Is There Any Coronavirus Relief for Participants Who Want to Postpone Plan Loan Payments?

Facts

Several participants in our 401(k) plan currently have outstanding plan loans, and many others are looking to initiate them. However, given the current pandemic, many participants are concerned that they won't have the funds available to continue making payments right now.

Question

Is there any leeway for participants in this situation to postpone payments on their plan loans?

Answer

Yes, the CARES Act does provides some respite for participant loan payments. We'll walk through the specifics on this new payment relief but wanted to share a few reminders first. Even though the new law does allow plans to temporarily offer higher loan limits than normal, most of the familiar loan rules are still in place. These include use a reasonable rate of interest, the need for loan documentation (promissory note, amortization schedule, etc.), and the requirement that a participant go through the application process (either via paper or online).

Now back to the question at hand. For affected participants with loans (new or existing), the CARES Act allows for the postponement of loan payments that would otherwise be due between March 27 and December 31, 2020. Specifically, participant loan payments due during this period may be suspended for up to one year. On the surface, this seems simple enough, but there's certainly more to consider.

As a quick refresher, an affected participant is someone who meets any one of the following requirements:

- S/he has been diagnosed with COVID-19;
- His/her spouse and/or a dependent has been diagnosed with COVID-19;
- S/he is experiencing adverse financial consequences as a result of being quarantined, furloughed, or laid off or having work hours reduced due to the coronavirus; or
- S/he is unable to work due to loss of childcare due to the coronavirus.

Interest & Loan Maturity

For any payments that are postponed, interest will continue to accrue at the loan's stated interest rate. While that will increase the overall cost of the loan over time, the CARES relief also allows for an extension of the maximum repayment period (normally 5 years) to help offset the financial impact. For example, assume Pat took a loan from the plan in January 2020 and amortized for the maximum 5-year period, making the final payment due December 2024. If Pat qualifies as an affected participant, she can not only postpone any payments due between March 27th and December 31st, but also extend the maximum repayment period by a year to December 2025. By spreading roughly 9 months of missed payments and accrued interest over an additional year, Pat's period loan payments should remain roughly the same once they resume.

Repayment & Reamortization

Here's where things get tricky, and we need more guidance. Although CARES provides for the postponement of payments within that window for a year per the Act, there is no postponement or relief for payments due after December 31, 2020. This means that payments that are due starting in January 2021 must be made as scheduled to avoid loan default.

As you might imagine, that has led to quite a few questions about how/when the one-year is actually applied. Some have suggested that it is all about the one-year extension of the repayment term. Others conclude that the postponed loans are not reamortized until one year later. Under that interpretation, the payments that resume in January 2021 would use the existing amortization schedule. Then, just before March 27, 2021 (one year after the first postponed payment), the loan would be reamortized to include the missed payments and interest. Payments would then continue from there using that new schedule.

This relief also applies for payments on new loans taken out during the timeframe in question. Also, not everyone will be an affected participant and those who are won't necessarily first become "affected" at the same time. That has led others to conclude that each loan will have to be reamortized at a different time, based on the date of the first delayed payment. We're hopeful we'll get guidance soon to clarify exactly what "one year" means here.

Which Loan Payments Count?

When we refer to "any loan payment," what exactly does that mean? While a participant's regularly scheduled payment that falls within that March 27 through December 31 window can qualify, other types of loan payments can also apply. Many loan policies accelerate the deadline to repay the loan in full on termination of employment. Let's assume our friend Pat terminates employment on June 30, 2020. If she is an affected participant, this relief would allow her to postpone the due date of that pay-off by a year until June 30, 2021. But, for reasons we will discuss below, that might not be the best option for her.

One thing the relief does not do, however, is postpone the cure period for any payments that were missed before March 27, 2020. Under the "regular" rules, a participant who missed a payment during the first quarter of the year would have until June 30th (the last day of the subsequent quarter) to catch up the missed payment(s) and accrued interest to prevent the outstanding balance from being treated as a taxable distribution. Because the relief is tied to the due date of the payment and not the end of the cure period, any payments missed between January 1, 2020 and March 27, 2020 would have to be caught up by the end of June to avoid the deemed distribution.

The Greater of Two Reliefs

While the ability to postpone loan repayments will be very welcome news to many plan sponsors and participants alike, there are some longer-term considerations to be weighed. For those who are confident they will be able to resume payments, the postponement option may be the preferred choice. However, if an affected participant is unsure about the future prospects for repayment, allowing the loan to go into default and become a deemed distribution during 2020 may be preferable.

The reason is that deemed distributions of participant loans that occur during calendar year 2020 can be treated as coronavirus-related distributions. That means there is no 10% early withdrawal penalty or 20% federal tax withholding, and the participant can spread the income over three years for tax purposes. Not to mention, that also includes the option to repay some or all of the amount in question over three years to avoid/minimize the tax hit. However, if the participant postpones loan payments for a year such that the deemed distribution occurs in 2021, coronavirus-related distributions will no longer be available at that time. That translates into a 10% penalty on the outstanding balance, and the participant will have to take the entire amount as taxable income in 2020.

Mandatory/Automatic or Optional?

A common question about several of the CARES Act provisions relates to whether they are mandatory or optional. We are awaiting guidance on that from the IRS related to the ability to postpone loan payments. However, when Congress provided similar relief in the wake of Hurricane Katrina, the IRS interpreted it as being optional, meaning that each plan sponsor could decide whether or not to offer it. Though we won't know for sure until actual guidance is published, the conventional wisdom at this point is that they will again conclude it is optional.

For those plans that choose to offer this relief, another question is whether or not it is automatically applied to payments on all outstanding loans. That is a definite "no" because only affected participants qualify. Since not all participants with loans will be affected by the virus, in many situations, a blanket delay of all payments would result in loans for unaffected participants going into default.

Logistics

All of the CARES Act relief will require changes to recordkeepers' websites and paperwork. As the Act was only signed into law on March 27th, we anticipate some lag time as recordkeepers work to update systems, which could translate into slower turn-around times and/or manual processes (at least in the interim). We would recommend reaching out directly to your plans' recordkeeper to confirm their timing and process to ensure all participant request are handled as expeditiously as possible. With that in mind, a few things to remember:

- **Participant Requests** Participants wanting to postpone loan payments must, at a minimum, provide two documentation items. They must self-certify to being affected by the virus, and they should make their request to postpone payments in writing. The latter is so that you have formal record to support discontinuing the payroll withholding of those payments.
- **Payroll Updates** Plan sponsors will need to update payroll to reflect the participant's request to temporarily cease payments of the loan. In addition, it is critically important that plan sponsors restart withholding payments beginning with the first pay period in January 2021 to avoid default.

- Reamortizations As discussed above, there are a number of open questions as to how and when loans must be reamortized. While some recordkeeping platforms may be able to automate this process, many cannot. When the time comes, it will be necessary to coordinate efforts among service providers to ensure this is done timely and accurately.
- 1099-R Reporting Many recordkeeping systems automatically generate Forms 1099-R when a loan is in default. Depending on how and when system changes for these postponements are implemented, it's possible there could be incorrect or erroneous tax reporting generated. For that reason, participants should carefully review and work with their tax advisors to ensure appropriate reporting of any 1099-Rs received for 2020.

Finally, an important note on the plan document. Plans are not required to amend for CARES Act provisions until the end of the 2022 plan year. That being said, we always encourage current documentation of any elective provisions so that there is a paper trail of what happened, when it happened, and how it was communicated just in case there are any questions down the road.

As the IRS and DOL issue guidance and we gain clarity on some of the unknowns, you can count on DWC to share that information with you. In the meantime, our team is happy to help with any questions you have along the way. Stay well!

For additional information on how the coronavirus pandemic is impact retirement plans, please visit our FAQ.

Related Resources

- Coronavirus: The Impact on Retirement Plans

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