Participant Loan Disclosures

Many 401(k) plans permit participants to borrow from their accounts. To prevent a plan loan from becoming a taxable distribution, it must meet a number of rules under IRC Section 72(p).

One of the requirements is that the loan must be based on a legally enforceable written agreement. This agreement, which may be either a paper or an electronic document, requires the participant to make amortized repayments at least quarterly, based on a repayment schedule.

This article is an overview of the various loan-related disclosures that plan sponsors should be familiar with if their plan allows participant loans.

Participant Loan Program

If not already described in its Summary Plan Description, a plan must adopt and distribute a "loan policy." This document outlines the plan's administrative procedures for granting and maintaining participant loans. It includes eligibility requirements, limitations on loan amounts, repayment requirements, default rules, and a description of loan initiation and/or maintenance fees (if applicable). Additional points to be covered include, but are not limited to, the effect a leave of absence or active military service has on a participant's outstanding loan, how outstanding loans are handled for a terminated participant, the number of loans permitted, whether refinancing is available, whether a designated Roth is a loan source, and prioritization (if any) of sources or investments to be used for the loan.

Loan Application

The loan application should include the amount being requested, the duration of the loan, the participant's signature, and the date. Accounts subject to spousal consent will require married participants to obtain their spouse's signature consenting to the use of a portion of the account balance as security for the loan. Spousal consent must be witnessed by either a plan representative or notary public. Loan applications may be provided in either paper or electronic format (provided the IRS and DOL electronic communication guidance is followed).

Promissory Note

Plan sponsors should document every loan in the form of a promissory note signed by the participant. The promissory note will specify the amount of the loan and a commercially reasonable rate of interest. (The plan administrator will be responsible for determining the interest rate.)

Amortization Schedule

The loan amortization schedule reflects what portion of each loan repayment is applied to principal and what portion is applied to interest. If a designated Roth source is part of the loan, then each repayment must include an amortized repayment to the designated Roth account.

Irrevocable Pledge

A participant typically will secure a loan with up to 50% of his or her vested account balance (as of the date the loan is granted). The irrevocable pledge and assignment of that portion of his or her accrued benefit is used as collateral for the loan.

If the loan is made from a plan in which earnings are allocated to individual participant accounts and is backed by the participant's vested interest, the security is required to cover the loan principal only. Security for loan interest is not required since a failure to repay the loan would only reduce the participant's own account. In plans with pooled assets, the security must be adequate to cover the loan principal and interest in the event the participant defaults on the loan.

Truth-in-Lending Disclosure

Prior to July 1, 2010, retirement plans that had made a certain number of participant loans in the prior calendar year were required to provide participants who were taking loans with disclosures under the Truth in Lending Act (TILA, also known as Regulation Z). TILA requires creditors to disclose certain financial terms of lending agreements to consumers. These disclosures include the amount financed, finance charge, interest rate (expressed as the annual percentage rate, or APR, which includes the effect of interest compounding), timing of payments, and total amount to be paid.

Effective July 1, 2010, TILA disclosures are generally no longer required for participant loans. However, there are some exceptions: Qualified plans that do not comply with the participant loan requirements of Section 72(p), disregard the 50% of vested account balance rule, or fail to meet the Section 401(a) requirements are still required to comply with the disclosure requirements of Regulation Z.

Note: Some plans still provide the TILA disclosure because it is simple to use and is an excellent disclosure of a loan's financial information.