Important Information | Distributions and Withdrawals | September 2003*

IRS Issues Additional Loan Rules

WHO'S AFFECTED These rules apply to loans made to plan participants from qualified defined contribution plans, including governmental plans, non-electing church plans, and tax sheltered annuity programs.

BACKGROUND AND SUMMARY Many defined contribution plans allow participants to take loans from their participant accounts. IRS rules governing loans, such as restrictions on the amount that can be taken as a nontaxable loan and the maximum period for repayment, have been in place for some time.

The IRS has now released additional rules applying to loans made on or after January 1, 2004. These rules:

- Clarify loan administration for participants who take a leave of absence to perform military service;
- Prohibit new loans to participants with an unpaid defaulted loan unless certain requirements are met;
- Provide guidelines for refinancing participant loans.

ACTION AND NEXT STEPS Plan sponsors whose plans offer participant loans should carefully review the new rules to determine if changes need to be made to the plan's loan program.

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Prudential Financial

PRUDENTIAL RETIREMENT

Pension ANALYST

Guidelines for nontaxable participant loans are not new. For example, in July 2000, the IRS issued final rules that addressed questions about loan administration, such as interest accrual on defaulted loans and the treatment of repayments made on a defaulted loan (see our November 2000 *Pension Analyst* titled "IRS Issues Final Rules on Plan Loans" for more information). Still, the IRS did not address certain administrative questions and concerns. Consequently, the IRS released additional final rules in December 2002, covering:

- Loan administration for participants on leaves of absence to perform military service.
- The availability of new loans to participants with an unpaid defaulted loan.
- Participant loan refinancing.

The new rules, effective for loans taken on or after January 1, 2004, are discussed below.

Participants on Military Leave

Existing regulations require participants to make loan repayments at least quarterly to avoid taxation on the outstanding loan amount. However, there is an exception for participants on a leave-of-absence. Participants on a non-military leave can stop payments for up to one year (or to the end of the leave, if earlier), and the loan will not go into default, provided specific income requirements are met. Interest continues to accrue during the entire suspension period.

The Uniformed Services Employment and Reemployment Act (USERRA) permits plans to allow participants on military leave to suspend repayments until they complete their military service, even if the leave lasts longer than one year, and the loan will not go into default. However, interest continues to accrue during the suspension period.

The new regulations require a participant who suspended loan repayments and returns to work after performing military service, to fully repay the loan (including all interest) in substantially level installments by the end of the original term of the loan plus the period of military service. However, if the original term of a loan that was not taken for the purchase of a principal residence was less than 5 years, the term of the loan can be extended to 5 years plus the period of military service.

The new regulations also clarify that, to comply with the Soldiers' and Sailors' Civil Relief Act of 1942, a maximum interest rate of 6% must be charged while the participant is performing military service. No change to the interest rate is required if the current rate is less than 6%. If the rate is greater than 6%, it can only be retained during the military service period through a court order, even if the participant asks to keep the higher interest rate.

Example: On July 1, 2003, a participant with a vested account balance of $80,000 borrows $40,000, at an interest rate of 8.75%. The loan is not a principal residence plan loan. Scheduled payments are $825 each month for 5 years. The participant makes payments for 9 months and then goes on military leave for two years. During the two-year period of military service, interest continues to accrue, but at a reduced rate of 6%, compounded annually. The participant's military service ends on April 2, 2006, and he resumes employment on April 19, 2006.

When the participant returns to work, the loan will be reamortized at the original interest rate

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(8.75%) and the loan maturity date will be extended from June 30, 2008, to June 30, 2010, taking into account his 2-year leave of absence. The reamortized amount includes both the outstanding principal and the interest that accrued during the leave (at 6%). However, the participant has two options with respect to the payment amount:

- *Increase payments to $930. With this payment amount, the loan will be repaid by the end of its term (June 30, 2010) with no additional amount due on that date.*
- *Continue paying $825 per month as originally scheduled. Due to the interest that accrued during the leave and additional interest that accrues because of the smaller payment amount ($825 vs. $930); $825 per month is not enough to repay the loan by the end of its term. A total of $6,487 in outstanding principal and additional interest will be due on June 30, 2010.*

Before a participant with an outstanding loan goes on military leave, you will need to determine if the interest rate needs to be reduced for the leave period. In addition, the participant should be informed of the option to suspend payments (if the plan allows), the interest rate that will be charged during the leave, and the repayment options when the participant returns to work. If a participant with an outstanding loan leaves to perform military duty, please notify your Prudential Retirement representative immediately if the loan rate is reduced to 6% during the leave so this can be accurately tracked. For additional information regarding the impact of military leaves on qualified plan administration, please refer to our October 2001 *Pension Analyst* titled "Terrorist Attacks Affect Retirement Plans: Federal Agencies Extend Deadlines and Employers Review USERRA Responsibilities

New Loans after a Default

Unless a participant is on a leave-of absence and can suspend payments, failure to make repayments at least quarterly results in a loan default. When a loan goes into default, it is reported as a taxable distribution, but the loan remains outstanding for other plan purposes. Consequently, the loan continues to accrue interest and the balance is considered outstanding when calculating the maximum amount the participant has available for another loan.

The new regulations prohibit plans from making additional loans to participants who have unpaid defaulted loans unless either:

- An enforceable agreement to repay the loan by payroll withholding exists between the employer and the participant, or
- The plan receives security for the loan in addition to the participant's account balance.

One of these conditions must be satisfied at all times for the duration of the loan. If neither condition exists while any portion of the loan is outstanding, the loan is taxable. *For example, if a participant revokes consent to payroll withholding before the loan is repaid and there is no outside security for the loan, the outstanding balance of the loan must be reported as a taxable distribution even if the participant continues repayments at least quarterly via personal check.*

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This restriction on new loans applies if the participant has defaulted on a loan in any plan of the employer. To relieve the administrative concern of controlled group employers with multiple plans in multiple locations, the regulations allow the employer to rely on the participant's certification that defaulted loans do not exist in other plans before issuing new loans.

Unless a participant still has an unpaid defaulted loan in another plan of the employer, plans that allow only one loan outstanding, prohibit new loans after a default, or require repayment via a payroll deduction agreement are generally not affected by the new requirements for obtaining another loan after a default.

Refinancing

To avoid taxation, a participant loan must meet four requirements:

- The term of the loan must not exceed five (5) years, unless the loan is used to purchase a principal residence;
- Substantially level repayments, made not less frequently than quarterly, must be made over the term of the loan;
- The loan must be evidenced by a legally enforceable agreement that shows compliance with the other three requirements listed here;
- The amount of the loan (when added to the outstanding balance of all other loans from a plan) must not exceed the lesser of:
  - $50,000, minus the difference between
    - The highest outstanding balance of loans from the plan during the last 12-consecutive-month period, and
    - The outstanding balance of loans from the plan on the date the loan is made; or
  - The greater of
    - One-half the vested account balance, or
    - $10,000.**

**ERISA requires that no more than 50% of the vested account balance can be used as security for a loan. If the amount of the loan exceeds 50% of the account balance, additional security is required. Prudential-drafted plan documents and loan notes do not allow for loans that exceed 50% of the participant's vested account balance.

The new regulations create guidelines to ensure that any replacement loan (i.e., the loan resulting from refinancing) still meets all of the above requirements.

A loan refinancing is defined as any situation in which one loan replaces another. This can include situations where a new loan replaces an existing loan in the same amount, but with better terms (e.g., a lower interest rate), or a situation where the new loan amount is greater than the existing loan. In any case, it is important to follow the new rules to ensure the five-year term limitation and the amount limitation are met when a loan is refinanced.

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If the replacement loan requires substantially level repayments and its term does not exceed the latest permissible term of the original loan, the replacement loan is not taxable. The latest permissible term of the original loan is five years from the date that loan was taken, with longer periods allowed if the loan was for the purchase of a principal residence or the participant suspended payments due to military service. *For example, a participant with a non-principal residence loan with a three-year term could refinance the loan and repay it within five years of the date the original loan was taken.*

If the term of the replacement loan does exceed the latest permissible term of the original loan, special rules apply. To ensure the term requirement and substantially level repayment requirement for the original loan are met, either:

- The maximum amount available for the replacement loan is calculated by considering both the amount of the replacement loan and the original loan as outstanding, or
- The replacement loan is amortized as two separate loans: the original loan and the amount of the replacement loan above the original loan.

A separate document provides examples showing the application of each of these options.

Effective Date and Next Steps

The final rules are generally effective for loans (including replacement loans) taken on or after January 1, 2004. An amendment to the plan document is unnecessary for many plans, as most of the provisions outlined in these regulations are contained in a separate loan program document maintained by the plan sponsor. However, a Summary of Material Modifications (SMM) or other employee communications may be needed. Plan sponsors whose plans offer participant loans should review their loan programs to determine if changes and/or participant communications are needed to comply with these rules. If you have questions about these rules, or their application to your plan, please contact your Prudential Retirement representative.

COMPLIANCE CLIPS

DOL Provides Guidance on Loans to Directors and Officers

As reported in our September 2002, *Pension Analyst*, the Sarbanes-Oxley Act of 2002 included a prohibition on personal loans from publicly-traded companies to directors and executive officers. As a result, practitioners have raised the question of whether this loan prohibition applies to retirement plan loans. The Securities and Exchange Commission (SEC) may eventually provide relief from these rules for plan loans, but has not yet issued guidance on this matter.

While we await SEC guidance on the loan prohibition, the Department of Labor has recently issued a Field Assistance Bulletin regarding participant loans to corporate directors and officers. The Field Assistance Bulletin clarifies that a restriction on plan loans to directors and executive officers will not be considered a failure to comply with the ERISA rule that loans must be provided

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on a reasonably equivalent basis to all participants. Thus, if a plan sponsor decides to not allow directors and executive officers to take plan loans due to the uncertainty caused by the Sarbanes-Oxley rules, the plan is not considered to be violating the ERISA loan rules.

We will keep you informed if the SEC issues guidance on whether the prohibition on personal loans to directors and executive officers applies to retirement plans. In the event you decide to not allow directors and executive officers to take plan loans, you should amend your plan's loan program or plan document to prevent those individuals from taking plan loans. In addition, you will need to communicate this change in policy to plan participants.

Pension Analyst by Prudential Retirement
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Editor: Mitzi Romano (860) 534-2768

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