Ferraiuoli LLC
Looking Forward

Employee Benefits Practice Group
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Notice to Clients and Friends

RETIREMENT PLAN LOANS: A LIFELINE ALTERNATIVE FOR YOUR EMPLOYEES (*BUT TO BE USED WITH CAUTION*)

One of many benefits for participants and their beneficiaries under an employer-sponsored tax-qualified retirement plan is the alternative to allow to obtain loans against their vested benefits in the retirement plan. Allowing loans under the retirement plan is not a mandatory plan-feature, but it could be a lifeline your employee (or their beneficiaries) might need to get over an emergency or financial necessity, without impacting the employee's taxable income.

- ***Why are Plan Loans useful?*** Loans under retirement plans are a valued plan-feature to participants (and their beneficiaries), since they permit for the receipt of retirement plan distributions without the occurrence of a distributable plan event, and not from a bank or any other financial institution that loans money and charges interests. In addition, this feature provides participants with an opportunity to take a loan without having to go through credit checks, securing the loan with collateral or the possibility of the loan getting rejected.

- ***Challenges of Using Plan Loans:*** Although permitting Plan Loans may be a useful alternative for employees, it is not free from challenges. On one hand, Plan Loans hinder participants savings and loan repayments usually impact future contributions to the plan, both of which may negatively impact the participant by reducing the benefits expected for retirement. On the other, it lends itself for possible errors in the handling of the loans, may trigger taxable events for participants and potential "prohibited transactions" for employers as well as it adds complexities to employers handling such plan features.

- ***What requirements must Plan Loans comply with?*** If employers decide to make available loans under a retirement plan, the plan must adopt procedures for applying and granting the loans and comply with certain requirements to avoid being considered a "deemed distribution" or a "prohibited transaction" as described below. Thus, the loans must (i) be made available to all employees and beneficiaries on a reasonable basis, (ii) not be available to Highly Compensated Employees (HCE) in an amount greater than other employees, (iii) accrue reasonable interests, and (v) be amortized in substantially level payments (at least quarterly) over its term.

  Additionally, plan loans are capped at $50,000 or 50% of the participant's vested benefits, whichever is lower; and under Puerto Rico law the repayment must be made within 5 years (or if it is for the purchase of a principal residence, the term set forth in the plan).

- ***The "Deemed Distribution" and "Prohibited Transaction" Risks***: In case the loan terms do not comply with applicable requirements, the loan may be considered as "deemed distributions" with respect to the borrower and, therefore, taxable income. For example, if loan repayments are not made at least quarterly, the loan amount exceeds $50,000, or the loan is in default due to lack of repayment, the outstanding loan balance may be considered as a "deemed distribution" and included as part of the participant's taxable income. Similarly, employers must be aware and comply with requirements applicable to plan loans to avoid incurring in a "prohibited transaction" with respect to the plan, which if not timely corrected via the U.S. Department of Labor's Voluntary Fiduciary Correction Program, may trigger the imposition of monetary penalties as excise taxes.

- ***Plan Loan Best Practices***: Plans that allow for loans to participants and their beneficiaries are recommended to develop and adopt a *Loan Policy***,** as a supplemental document to the Plan, with the procedures to apply for and granting loans to avoid "deemed distributions" and the plan incurring in "prohibited transactions" as well as ongoing plan loan internal audit processes. Furthermore, in the *Loan Policy* plan sponsors may set forth applicable specifications related to minimum loan amounts, maximum number of loans and whether loans may be taken against participant's balance in all plan accounts or only certain ones. Also, by having a separate *Loan Policy*, it provides flexibility to the plan, as the *Loan Policy* terms may be modified without having to formally amend a plan document.

Employers and retirement plan administrators should be mindful of the benefits, requirements and risks of allowing loans under retirement plan, and consider preparing and adopting a *Loan Policy* in accordance with best practices to reduce plan loan-related risks.

250 Muñoz Rivera Avenue, 6th Floor, San Juan, PR 00918 | T 787.766.7000 | F 787.766.7001 | www.ferraiuoli.com