

MEMO# 15416

December 3, 2002

IRS ISSUES FINAL REGULATIONS ON PLAN LOANS

[15416] December 3, 2002 TO: PENSION MEMBERS No. 58-02 PENSION OPERATIONS ADVISORY COMMITTEE No. 80-02 RE: IRS ISSUES FINAL REGULATIONS ON PLAN LOANS The Internal Revenue Service has issued final regulations under Code section 72(p) regarding loans from qualified employer plans to plan participants or beneficiaries. These regulations adopt with modifications the proposed regulations issued in July 2000.¹ Notably, the final regulations are responsive to a number of recommendations made by the Institute.² The following discussion summarizes the revisions and clarifications reflected in the final regulations.

Multiple Loans. Consistent with the Institute's comments, the final regulations do not include any limitation on the number of loans that can be made under Code section 72(p). The proposed regulations had provided that a deemed distribution would occur if a participant obtains more than two loans per year.

Loans After Deemed Distributions. The final regulations retain the proposed rule imposing additional requirements on loans issued to a plan participant or beneficiary who had defaulted on a previously issued loan. Accordingly, for loans made subsequent to a loan that has been deemed distributed, the plan must enter into an agreement under which either repayments are made by payroll withholding or adequate security for the additional loan (in addition to the participant's accrued benefit) is obtained.

¹ See Institute Memorandum to Pension Members No. 41-00 and Pension Operations Advisory Committee No. 59-00, dated August 2, 2000. The IRS in July 2000 had issued both final and proposed regulations under section 72(p) of the Internal Revenue Code. The final regulations addressed, among other things, the formation and required terms of loan agreements, the determination of deemed distributions, the treatment of loans after deemed distributions, and "cure" periods for missed payments. The proposed regulations addressed the suspension of loan payments during a leave of absence for military service, the effect of a new loan following a deemed distribution of a prior loan, and the effect of refinancings and multiple loans. The preamble to the proposed regulations also requested comments on the application of the Electronic Signature in Global and National Commerce Act (ESIGN).

² See Institute Memorandum to Pension Committee No. 81-00, Pension Operations Advisory Committee No. 80-00 and October 11th Conference Call Participants, dated October 31, 2000.

The preamble to the final regulations, however, observes that in order to satisfy the limitations on the maximum amount that may be borrowed from a plan, the issuer of any loan under section 72(p)(2) must inquire about other loans made from the plan or any other plan of the employer before extending a loan. The preamble, therefore, provides that the issuer can condition a new loan on a participant's disclosure of such prior loans and, for this purpose, rely on an employee's certification concerning the status of the prior loans, assuming the issuer has no reason to doubt the employee's certification.

Loan Refinancing Arrangements. The final regulations generally adopt the proposed rules on loan refinancings. Thus, a refinancing

arrangement must satisfy the requirements of section 72(p)(2)(B) and (C) that loans be repaid in substantially level installments, not less often than quarterly and over a period not in excess of five years. Additionally, a refinancing is treated as a continuation of the prior loan, plus a new loan to the extent of any increase in the loan balance. The final regulations, however, reflect a modification that accommodates the extension of a prior loan with an original term of less than five years to a term of five years from the date of the prior loan. Application of ESIGN. The preamble to the final regulations notes that the IRS and the Treasury anticipate issuing proposed regulations on the extent to which notices under the various Code requirements relating to qualified retirement plans can be provided electronically (taking into account the effect of ESIGN). These proposed regulations may consider the requirements applicable to electronic plan loan agreements. Additionally, a footnote in the preamble discusses the applicability of the Federal Reserve Board's Regulation Z — which implements the requirements of the Truth in Lending Act — to plan loans. Specifically, the footnote states that the staff of the Board of Governors of the Federal Reserve System has advised the IRS that a plan loan satisfying section 72(p)(2) and the final regulations would constitute an extension of credit under 12 C.F.R. 226.2(a)(14) of Regulation Z. Thus, unless the plan or the loan is otherwise exempt from Regulation Z, a plan loan that satisfies the requirements of Q&A 3(b) of the regulations (i.e., the enforceable agreement requirement) would be subject to the disclosure and other requirements of Regulation Z. The staff of the Board has also advised that pending the Board's adoption of final rules on electronic disclosures, creditors may provide electronic disclosures required by Regulation Z if the consumer's consent is obtained as required under ESIGN.³ Loans Under 457(b) Plans. With regard to the permissibility of plan loans from governmental 457 plans, the preamble to the final regulations notes that proposed regulations under section 4574 issued earlier this year clarify the conditions under which loans can be made to participants and that section 72(p) applies to such loans.⁵ 3 See 67 Fed. Reg. 71824 n. 1 (December 3, 2002). 4 See Institute Memorandum to Pension Committee No. 16-02 and Pension Operations Advisory Committee No. 32- 02, dated May 9, 2002. 5 The Institute's letter in response to the proposed plan loan regulations had sought clarification that governmental employers could offer loans to 457(b) plan participants in a manner consistent with section 72(p). 3 Loan Repayment Suspension During Military Service. The final regulations generally adopt the regulations as proposed with regard to the suspension of loan repayments for periods during which a participant is performing military service.⁶ Accordingly, a plan that permits suspension of loan repayments during a leave of absence for military service will not cause the loan to be deemed distributed, even if the leave exceeds a year. Effective Date. While the preamble to the final regulations provides an "effective date" of December 3, 2002, both the preamble and the final regulations specify that the final regulations apply to assignments, pledges, and loans made on or after January 1, 2004.⁷ Thomas T. Kim Associate Counsel Note: Not all recipients receive the attachment. To obtain a copy of the attachment, please visit our members website (<http://members.ici.org>) and search for memo 15416, or call the ICI Library at (202) 326-8304 and request the attachment for memo 15416. Attachment (in .pdf format) 6 Two modifications are reflected in the final regulations with regard to this rule. First, an example in the final regulations has been modified to reflect the application of a maximum 6 percent interest rate during military leave pursuant to the Soldier's and Sailors' Civil Relief Act Amendments of 1942. Second, the final regulations clarify that loan repayments can be revised at the end of a military leave to extend the repayment schedule in the event the loan originally had a term of less than five years. The latter revision is consistent with the change made to the loan refinancing rules. 7 The preamble also provides that the final regulations do not apply to loans made under an insurance contract that is in effect on December 31, 2003, if the insurance carrier is required to offer loans to

contractholders that are not secured (other than by the participant's or beneficiary's benefit under the contract).

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