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Update on issues affecting Taft-Hartley plans SEPTEMBER 2018

Implementing a participant loan provision in a Taft-Hartley Defined Contribution Plan: What to consider

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Participant loan provisions in a Taft-Hartley Defined Contribution (DC) retirement plan can be a complex subject. On one hand, it offers a flexible method for plan participants to access their money prior to retirement if necessary. On the other hand, it's easy for a plan sponsor to look at the issue from a more paternalistic view and want to help protect their participants from creating a negative impact on their retirement nest egg.

According to a 2018 Plan Sponsor Defined Contribution Survey, 79% of all plans include a loan provision,[1] and the utilization of participant loans in all industries when compared to labor unions varies by less than 2%. Does your DC retirement plan offer a loan provision to participants? If so, was it designed the best way possible for your membership? How closely are you and/or your recordkeeper or administrator reviewing it to make sure it is being administered properly and in accordance with the terms of the plan document and government regulations? What type of best practices have been put into place?

This topic of participant loans has become a focus over the last few years based on internal plan audits as well as IRS and Department of Labor (DOL) audits. As a result, it is important that plan sponsors ensure the loan program has been thoroughly vetted and in compliance.

What you should know

Like other types of DC plans, Taft-Hartley DC participant loans are an optional plan provision that a plan sponsor can choose to offer participants. Unlike a hardship distribution, participant loans may be available for any purpose unless the plan sponsor chooses to restrict it for specific purposes, which we will address in this paper. In essence, a participant loan from a DC plan allows a participant to borrow from their own plan account balance and then pay themselves back, plus interest, over time. The interest rate on the loan must be commercially reasonable to a bank loan and participants must make at least quarterly payments to the loan. If they fail to do so, the loan must be defaulted no later than the end of the quarter following the quarter in which the payment was missed. Upon default, the remaining balance turns into a deemed distribution, becomes taxable to the participant at that time, and a Form 1099-R is issued. If the participant is still actively working, the loan remains outstanding despite the fact that it has been taxed. In addition, interest must continue to accrue on the loan and the loan still "counts" toward the allowable number of loans the participant may have.

Similar to other plan provisions, participant loans are subject to limits, regulatory and/or plan level. From a regulatory perspective, loans are held to both a maximum dollar amount and maximum repayment term. The maximum loan a participant may request is the lesser of $50,000 or 50% of the participant's account balance, reduced by the highest outstanding loan balance in the past 12 months. For example, if the account balance is $50,000 and the participant has never taken a participant loan under the plan, the maximum loan that participant could borrow is $25,000. The terms of the loan cannot exceed five years unless the loan is requested for the purchase of a principal residence, at which point the term of the loan can extend past five years and documentation is required.

At an individual plan level, a plan sponsor can write their plan loan provision to be less liberal than the regulatory requirements outlined previously and individually design the loan provision. These include but are not limited to: restrict loans for specific reasons, require spousal consent before the loan is processed from the plan, allow multiple loans at one time, allow loans for inactive participants, limit the term of the

1 *2018 Defined Contribution Plan Industry Report: Labor Unions*. Plan Sponsor, 2018.

loan to less than five years dependent on the amount of the loan, limit "lienable" calculations to vested account balance rather than total account balance, and limit the "loanable" sources to participant contributions rather than employer.

Obstacles

One trend becoming more common for Taft-Hartley plans is to only allow loans to be taken for specific reasons. Many use the IRS safe harbor hardship withdrawal reasons, while others allow loans to be taken for alternative reasons. Regardless, if the loan program only allows loans to be taken for certain reasons, then the administrator must abide by the terms of the loan program and maintain back-up documentation to support the reason the loan is being taken.

In a corporate DC plan, loan payments are predominantly made through payroll deductions. Taft-Hartley plans normally do not offer this repayment option due to employers of the plan not being involved in the loan process. Instead, participants typically make payments to the loan via a loan invoice, coupon book, or an automatic clearing house (ACH) payment from their bank account. As a result of leaving the option to make payments in the participant's hands, potential for the loan to default in a Taft-Hartley plan can be much higher than in a corporate plan. The administrator of the loan program should be monitoring payments and defaulting loans in a timely manner, which can be difficult if the participant is submitting payments at will.

Pursuant to IRS regulations, if the participant defaults on a loan, a subsequent loan cannot be taken unless payments are made through payroll deduction or the plan obtains additional collateral from the participant. This creates an issue for Taft-Hartley plans because payroll deduction is typically not offered and plan sponsors do not want to be in the business of collecting collateral from participants.

How to decide whether a participant loan provision is the right solution

Trustees should be provided with certain information from the loan administrator so they can monitor how the loan program is operating. Ultimately, they are responsible for the loan provision being in compliance, so it is imperative they have the necessary information to ensure it is being administered according to the plan terms and government regulations. Here are some items that should be provided and what should be analyzed:

- The loan program default rate. If the default rate is high, then the plan sponsor should closely review the program and determine if it is acting as more of a withdrawal provision than a loan provision. If participants take a loan and never make a single payment, it is a potential problem.
- Making sure plan loans shall be available on a reasonably equivalent basis to participants.
- Evidence that loans are being defaulted in a timely manner.
- Evidence that loans are not being extended past the original terms of the loan.
- Evidence that participants are not allowed to take another loan if they have defaulted on a previous loan and subsequent loan payments are not made via payroll deduction.
- Evidence the plan has specific reasons documented for taking a loan and the administrator is following those reasons and has obtained adequate documentation to support the loan.

Clean up the loan provision/operations

There are steps that plan sponsors can take to make the loan program operate more effectively. A few suggestions are:

- Educate participants at the time they are taking the loan on how it can affect their retirement savings and inform them of their obligation to pay off the loan, especially regarding paying taxes twice on the money borrowed.
- Clearly document the approved loan reasons, if any. If the plan has specific reasons allowed for taking loans or allows for primary residence loans, facts and circumstances can be too vague and expose the plan during an audit. Documentation must be clear and fit the administrative requirements before any new loan is approved.
- To help keep the default rate low:
  - Require mandatory repayment via ACH withdrawal from the participant's bank account. This automated feature removes the responsibility from the participant's hands and tends to have a high level of success preventing loan defaults.
  - If a participant falls behind on payments, send multiple warning letters defining the grace period and explaining what will happen if the loan goes into default.
  - Allow participants to make up missed payments (prior to default) due to insufficient funds or incorrect banking information provided. If this option is selected, the duplicate payment is applied to both principal and interest in the same manner as the missed payment(s).

By taking these steps, the plan sponsor can protect the plan in an audit situation. Being provided with information to review current outstanding loans and activity will allow the plan sponsor to understand whether the loan program is in compliance and working as intended. If it is not, an informed decision should be made about how it should be rectified, or, in a worst case scenario, whether the loan program should be eliminated. Loans are not a protected benefit so the elimination of the program is a viable option.

Conclusion

Loans can serve a purpose in a retirement plan and be a simple way to allow participants in need to access their retirement savings prior to retirement. However, it's important to remember that just like any personal loan, the participant has an obligation to repay it according to the terms of the plan. As with any plan provision, it is important the plan sponsor monitors if it is working in accordance with the plan document or loan policy and government regulations. As a fiduciary, plan sponsors should take an active role in ensuring that the program is in compliance by laying out and following a detailed set of procedures and documenting each step along the way. This can help the plan sponsor ensure smooth loan administration and meet their fiduciary obligation.

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