Pension ANALYST

IRS Issues Final Rules on Plan Loans

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. Rules have been in place for some time limiting both the amount a participant can take as a loan and the length of the loan, and setting a minimum repayment frequency. However, many questions arose about how to treat loans that do not meet these requirements, either when the loan is made, or at a later date.

Final rules, published by the IRS on July 31, 2000, clarify many aspects of loan administration, such as:

- When a loan must be treated as a taxable distribution;
- The continued accrual of interest on defaulted loans;
- How one loan default may affect a participant's ability to receive another loan; and
- The treatment of repayments made on a defaulted loan.

In addition, these rules specify the criteria that must be met before a participant can take a loan through electronic means.

ACTION AND NEXT STEPS Plan sponsors whose plans offer participant loans should carefully review the final rules to uncover any required changes to the plan's loan program. The final rules are generally effective for plan loans taken on or after January 1, 2002.

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*Republished December 2004 to reflect Prudential Financial's acquisition of CIGNA's retirement business.

A plan loan is not considered a taxable distribution if the following requirements are met:

- The amount of the loan does not exceed the amount limitation, described below;
- The term of the loan does not exceed five (5) years, unless the loan is used to purchase a principal residence;
- Substantially level repayments, made not less frequently than quarterly, are required over the term of the loan; and
- The loan is evidenced by a legally enforceable agreement that shows compliance with the three requirements listed above.

If any of these four requirements is not met, the loan is subject to federal income tax.

The IRS final rules clarify how to fully comply with these four requirements, and provide direction for the handling of loans that do not meet these criteria.

Requirements for a Non-Taxable Loan

Amount Limitation

Any 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.

The final rules do not change this formula, but they do clarify that interest continues to accrue on outstanding defaulted loans and that the accrued ("phantom") interest is included as part of the outstanding balance.

Maximum Term

A plan loan must be repaid in no more than five (5) years unless the loan is for the purchase of a principal residence (a "home loan").

The new rules confirm that a loan does not have to be secured by the residence to be considered a home loan. In addition, a refinancing generally does not qualify as a principal residence loan. However, if a plan loan is used to repay a loan from a third party that would qualify as a home loan if there were no third party, the loan can be granted for a term exceeding five (5) years.

For example: On July 1, 2003, a participant requests a $50,000 plan loan, with a 15-year repayment period (monthly payments). On August 1, 2003, before the plan has acted on the loan request, the participant buys a principal residence. He uses a $50,000 bank loan to pay a portion of the purchase price. On September 1, 2003, the plan grants the $50,000 loan to the participant, *which he uses to pay off the bank loan. Since the plan loan would otherwise qualify as a principal residence loan, the loan repayment period can extend beyond five (5) years, to the requested 15-year period.*

Substantially Level Repayments

To avoid taxation, a plan loan note must require substantially level repayments made at least quarterly. However, participants who meet certain criteria can suspend loan payments without incurring default.

If a participant is on a military leave, a plan can allow a participant to stop repayments for any part or all of that leave period, even if it extends beyond one year. During this period, the loan will not go into default.

For a participant on any other type of leave, payments can be stopped for up to one year (or to the end of the leave, if earlier) if the participant is either receiving

- No pay from the employer, or
- A rate of pay (after income and employment tax withholding) that is less than the amount of the scheduled repayments.

When the payment suspension period ends, a loan default occurs if repayments do not begin. Unless the suspension was due to a military leave, the loan must still be repaid by its original maturity date. The participant must pay the interest that accrued during the leave as well as the remaining principal and scheduled interest payments. The participant can use the following methods to repay the loan:

- Re-amortize the principal and all accrued interest over the remaining term of the loan.
- Continue the scheduled payments and pay off the additional accrued interest at the end of the loan's term.

Legally Enforceable Agreement

A plan loan is considered a taxable payment to the participant unless a legally enforceable agreement is in place. The amount and date of the loan and the repayment schedule must be stated in the agreement. The agreement can consist of more than one document and does not have to be signed if it is enforceable under applicable law without a signature.

The final regulations clarify that a legally enforceable agreement can be either a written paper document, or set forth in an electronic medium that is reasonably accessible to the participant through a system that:

- Is designed to prohibit anyone other than the participant from requesting a loan;
- Allows the participant to review, confirm, change or rescind the terms of the loan before the loan is made; and
- Provides either a written or electronic confirmation of the loan terms. If an electronic confirmation is given, that confirmation must be as understandable as a written confirmation. In addition, the participant must be told that a paper confirmation is available at no charge.

Defaulted Loans

If a loan does not meet each of the four requirements noted above, the loan is a deemed distribution. When a plan loan becomes a deemed distribution, it becomes taxable income to the participant. The insert titled “Timing and Amount of Deemed Distributions” provides a summary of when and how much of the loan should be reported as taxable, if applicable.

While a loan may become a deemed distribution at any time, including at the time it is granted, a deemed distribution typically occurs when scheduled payments are not made and the loan goes into default. The final regulations provide that a plan can allow a “cure period” before reporting a loan in default. The maximum cure period is to the end of the calendar quarter following the calendar quarter in which the unpaid repayment was due.

Although a defaulted loan becomes taxable as a deemed distribution, it is not considered an actual distribution. It remains an asset of the participant's account. The loan is still considered outstanding until it is either repaid or "offset." A loan offset occurs when the participant’s account balance is used to repay the loan. An offset can only occur if the participant is eligible to receive a payment from the plan (e.g., at age 59½, retirement, termination, etc.).

The effects of a loan default as compared to a loan offset are significant. A loan in default that has not been offset is still an outstanding loan. It must be counted if the plan limits the number of loans a participant may have outstanding. It is also taken into account in the calculation to determine the maximum amount available for a new loan. In addition, interest continues to accrue on the unpaid loan balance. Since it is not a true distribution, the amount of the default cannot be rolled over.

However, after a loan is offset, it is no longer considered outstanding. Therefore, it is not taken into account for purposes of determining the amount available for another loan. Since the offset satisfies the loan, interest stops accruing. In addition, the amount of a loan offset can be rolled into another qualified plan or an IRA.

Interest Accrual

As noted above, when a defaulted loan is still outstanding, it continues to accrue interest until it is either repaid or offset. This phantom interest that accrues after the default is not reported as additional taxable income to the participant. However, it does need to be included as part of the outstanding balance of the loan when calculating the amount the participant can take as another loan.

For example: A participant fails to make the scheduled repayments on his loan. On January 1, 2001, the entire outstanding balance of $10,000 becomes a deemed distribution (i.e., taxable). Interest in the amount of $800 accrues from January 1, 2001, to January 1, 2002. The $800 is not reported as taxable income to the participant, but assuming the participant requests another loan on January 1, 2002, the calculation to determine the maximum amount available must take into account an outstanding loan of $10,800.

Repayments after Default

If a participant repays a defaulted loan, those repayments create a tax basis in the participant's account. Although the amount of the repayments are non-taxable when eventually paid to the participant upon termination, retirement, etc., those repayments are not classified as post tax contributions (i.e., they are not included in ACP testing or the annual additions limit).

For example: Assume the same facts as the example above. If the plan requires that only one loan can be outstanding at any time, the participant will need to repay the first loan before a second loan can be taken. To fully repay the loan on 1/1/02, the participant will need to pay the outstanding amount plus accrued interest ($10,800). Once repaid, the provisions of the source of money from which the loan was processed (elective deferrals, match, etc.) are applied. However, when the $10,800 is eventually paid from the plan, it must be reported as nontaxable (i.e., the participant has a basis in the account of $10,800) because the amount has already been taxed as a deemed distribution.

Effective Date and Next Steps

The final rules are generally effective for plan loans taken on or after January 1, 2002. Plan sponsors whose plans offer participant loans should review their loan programs to determine if changes 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.

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Editor: Mitzi Romano (860) 534-2768

Timing and Amount of Deemed Distribution

Initial Loan Requirements to Avoid Deemed Distribution	When Loan Becomes a Deemed Distribution if Requirement is Not Met	Amount of Deemed Distribution if Requirement is Not Met
*$50,000/50% amount limitation**	At the time the loan is made.	The amount that exceeds the $50,000/50% limitation.
Five-year term for non-principal residence loans	At the time the loan is made.	Entire amount of the loan.
Substantially level repayments made not less frequently than quarterly	1. If the loan does not require level repayments, it becomes a deemed distribution on the day the loan is made. 2. If a scheduled repayment is not made when due, the loan becomes a deemed distribution on that date. However, the plan sponsor can allow a "cure period" before the loan becomes a deemed distribution. If the repayment is made before the end of the "cure period," the loan is not a deemed distribution. The "cure period" cannot extend beyond the last day of the calendar quarter following the calendar quarter in which the last repayment was due.	The entire outstanding balance of the loan, including accrued interest.
Legally enforceable agreement	At the time the loan is made.	Entire amount of the loan.

*$50,000/50% Amount Limitation:

Any loan (when added to the outstanding balance of all other loans from a plan) must not exceed the **lesser of** I. or II. below:

I. $50,000 minus the difference between:
   a. the highest outstanding balance of loans from the plan during the last 12-consecutive-month period, over
   b. the outstanding balance of loans from the plan on the date the loan was made; ***or***

II. The greater of:
   a. one-half of the vested account balance, or
   b. $10,000.**

**ERISA requires that no more than 50% of the 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 account balance.