Grab the Money and Run? Retirement Plan Loans and Hardship Distributions

Tax Exempt and Government Entities
Employee Plans
2013 Nationwide Tax Forums

What are loans and hardship distributions?

- Loan
  - – Similar to a bank loan
  - – Not a taxable event
  - – No restrictions on use of funds
- Hardship distribution
  - – Not paid back
  - – Taxable
  - – Must be for certain emergency purposes

What kinds of plans can allow loans and hardship distributions?

- Loans
  - Only allowed in plans with separate participant accounts
  - Not allowed from IRAs and IRA-based plans
- Hardships
  - Only allowed in DC plans that allow employee salary deferrals
  - Can take a distribution from an IRA for any purpose

Should your plan allow loans and hardship distributions?

- Plans are not required to offer them
  - Not required to offer to the full extent allowed under the law
  - If offered, must be offered to everyone
- Tips to remember
  - Plan document must provide
  - Administrative procedures
  - Tax consequences
  - Impact on retirement savings

Tax rules for plan loans

- Must be
  - Included in plan provisions
  - Written legally enforceable agreement
  - Secured
- Can’t be for more than legal limits
- Reasonable rate of interest
- Payments
  - At least quarterly and,
  - Generally, for no more than 5 years

Maximum loan amounts

- Maximum loan is lesser of:
  - 50% of vested account balance, or
  - $50,000
- Exception – up to $10,000, even if more than 50% of vested account balance
  - Don’t have to allow
  - Must get additional security

Number of loans

- More than one loan ok IF
  - Plan document allows
  - Maximum loan reduced by highest outstanding loan balance during prior one-year period
- Example:
  - Vested account balance = $80K
  - March 1 loan = $27K
  - October 1 – still owes $18K and requests new loan

Loan repayment schedule

- Generally, must be repaid within 5 years
  - Exception for main home purchase = 30 years
- Repayment terms must be in writing
  - Substantially equal payments
    - At least quarterly
    - Include both principal and interest
- Reasonable interest rate

Loan defaults

- Plan will specify when loan is defaulted
- Treated as a distribution
- Not eligible for rollover
- Default vs. offset

Leaving employment before the loan is repaid

- Immediate repayment likely required
- If not repaid, treated as an actual distribution
  - Subject to regular income and 10% additional early distribution taxes

Correcting loan defaults through VCP

- Correction of a defaulted loan so not a taxable distribution to employee
- Apply for relief through VCP, using Schedule 5
- Common loan errors

Informal loans and prohibited transactions

- For example, salary deferrals withheld, but not timely deposited
- Prohibited transaction = transaction between plan and DP that’s not allowed under the law
- Initial excise tax = 15% of amount involved
- Transaction must be corrected
- If in an IRA = entire IRA treated as a distribution

Tax rules for hardship distributions

- Only allowed in plans with employee salary deferrals
- Plans not required to allow
- Distribution must be:
  - For an immediate and heavy financial need, and
  - Limited to amount of need

Immediate and heavy financial need

- Plan document must specify
- IRS rules approve distributions for:
  - Medical expenses
  - Purchase of principal residence
  - Tuition and related fees
  - Payments to prevent foreclosure
  - Funeral expenses
  - Payments to repair casualty damage to your principal residence

Limited to amount necessary

- Limited to amount needed to satisfy need and taxes owed because of distribution
- Must look to other sources first:
  - Insurance
  - Liquidation of assets
  - Stop elective deferrals
  - Plan loans
  - Reasonable commercial loans

Amount eligible for distribution

- Generally limited to elective deferrals made to plan reduced by previous elective deferral distributions

6-month suspension of elective deferrals

- Must suspend contributions to any plans maintained by employer for 6 months after receiving distribution

Tax consequences to employee

- Subject to income tax in year of distribution
- If under age 59 ½ , subject to 10% additional tax
- Can add taxes due to amount of hardship request

Hardship distributions are permanent

- Permanent reduction in account balance
  - Can’t be repaid
  - Can’t be rolled over
  - Barred from new contributions for 6 months

Hardships and IRAs

- No “hardships” from IRAs
- Can take a distribution at any time for any reason
  – Subject to income tax and 10% additional tax, unless meets an exception

Mistakes with hardship distributions

- Consequences to the plan
- If not allowed by the plan, but allowed in operation, can jeopardize tax-exempt status of plan trust
  - Affects employer, employee and trust
- Can be resolved through EPCRS

Avoiding loan and hardship distribution mistakes

- Read the plan document
- Create procedures manual
- Use software or automated tools
- If you find a mistake, correct sooner, rather than later

Questions and resources

- www.irs.gov/retirement
- RetirementPlanQuestions@irs.gov
- 877-829-5500
- Newsletters
- 2013 New Roth Conversion Opportunities and Other Retirement Curveballs