

Desk Side Chat...With Monika Templeman

ABCs of Loans and Hardship Distributions

In each issue, Monika Templeman, Director of EP Examinations, responds to questions and offers insights on retirement plan topics uncovered during audits. You may provide feedback or suggest future topics for discussion by e-mailing her at: RetirementPlanComments@irs.gov

Henny Youngman is attributed to saying, “I went to the bank and went over my savings. I found out I have all of the money that I’ll ever need...if I die tomorrow.” Being a comedian, it was funny in its time. However, the current economic landscape makes this quote more serious.

Sadly, this is true. As a society we’re getting older and less frugal. This is particularly alarming in light of the current economic factors that are impacting our nation. Although more than \$11.7 trillion is currently invested in retirement plans, the amount was approximately \$16 trillion in September 2008 – obviously the economic downturn impacted retirement plans. Almost everyone lost money in their retirement accounts and many people either have lost jobs or are facing the possibility of losing their jobs. We are finding that many participants are now looking to their retirement plans for temporary relief of their financial distress. We are doing our best to assist plan sponsors and participants in understanding the rules for the different ways money can be taken out of the plan. We also want to caution plan participants of the need to save for retirement and to avoid depleting their retirement savings for anything short of an emergency. Only 44% of families nearing retirement have an IRA with an average account balance of \$60,000. The question isn’t at what age you want to retire, it’s at what income.

Let’s start with plan loans. Which types of plans can offer plan loans?

Qualified plans, such as profit-sharing, 401(k) and money purchase plans are permitted to have loans as long it is stated in the plan document. IRA-based plans, such as SEPs, SIMPLE IRAs and SARSEPs, and traditional and Roth IRAs are not permitted to provide loans.

Are there limitations on the amount of the loan?

The amount participants may take for a loan is limited to the lesser of: 50% of their vested account balance or \$50,000. The vested interest is the amount that actually belongs to the participant, even if they terminate employment.

Loans need to be repaid back to the account. What requirements are there for loan repayments?

The participant must make payments at least quarterly, over a period not exceeding five years. There is an exception to the 5-year rule for loans taken out for the purchase of the participant’s primary home.

When are there taxability issues with plan loans?

Loans that initially don’t meet the requirements of the Code because they aren’t limited to 50% of the vested account balance or they exceed \$50,000 are treated as a distribution when the loan is made and is taxed accordingly. Missing payments cause the loan to go into default and therefore taxed as a distribution. Sometimes, this is just a payroll mix-up. Suddenly, the loan payments are no longer coming out of the participant’s payroll check. If the error is not corrected, then the law treats the loan as a deemed distribution and it is includible in the participant’s income. Some plans allow for a “cure period” in which participants can make up missed payments.

The number one taxability issue we see with loans occurs when a participant terminates employment with an outstanding loan balance. In this situation, plans usually offset the distribution of the participant’s account by the amount of the outstanding loan balance. For tax purposes, the amount of the distribution includes the loan balance at the time of the offset. If the participant wants to roll over his or her entire benefit, then he or she must come up with money that represents the loan offset as well as money to cover the 20% mandatory federal income tax withholding that applies to the full amount including the loan offset. The 10% additional early distribution tax applies if the person is under age 59 ½ unless some [exception](#) to this early withdrawal tax applies.

Can owner-employees borrow from the plan?

An owner employee is allowed to borrow from the plan. However, he or she must follow the same rules as any other participant. It must be a formal loan meeting all of the loan requirements dealing with amounts and repayment. If it does not then it may be a [prohibited transaction](#). What is **not allowed** is the employer dipping into plan assets – maybe informally borrowing a little just to tide it over – to meet payroll or pay other bills and then pay it back later. This is **never** permitted.

Another problem we frequently encounter in tough economic times is when an employer withholds salary deferrals from employees' pay intending to deposit the money in its 401(k) or SIMPLE IRA plan, but doesn't. The employer "borrows" the money, maybe to cover payroll, or rent or whatever, thinking that it won't hurt to wait a few weeks until the withheld salary deferrals are deposited into the plan's funding vehicle. Again, this is **never** okay. The Department of Labor looks very harshly on this fiduciary violation. The money must be deposited in the trust or IRAs as soon as the money can be reasonably segregated from the employer's assets.

Let's turn our attention to hardship distributions. What type of plans can offer hardship distributions?

You'll only find hardship distributions in defined contribution plans, such as 401(k), 403(b) and 457 plans.

What are the requirements for hardship distributions?

The regulations require that there has to be an "immediate and heavy financial need." A distribution is deemed to be for an "immediate and heavy financial need" as defined in the plan, but generally, if it is for medical expenses, purchase of principal residence, tuition and related education expenses, to prevent eviction, funeral expenses, and repairing casualty damage to the employee's house. Also, a distribution must be necessary to satisfy an immediate and heavy financial need as defined by plan terms. The participant must exhaust all loans available under all plans of the employer. Some plans may also require that the employee not have other resources available to meet the need, including the employee's spouse's and minor children's assets.

I think it is important to note that the Pension Protection Act modified the 401(k) hardship rules to treat a participant's beneficiary the same as a participant's spouse and dependents for purposes of qualifying for certain hardship distributions. Certain hardship distributions (medical, tuition and funeral expenses) can now be made to a participant based upon the need of a grandchild or domestic partner if that individual has been designated as a beneficiary under the plan.

When are there taxability issues with hardship distributions?

Employees should keep in mind that hardship distributions are not tax free money. Generally, they are subject to income tax in the year of distribution and, if the employee is under the age of 59 ½, to the 10% early distribution tax unless some [exception](#) to this early distribution tax applies. However, these distributions are not subject to the mandatory 20% income tax withholding.

Any final words of caution you wish to provide to the plan sponsors?

Yes. If you wish to allow loans, hardship distributions, and even the modified hardship rule for the participant's beneficiary, the plan must include the language allowing them. Too many times my examination agents find that the plan sponsor allows these provisions to occur in operation because they may have read or heard that they are permitted by law, but their plan specifically prohibits them or is silent. I would suggest that every plan sponsor read their plan before they offer any of these arrangements to their participants.