balance of loans from the plan on the date the loan is made, including the loan being made on that date. Given that it is now 2016, this seems a reasonable assumption.

18. In the author's experience, many plans do not include the $10,000 limit and, thereby, will not permit the loan to exceed 50 percent of the participant's vested account balance, even if that limits the loan to less than $10,000.
19. *See* Aon Hewitt, "2015 Trends & Experience in Defined Contribution Plans" report.
20. *See* Treas. Reg. § 1.403(b)-6(c); D.P. Schwallie, Lesser Known Differences between 403(b) and 401(k) Plans, 20 *Journal of Deferred Compensation* 6 (Summer 2015); and D.P. Schwallie, A Choice for Tax-Exempt Employers: 403(b) or 401(k) Plan?, 32 Benefits Quarterly 36 (2nd Quarter 2016).
21. *See* Treas. Reg. § 1.72(p)-1, Q&A-4(a).
22. *See* Treas. Reg. § 1.72(p)-1, Q&A-10.
23. The additional tax on early distribution does not apply to a 457(b) plan. *See* Code § 72(t). Note that the exception for substantially equal payments only applies if the payments commence after separation from service. *See* Code § 72(t)(3)(B).
24. *See* Treas. Reg. §§ 1.72(p)-1, Q&A-12 and Q&A-13(a)(2).
25. *See* Treas. Reg. § 1.72(p)-1, Q&A-19.
26. *See* 2016 Instructions for Forms 1099-R and 5498, p.8.
27. *See* 2015 Instructions for Form 5500, pp.34-36 and 43-45.
28. *See* 2016 Instructions for Forms 1099-R and 5498, p.4, and 2015 Instructions for Form 5500, p.58.
29. *See* Treas. Reg. §§ 1.72(p)-1, Q&A-13 and 1.402(c), Q&A-9(b) and 1.403(b)-6(f).
30. *See* Treas. Reg. § 1.402(c)-2, Q&A-9(c), example 2. For what it's worth, the author is aware of 401(k) plans that, by their terms, apply a plan loan offset as of the earliest date on which the participant becomes eligible for a distribution from the plan (such as age 59½, if the plan provides for distributions at 59½) and which received a favorable determination letter from the IRS.
31. *See* Treas. Reg. § 1.402(c)-2, Q&A-9(a). Effectively, a plan loan offset of a loan deemed distributed (because repayments were not timely made and not within the plan's cure period, if any) made subsequent to the deemed distribution is not rollover eligible.
32. *See* Treas. Reg. § 31.3405(c)-1, Q&A-11.
33. *See* Treas. Reg. § 1.72(p)-1, Q&A-19.
34. A plan loan must be made pursuant to a legally enforceable agreement with adequate security and an interest rate and repayment terms that are commercially reasonable. *See* Treas. Reg. § 1.72(p)-1. With respect to plans subject to ERISA, *see also* 29 C.F.R. §§ 2550.408b-1(a)(3) and 2550.408b-1(d)(1) and DOL Advisory Opinion 2002-02A.
35. As the net result of a plan loan offset is no change in the participant's account balance, the continuing interest on a deemed distributed plan loan that has not been offset is sometimes referred to as "phantom interest."
36. *See* Treas. Reg. § 1.72(p)-1, Q&A-21.
37. *See* Treas. Reg. § 1.72(p)-1, Q&A-19(b)(2).
38. *See* Treas. Reg. § 1.72(p)-1, Q&A-17.
39. *See* Treas. Reg. § 1.72(p)-1, Q&A-20(a)(1).
40. *See* Aon Hewitt, "2015 Trends & Experience in Defined Contribution Plans" report.
41. *See* Treas. Reg. § 1.72(p)-1, Q&A-20(a)(2).
42. *See* Treas. Reg. § 1.72(p)-1, Q&A-20(b).

43. The prohibited transaction rules of Code § 4975 do not apply to governmental or non-electing church plans nor to 403(b) plans. *See* Code §§ 4975(e)(1) and 4975(g). However, under Code Section 503, the trust holding assets of a governmental or church plan may lose its tax-exempt status in the case of a prohibited transaction described in Code Section 503(b). Prior to the enactment of ERISA, Code Section 503 applied generally to plans qualified under Code section 401(a), but was amended to apply only to governmental and church plans with the addition of Code Section 4975 by ERISA. The prohibited transactions described in Code Section 503(b) seem unlikely to involve typical plan loans to participants in governmental or church plans, except in unusual circumstances.
44. *See* Code § 4975.
45. *See* Code § 4975(d)(1).
46. *See* Code § 4975(e)(2).
47. *See* Treas. Reg. § 1.72(p)-1, Q&A-16.
48. Employee participation must be completely voluntary and the plan must be funded solely by elective deferrals (including Roth contributions). The employer may enter into salary reduction agreements and remit funds collected as required by vendor agreements, hold one or more group contracts in the employer's name and exercise rights as representative of its employees under the contract (at least with respect to contract amendments), limit investments and vendors to a number and selection designed to afford employees reasonable choice in light of all relevant circumstances (more than one vendor), act to ensure compliance with 403(b); but cannot make discretionary determinations in administering the plan, such as determinations regarding loans, hardships, QDROs, or plan-to-plan transfers. A 403(b) plan otherwise eligible for the safe harbor exception from ERISA (described in 29 C.F.R. § 2510.3-2(f)) may offer loans, provided the governing documents allocate to the 403(b) plan custodian or annuity provider, and not the employer, all responsibility for making any discretionary determinations involving plan loans. However, the employer's selection of a third-party administrator to make discretionary decisions would also be inconsistent with limited employer involvement, which could result in the plan being subject to ERISA. Nevertheless, the employer may refuse to include those annuity contracts and custodial accounts in its safe harbor non-ERISA 403(b) arrangement that have plan loans or other such optional features, if such restriction on contracts and accounts is intended to reduce the employer's costs in offering the safe harbor non-ERISA arrangement or is designed to exclude features that in operation could result in the employer being forced to take actions that would exceed the employer involvement permitted under a safe harbor non-ERISA 403(b) plan. *See* 29 C.F.R. § 2510.3-2(f), U.S. Department of Labor (DOL) Field Assistance Bulletin No. 2007-02, and DOL Field Assistance Bulletin No. 2010-01.
49. *See* ERISA §§ 406 and 408(b)(1).
50. *See* 29 C.F.R. § 2550.408b-1(a)(3).
51. *See* ERISA § 502(i).
52. *See* ERISA § 3(14).
53. *See* ERISA § 502(i) and Code § 4975(e)(1).
54. *See* 29 C.F.R. § 2550.408b-1. The examples under the regulations provide additional clarification as to each of these requirements.

55. Uniformed services as defined in 38 U.S.C. Chapter 43. *See* ERISA § 408(b)(1) and Code § 414(u).
56. *See* 29 C.F.R. § 2550.408b-1(a)(2). The examples under 29 C.F.R. § 2550.408b-1(a)(4) provide additional clarification as to the scope of the prohibited transaction exemption.
57. *See* 29 C.F.R. § 2550.408b-1(b)(1).
58. *See* 29 C.F.R. § 2550.408b-1(b)(2). DOL Field Assistance Bulletin 2003-1 further provides that plan fiduciaries of public companies may deny participant loans to officers and directors (or the equivalent thereof) on the basis that such loans may violate Section 13(k) of the Securities Exchange Act of 1934 (added by Section 402 of the Sarbanes-Oxley Act of 2002) without violating the requirement that loans be available to all participants and beneficiaries on a reasonably equivalent basis.
59. *See* 29 C.F.R. § 2550.408b-1(c).
60. *See* 29 C.F.R. § 2550.408b-1(b)(2).
61. *See* 29 C.F.R. § 2550.408b-1(d).
62. *See* 29 C.F.R. § 2550.408b-1(e).
63. *See* 29 C.F.R. § 2550.408b-1(f).
64. *See* EBSA Enforcement Manual, Civil Penalties, § 2,502(l) Civil Penalties, available on the DOL Web site at *http://www.dol.gov/ebsa/oemanual/cha35.html.*
65. *See* ERISA § 502(l); 29 C.F.R. §§ 2570.81, 2570.85(a), and 2570.86.
66. *See* Aon Hewitt, 2016 Universe Benchmarks, *Measuring Employee Savings and Investing Behavior in Defined Contribution Plans* (Summer 2016).
67. Informal IRS guidance indicates that plan sponsor should retain the following records, in either paper or electronic format, for every plan loan:
    - Evidence of the loan application, review and approval process;
    - An executed plan loan note;
    - If applicable, documentation verifying that the loan proceeds were used to purchase or construct a primary residence;
    - Evidence of loan repayments; and
    - Evidence of collection activities associated with loans in default and the related Forms 1099-R, if applicable.

    Further, if a participant requests a loan with a repayment period in excess of five years for the purpose of purchasing or constructing a principal residence, the plan sponsor must obtain documentation of the home purchase before the loan is approved. IRS audits have found that some plan administrators impermissibly allow participants to self-certify their eligibility for these loans. *See* "It's Up to Plan Sponsors to Track Loans, Hardship Distributions" on the IRS Web site at: *https://www.irs.gov/Retirement-Plans/Its-Up-to-Plan-Sponsors-to-Track-Loans-Hardship-Distributions*.