

## IRS FINAL LOAN REGULATIONS

On December 3, 2002, the IRS issued the final loan regulations which apply to assignments, pledges and loans made on or after January 1, 2004. Therefore, now is the time to review your plan document, loan policy, participant loan forms and participant disclosures to determine what modifications (if any) are needed to comply with the new final regulations.

The final regulations address four areas of changes from the proposed regulations including: (1) refinanced loans; (2) number of loans outstanding at one time; (3) loans to employees on leave for military service; and (4) loans after default and deemed distribution. We will address each of these items and how each of these items may impact the documentation for the plan.

### Refinanced Loans

Pursuant to the final regulations, loans can generally be refinanced and additional amounts may be borrowed as long as the refinancing complies with the dollar limits and repayment requirements (e.g., substantially level installments, at least quarterly payments and loan period not to exceed five years) of Code Section 72. The refinanced loan is treated as a continuation of the prior loan, plus a new loan to the extent of an increase in the loan balance. However, the prior loan must still be repaid in substantially level installments over a period not longer than the original term remaining on the prior loan in order for the refinancing not to result in a deemed distribution. To the extent the refinanced loan exceeds the prior loan amount, that excess amount can be repaid over a five-year period from the date of refinancing. If the prior loan had an original term of less than five years, the loan may be refinanced to a term of five years from the date of the prior loan.

If a plan will allow loans to be refinanced:

1. Review the plan document to ensure that the language does not prohibit any refinancing.
2. Amend the loan policy to state under what circumstances refinancing will be permitted.
3. Update the participant loan request form to ask whether this is a request for a refinance and, if so, the prior loan balance and prior loan payment schedule. Also, ensure that the form inquires whether there are any other outstanding loans (or were there any outstanding loans within the last 12 months) so that the Code Section 72 dollar limit is not exceeded.
4. Update participant disclosures to explain the IRS rules on refinancing and clarify that the refinance cannot extend the repayment schedule of the original loan beyond five years.

### Number of Loans Outstanding at One Time

The final regulations clarify that multiple loans may be made to participants during a single year. The IRS removed the two loan limit that was in the temporary regulations. However, the plan administrator must be cautioned to ensure that the participant does not exceed the maximum loan limit with these multiple loans.

If the plan will not limit the number of loans made to a participant during a single year, then:

1. Review the plan document and make sure that the plan does not limit loans to a particular number each year.
2. Review the loan policy and procedures to ensure that it does not state a maximum number of loans a participant may receive during a single year.
3. Make sure that the participant loan request form inquires whether there are any other outstanding loans (or were there any outstanding loans within the last 12 months) so that the Code Section 72 dollar limit is not exceeded.
4. Review participant disclosures to determine if there are a stated maximum number of loans a participant may receive in a single year.

If the plan will limit the number of loans made to a participant during a single year, then:

1. Review the loan policy and procedures to ensure that the maximum loan limit is stated.
2. Make sure that the participant loan request form inquires whether there are any other outstanding loans (or were there any outstanding loans within the last 12 months) so that the Code Section 72 dollar limit is not exceeded.
3. Review participant disclosures to state the maximum number of loans a participant may receive in a single year.

### Loans to Employees on Military Leave

Pursuant to Code Section 414(u), a plan may suspend repayment on a loan for employees on military leave. The repayment of the loan must recommence when the employee's military leave ends. However, this does not alter the accrual of interest during the period of military leave (under the Soldiers' and Sailors' Civil Relief Act, the maximum interest rate is 6%). As a result, the pre-suspension installment rate will not

be sufficient to cover the principal plus additional interest. The regulations provide the following options:

1. If the original loan term was less than five years, it can be extended to five years.
2. If the original loan term was five years, the participant may choose to increase the amount of the payments or to make payments at the previous rate with a balloon payment due at the end of the required time.

You should review the loan policy and procedures and participant disclosures to ensure that they adequately address what happens to loans while employees are on military leave.

#### Loans after Default and Deemed Distribution

If a loan is deemed distributed and has not been repaid, then all future loans will be deemed distributions unless one of the following conditions is satisfied for the entire term of the new loan:

1. There is an arrangement among the plan, the participant and the employer, enforceable under applicable law, under which repayments will be made by payroll withholding.
2. The plan receives adequate security from the participant that is in addition to the participant's accrued benefit under the plan.

If a plan will allow new loans after a deemed distribution, then:

1. Amend the loan policy and procedures to adopt one or both of these options.
2. Make sure that the participant loan request form enquires whether the participant had a loan default and a deemed distribution. This is particularly important since all plans of the employer are treated as one plan for purposes of Code Section 72.
3. Make sure the payroll withholding form complies with and is enforceable under applicable state law.

The new final regulations will impact a plan's loan program and, as such, the various documents should be reviewed and modified prior to January 1, 2004.