PROPERLY ADMINISTERING PARTICIPANT LOANS

Items for Consideration

AMOUNT BORROWED

The IRS rules state that participants can borrow at most the lesser of 50% of their vested account balance or $50,000 minus the highest outstanding loan balance in the last 12 months. In other words, figuring out the maximum amount someone can borrow isn't easy. And, if too much is lent out, the plan and the participant could face penalties.

- ☐ Does your plan utilize the IRS limits to determine the maximum loan amount available or did you elect a different lower limit?
- ☐ Who is responsible for determining the loan limits?
- ☐ Is this information available to participants on a website and if so, who ensures the data provided to the participant on the website is accurate?
- ☐ If a participant asks how much they can borrow, how is the answer provided?
- ☐ Who is liable if more money is lent to a participant than was allowable?

INTEREST RATE USED

As with any loan, there is interest due on the amount borrowed. The interest is repaid to the plan and usually to the particular participant who borrowed the funds in the first place. The plan document or plan's loan policy normally indicate the interest rate to be used. Your plan document may indicate that you should use a commercially equivalent rate of interest for a similar loan or it may specify a rate time tied to an index like the prime rate published in the Wall Street Journal on the 1st day of each calendar quarter plus 1%.

- ☐ What loan interest rate does your plan use?
- ☐ Who determines that interest rate?
- ☐ Who is liable if the interest rate used is incorrect?

TERM OF THE LOAN

Participants must normally repay a loan within 5 years. However, if the plan document so allows and the participant is borrowing for the purpose of buying their primary residence, the term of the loan can be longer than 5 years.

- ☐ What terms are provided for in your plan's document or loan policy?
- ☐ Who is responsible for monitoring that loans are due and payable for the end of the maximum possible term?
- ☐ If a primary residence loan, what paperwork do you require to confirm the participant is actually buying a house and the amount requested is not more than the amount needed for the purchase?
- ☐ Who is liable if the incorrect term is used?

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REASONS FOR LOANS

Some plans limit the reasons for which a participant can request a loan. The most common limit is to state the participants must have a financial hardship in order to borrow. Even with this limit, there are complications. Some plans use the IRS's published 6 hardship reasons. Other plans state that each individual case will be evaluated to determine if a hardship exists.

- ☐ Does you plan limit the reasons why a participant can request a loan? If so, how?
- ☐ What documentation do you require to substantiate the reason?
- ☐ If a determination is made on a case by case basis, what process is used, how are records maintained, how do you ensure the same result would be given if the same fact patter were presented again years later?
- ☐ Who is liable if a loan is made for a reason other than that which is allowed or if insufficient documentation is provided to substantiate the reason?

PROCESS FOR REQUESTING A LOAN

A participant must formally request a loan. This can be done through an on-line system or utilizing a paper form. The participant will need to indicate how much they want to borrow, what term they want to repay over and, if required by your plan, the reason and corresponding backup documentation for the loan.

- ☐ What process must a participant go through to request a loan?
- ☐ Does that process allow the party reviewing the amount requested, the term, the interest rate and the reason the opportunity to agree that what the participant is requesting is acceptable?
- ☐ Who will maintain records of any documentation provided as part of the loan application?
- ☐ If the loan is denied, because the participant asked for too much money for example, what is the process for denying a loan?
- ☐ What are the next are the next steps if the loan is approved?

LOAN DOCUMENTS

A loan is generally defined (in an oversimplified way) as an agreement between two parties where the lender agrees to lend money to the borrower and the borrower agrees to repay the lender. IRS regulations require that participant loans be written. The written documents needed are a promissory note, an amortization or repayment schedule, and for larger plans a truth in lending statement.

- ☐ Who prepares the needed loan documents?
- ☐ How does the participant sign them?
- ☐ Who retains the signed documents in they are needed later?
- ☐ Who is liable if the documents aren't signed before the money is paid out?

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STARTING REPAYMENTS

Once a participant takes a loan, they normally are issued the money they requested. Now they have to start paying the loan back. Most plans require repayment through payroll deduction, i.e. the money comes out of the employee's paycheck each pay period and is transmitted to the plan along with any deferrals. The loan documents will indicate which pay period the repayments should commence.

- ☐ Are you responsible for starting up the repayments in your payroll system or is one of your service provider team taking that responsibility?
- ☐ If you must start up the loan repayments, how do you know a loan has been taken and when repayments are to start? Also, who in your office will be assigned to start the repayments?
- ☐ If a member of your service provider team is responsible, how do you audit this process to ensure it is actually occurring?
- ☐ Who is liable if repayments don't commence timely?
- ☐ If repayments are made by participant in some manner other than through payroll, how does that happen and where in the process do you have liability?

STOPPING REPAYMENTS

Loan repayments will need to cease when a participant has fully paid off their loan. Unfortunately, we also see plan sponsors stop loan repayments because the participant asks them to. The promissory note normally doesn't contain language that a participant can stop repaying the loan simply because the loan repayments are financially burdensome or they just don't want to repay.

- ☐ Who is tracking loans to identify when they are close to being paid off?
- ☐ How is the proper person in your payroll department notified to stop loan repayments?
- ☐ If this is an automated process for your plan, how do you ensure loan repayments are actually stopped?
- ☐ Are you liable if loan repayments aren't stopped timely?
- ☐ How do you avoid stopping loan repayments because the participant asks you to?

AMOUNT OF REPAYMENT

The loan documents will indicate the required minimum repayment amount and the frequency with which such repayments are due. Participants can repay more than is required, but they cannot repay less.

- ☐ How is the amount due each pay period set up in payroll?
- ☐ If the participant wants to repay more than is due, what is your procedure to allow such additional repayments?
- ☐ Some recordkeeping systems will only allow additional repayments if they a multiple of what is already due, for example 2 payments at a time or 3 payments at a time. What does your service provider team allow?
- ☐ Since extra payments will mean the loan will pay off early, who is responsible for ensuring the early payoff date is recalculated and communicated to the payroll system?

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LEAVES OF ABSENCE

From time to time, participants go out on leaves of absence. The leaves might be for military service or for something FMLA related, a sabbatical or perhaps just a general leave. During these periods, repayments generally cannot be made through payroll deduction as the employee usually isn't receiving a paycheck. There are special rules for military leaves of absence and FMLA leaves that can extend the time the employee has to repay the loan.

- ☐ Which member of your service provider team is available to assist you with leaves of absence?
- ☐ Do you have a process to notify that service provider when an employee goes out on a leave of absence?
- ☐ Does your process include providing information to the service provider on the type of leave?
- ☐ If the loan repayments need to be adjusted in payroll to reflect the impact of the leave of absence, who is responsible for making these updates?
- ☐ Who is liable if a problem occurs relating to leaves of absences?

LOAN DEFAULTS

Participant loans must be repaid. If repayments stop, (i.e. the employee is fired or terminates and so repayments through payroll deduction stop), there is a period of time in which the employee can repay the outstanding balance of the loan. Once that period ends, the outstanding balance of the loan becomes taxable to the participant.

- ☐ What provisions are in place to determine if a participant has failed to make loan repayments long enough for the loan to become taxable?
- ☐ Is declaring a loan in default an automatic process (i.e. once the right amount of time has passed, the loan is automatically taxed) or are there steps that must be taken? If so, who must do those steps?
- ☐ Are the procedures in place to ensure participants on leaves of absence don't have their loans defaulted too early?
- ☐ Who is liable to ensure the 1099-Rs are issued on the defaulted loans so the IRS knows that taxes are due?
- ☐ Who is liable for ensuring loans are properly defaulted?

LOAN OFFSETS

If a participant stops making payments on a loan for long enough, the loan defaults. However, that doesn't always mean the loan is distributed out of the plan. If the participant doesn't have the right to get a distribution otherwise at the time of the default, the loan remains on the books of the plan and can still be repaid.

- ☐ Who monitors when loans default?
- ☐ Is this done by you or someone on your service provider team?
- ☐ If you need to do this work, who on your staff has the proper training and is there a procedure in place to ensure it is done properly?
- ☐ Who is liable if loan offsets don't occur timely?

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ADMINISTERING HARDSHIP WITHDRAWALS

Items for Consideration

PLAN PROVISIONS

The plan document will indicate whether hardship withdrawals are allowed, the frequency and the minimum amount that can be withdrawn. The plan document should also indicate whether the safe harbor or facts and circumstances tests are used for the reason for the hardship and for proving the participant has no other means to satisfy the hardship.

- ☐ Does your plan document allow for hardship withdrawals?
- ☐ What are the restrictions on those withdrawals, if any, in terms of timing or amount?
- ☐ Does your plan use the safe harbor or facts and circumstances test for determining the reason a participant can request a hardship?
- ☐ Does your plan use the safe harbor or facts and circumstances test for determining the amount that can be withdrawn?

FACTS AND CIRCUMSTANCES TESTING

If your plan uses facts and circumstances testing, then someone must evaluate each request, review the available information and make a determination. It would be best practice to record the decisions to ensure that two participants with the same basic request are treated the same way, even if the two requests occur months or years apart.

- ☐ Who reviews requests?
- ☐ What is the process used to review such a request?
- ☐ Is the process in writing?
- ☐ Is there a library of prior decisions that can be used for reference?

DOCUMENTATION SUPPORTING THE REQUEST

Regardless of which testing method is used to determine if a hardship exists, documentation should be maintained proving the participant had a valid reason and was requesting a reasonable amount.

- ☐ Is documentation of a hardship asked for from the participant?
- ☐ Who is asking for that documentation?
- ☐ Who retains the records for future use in the event of an audit?
- ☐ If the records are maintained by a member of your service provider team, will you be able to access the records at a later date if needed?

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IMPORTANT INFORMATION ABOUT USING THIS DOCUMENT

The answers to the questions in this questionnaire could, and very well might be, used against you in a DOL audit or a lawsuit. **We do NOT recommend that you complete and retain this questionnaire without first reviewing the answers with ERISA legal counsel.** The intention is to provide you with questions to discuss internally rather than to create a paper trail that can be used against you.

Depending on your particular situation, there may be other items you should consider. Larger entities will have plan document issues with regard to mergers and acquisitions which are not covered by this questionnaire. There may be administrative policies that exist outside of the plan documents that help govern how the plan works that are not addressed here. This questionnaire is not intended to be exhaustive.