



## Best Practices on Handling Participant Loans and Hardship Withdrawals

November 16, 2023

By: Mayleen Santiago Garcés

Carlos J. Villafañe-Real

Puerto Rico | Miami | [mcvpr.com](http://mcvpr.com)



2023

Popular Retirement Plans  
Conference

# Disclaimer

- The contents of this presentation has been prepared for educational purposes only. It is not intended as, and it does not constitute, legal advice. It is recommended that anyone who reads this presentation obtains legal advice from their attorney or financial advisor prior to performing any of the transactions described herein.

# Objectives of the Presentation

- Laws and regulations that must be complied with for the establishment and operation of participant loan programs and hardship distributions in PR Code qualified retirement plans.
- Tax considerations and consequences of noncompliance with the applicable ERISA, federal and PR Code laws and regulations.
- Common errors in the administration of loans, how to avoid them and the correction alternatives available.
- Impact of changes in loan programs and hardship withdrawals under federal law in PR Code plans.

# PARTICIPANT LOANS

# Participant Loans: Overview

- Section 406(a)(1)(B) of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”) prohibits the lending of money or other extension of credit between a “plan” and a “party in interest”.
  - “A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect lending of money or other extension of credit between the plan and a party in interest”.
- This transaction is known as a “Prohibited Transaction”.

## Participant Loans: Overview (Cont.)

- A violation of the “Prohibited Transaction” rules constitutes a breach of fiduciary duty under ERISA.
- Section 408(b)(1) of ERISA, exempts certain transactions like “participant loans” from being treated as “Prohibited Transactions” if certain requirements are met.

# Participant Loan: Requirements under ERISA and PR Code regulations

- Participant loans must:
  - ❑ Be made available to all participants and beneficiaries on a reasonably equivalent basis.
  - ❑ Not be made available to highly compensated employees in an amount greater than the amount made available to other employees.
  - ❑ Be made in accordance with specific provisions regarding such loans set forth in the plan.

# Participant Loan: Requirements under ERISA and PR Code regulations (Cont.)

- Participant loans must:
  - Bear a reasonable rate of interest.
  - Be adequately secured.



# Participant Loans: Reasonably Equivalent Basis

- Loans are available to all plan participants and beneficiaries without regard to any individual's race, color, religion, sex, age or national origin.
- In making such loans, consideration has been given only to those factors which would be considered in a normal commercial setting by an entity in the business of making similar types of loans. (Example: the applicant's creditworthiness and financial need); and
- An evaluation of all relevant facts and circumstances indicates that, in actual practice, loans are not unreasonably withheld from any applicant.



# Participant Loans: Reasonably Equivalent Basis (Cont.)

- A participant loan program will not fail the reasonably equivalent basis requirement if the program established a minimum loan amount of \$1,000.

## Participant Loans: Available to HCE employees in an amount greater than to other employees

- Loans will not be considered to be made available to highly compensated employees, officers or shareholders in an amount greater than the amount made available to other employees if, upon consideration of all relevant facts and circumstances, the program does not operate to exclude large numbers of plan participants from receiving loans under the program.
- A participant loan program will not fail to meet the requirement merely because the plan documents specifically governing such loans set forth either (i) a maximum dollar limitation, or (ii) a maximum percentage of vested accrued benefit which no loan may exceed.

## Participant loans: Available to HCE employees in an amount greater than to other employees (Cont.)

- If the maximum percentage of vested accrued benefit is chosen, a loan program will not fail to meet this requirement solely because maximum loan amounts will vary directly with the size of the participant's accrued benefit.

# Participant Loans: Specific Plan Provisions

- Participant loans are made in accordance with specific provisions regarding such loans set forth in the plan if:
  - The plan provisions regarding such loans contain (at a minimum) an explicit authorization for the plan fiduciary responsible for investing plan assets to establish a participant loan program; and
  - The participant loan program which is contained in the plan or in a written document forming part of the plan includes, but need not be limited to, the following:
    - ✓ The identity of the person or positions authorized to administer the participant loan program;

# Participant Loans: Specific Plan Provisions (Cont.)

- ❑ The participant loan program which is contained in the plan or in a written document forming part of the plan includes, but need not be limited to, the following (cont.):
  - ✓ A procedure for applying for loans;
  - ✓ The basis on which loans will be approved or denied.
  - ✓ Limitations (if any) on the types and amount of loans offered.
  - ✓ The procedure under the program for determining a reasonable rate of interest.
  - ✓ The types of collateral which may secure a participant loan; and
  - ✓ The events constituting default and the steps that will be taken to preserve plan assets in the event of such default.

## Participant Loans: Reasonable Rate of Interest

- A loan will be considered to bear a reasonable rate of interest if such loan provides the plan with a return commensurate with the interest rates charged by persons in the business of lending money for loans which would be made under similar circumstances.

## Participant loans: Adequate Security

- If the security posted for such loan is something in addition to and supporting a promise to pay (i.e., the promissory note), which is so pledged to the plan that it may be sold, foreclosed upon, or otherwise disposed of upon default of repayment of the loan, the value and liquidity of which security is such that it may reasonably be anticipated that loss of principal or interest will not result from the loan. The adequacy of such security will be determined in light of the type and amount of security which would be required in the case of an otherwise identical transaction in a normal commercial setting between unrelated parties on arm's-length terms.



## Participant loans: Adequate Security (Cont.)

- A participant's vested accrued benefit under a plan may be used as security for a participant loan to the extent of the plan's ability to satisfy the participant's outstanding obligation in the event of default. For these purposes:
  - no more than 50% of the present value of a participant's vested accrued benefit may be considered by a plan as security for the outstanding balance of all plan loans made to that participant.

## Participant loans: Adequate Security (Cont.)

- ❑ a plan will be in compliance with the no more than 50% of the present value of a participant's vested accrued benefit requirement, with respect to any participant, if it meets the requirement immediately after the origination of each participant loan secured in whole or in part by that participant's vested accrued benefit.

# Participant Loans: PR Code Requirements

- Section 1081.01(b)(3)(E) incorporates provisions of some of the participant loan rules under US Code Section 72(p):
  - Level amortization requirement – loan, per its terms and in its operation must be repaid through substantially similar payments at least quarterly.
    - What about military leave, leaves of absence and missed payments that are paid in the cure period?
    - Bankruptcy.

# Participant Loans: PR Code Requirements (Cont.)

- ❑ Loan term – loan, per its terms and its operation must be repaid in a period not to exceed 5 years, except in the case of a participant loan to finance the purchase of the principal residence, can be repaid for a period no longer than the period established under the terms of the plan.
- Section 1081.01(b)(3)(E) did not incorporate the maximum loan amount limit requirement of US Code Section 72(p).

# Participant Loans: Taxation

- Generally, participant loans will not be treated as a taxable distribution if the PR Code loan requirements are met.
- Participant loans will be treated as defaulted and thus, as a taxable “deemed distribution”:
  - As of the due date (established under the amortization tables of the loan and the terms of the plan) of the first periodic payment of the participant loan that the participant fails to pay on time.
  - Example: failure to pay the loan upon separation from service.

## Participant Loans: Taxation (Cont.)

- Participant loans will be treated as defaulted and thus, a “deemed distribution”:
  - If the plan document or loan policy provides for a period of correction of the repayment of loans known as a “Cure Period” the participant loan will be considered a “deemed distribution” effective: (i) as of the las day of the “Cure Period” or, if earlier (ii) the date the total balance of the participant’s account is distributed.

# Participant Loans: Taxation (Cont.)

- Tax treatment of Participant loans will depend:
  - If deemed distributed prior to separation from service, taxed as a partial payment subject to the ordinary income tax rates of the PR Code and 10% Puerto Rico income tax withholding.
  - If deemed distributed after separation from service:
    - ✓ If received in the same year of the total distribution, lump sum distribution treatment eligible for special 20% Puerto Rico income tax withholding.
    - ✓ If received in a different year of the distribution, partial payment subject to ordinary income tax rate of the PR Code.

# **PARTICIPANT LOANS COMMON ERRORS AND CORRECTION PROGRAMS**



# Participant Loans: Errors Can Happen

- Errors in participant loans often result in a failure:
  - To comply with the ERISA prohibited transaction exemption and thus, in violations of ERISA's fiduciary provisions.
  - To satisfy PR Code nontaxable loan requirements.

# Participant Loans: Common Errors

- Failure to timely deposit participant loan repayments in trust.
- Failure to comply with the limit on participant loan maximum amounts.
- Failure to comply with the limit on participant loans in duration or level amortization.
- Failure to charge fair market interest rate for participant loan.
- Failure to repay loan in accordance with its terms (Loan Default).

## Participant Loans: Common Errors (Cont.)

- Erroneous participant loan (no plan loan provision or too many loans).
- Failure to obtain spousal consent

# Participant loans: Correction of Errors

- PR Treasury does not have a corrective procedure for the correction of plan loans errors.
- Many plan administrators use the IRS Employee Plans Compliance Resolution System (“EPCRS”) procedures as analogous method for correcting plan loan errors.
- Most recent version of EPCRS available in IRS Revenue Procedure 2021-30.
- SECURE 2.0 Act expanded self correction programs under the EPCRS.

## Participant loans: Correction of Errors (Cont.)

- IRS Notice 2023-43 provides limited interim guidance until official revision of EPCRS is published.

## Participant loans: Correction of Errors (Cont.)

- DOL's Voluntary Fiduciary Correction Program (VFCP):
  - Program of correction of ERISA fiduciary violations resulting from some plan loan failures.
  - On November 21, 2022, the DOL released a proposed amendment and restatement to the VFCP to add a new self-correction feature.
  - SECURE 2.0 Act directs the DOL to start treating the requirements of the VFCP as met for a fiduciary violation if the similar loan error is self-corrected according to the rules of Section 6.07 of the EPCRS.

# Best Practices for Establishing and Maintaining Participant Loan Programs

- Establish a loan program including carefully reviewing the required forms, procedures for approvals and implementing repayment of loans through payroll.
- Coordination between the plan, payroll provider and the recordkeeper to ensure that loans are amortized, that payroll deductions are implemented, and loan payments are timely deposited in the plan.
- Implement a system to monitor the administration of the loan program (i.e., request loan reports made available through the plan's recordkeeper, to among others, check for defaults).

# **HARDSHIP WITHDRAWALS**



# Hardship Withdrawals: Overview

- PR Code Section 1081.01(B)(vi) and its regulations provide that pre-tax contributions can not be distributed to the participant earlier than the occurrence of certain events such as the occurrence of a “hardship”.

# Hardship Withdrawal: Requirements

- Hardship withdrawal is a distribution:
  - that is made by reason of an immediate and heavy financial need of the employee, and
  - the distribution is necessary to satisfy such financial need.
- The determination of the existence of an immediate and heavy financial need and of the amount is necessary to satisfy such financial need must be made in accordance with objective and nondiscriminatory parameters established in the plan document.

# Hardship Withdrawal: Heavy and Immediate Financial Need (Facts and Circumstances)

- Facts and Circumstances Test.
  - Under the facts and circumstances test, the employer must analyze all relevant facts and circumstances surrounding the employee's financial need.

# Hardship Withdrawal: Heavy and Immediate Financial Need (Safe Harbor Test)

- Under the Safe Harbor Test, there is a Heavy and Immediate Financial Need when the distribution is made by reason of:
  - ❑ Medical expenses described in Section 1033.15(a)(4) of the PR Code incurred by the employee, the employee's spouse, or the employee's dependent.
  - ❑ The purchase (excluding mortgage payments) of a principal residence of the employee.
  - ❑ Payment of tuition and education expenses for the following 12 months of post-secondary education of the employee, the employee's spouse, the employee's children or dependents. or
  - ❑ Prevent the eviction or foreclosure of the employee's principal residence.

# Hardship Withdrawal: Distribution Necessary to Satisfy Financial Need (Employee Representations)

- A distribution may be considered necessary to satisfy the heavy and immediate financial need if the employer relies on the employee's representation that the need cannot be satisfied through:
  - ❑ Reimbursement of compensation by insurance or otherwise;
  - ❑ By reasonable liquidation of the employee's assets, to the extent that such liquidation does not cause by itself an immediate financial need;
  - ❑ by cessation of elective contributions or employee contributions under the plan; or

# Hardship Withdrawal: Distribution Necessary to Satisfy Financial Need (Employee Representations) (Cont.)

- A distribution may be considered necessary to satisfy the heavy and immediate financial need if the employer relies on the employee's representation that the need cannot be satisfied through:
  - By other distributions or nontaxable (at the time of the loan) loans from plans maintained by the employer or by any other employer, or by borrowing from commercial sources on reasonable commercial terms.

# Hardship Withdrawal: Distribution Necessary to Satisfy Financial Need (Requirements)

- A hardship withdrawal is deemed necessary to satisfy a heavy and immediate financial need if all the following requirements are satisfied:
  - The distribution is not in excess of the amount of the immediate and heavy financial need of the employee (including income taxes and penalties resulting from the distribution).
  - The employee has obtained all distributions, other than hardship distributions, and all nontaxable loans currently available under all plans maintained by the employer.

# Hardship Withdrawal: Distribution Necessary to Satisfy Financial Need (Requirements)(Cont.)

- A hardship withdrawal is deemed necessary to satisfy a heavy and immediate financial need if all the following requirements are satisfied:
  - The plan, and all other plans maintained by the employer, provide that the employee's elective contributions, and the employee's contributions shall be suspended for at least 12 months after receipt of the hardship distribution. The phrase “all other plans maintained by the employer” means all qualified and nonqualified plans of deferred compensation maintained by the employer excluding mandatory employee contribution of a defined benefit plan; and



# Hardship Withdrawal: Distribution Necessary to Satisfy Financial Need (Requirements)(Cont.)

- A hardship withdrawal is deemed necessary to satisfy a heavy and immediate financial need if all the following requirements are satisfied:
  - The plan, and all other plans maintained by the employer, provide that the employee is prohibited from making elective contributions for the taxable year of the employee immediately following the taxable year of the hardship distribution in excess, of the applicable limitation under the PR Code for such next taxable year, minus the employee's elective contributions for the taxable year of the hardship distribution.

## Hardship Withdrawals: (Taxation)

- Taxable as ordinary income in the participant's income tax return for that year.
- Subject to 10% income tax withholding at the time of the distribution.
- Must be reported in Form 480.7C in the year of the distribution.

# Hardship Withdrawals: US Code Hardship Withdrawal Rules Not Applicable in Puerto Rico

- The US Code:
  - Includes as a heavy and immediate financial need:
    - ✓ Expenses and losses (including loss of income) incurred by the employee (who lived or worked on the disaster area) on account of a federal declared disaster designated as such by the Federal Emergency Management Agency (“FEMA”).
    - ✓ Expenses relating to damage to a principal residence due to a casualty loss.

# Hardship Withdrawals: US Code Hardship Withdrawal Rules Not Applicable in Puerto Rico (Cont.)



- The US Code:
  - Allows participants to make hardship withdrawals for certain expenses incurred (i.e., educational, medical or funeral expenses) by their “primary” beneficiaries.
  - Removes:
    - ✓ The suspension of employee contributions after a hardship withdrawal.
    - ✓ The requirement of taking a plan loan prior to taking a hardship withdrawal.

# Questions

