TCRS 2004-01: Final Loan Regulations

2004 promises to be a very active year on the legislative and regulatory front. The Transamerica Center for Retirement Studies promises to keep you appraised on all the latest developments.

Our first release for the year, TCRS 2004-01, outlines the IRS' final regulations for 401(k) plan loans which became effective for plan loans made on or after on January 1, 2004. These regulations were initially proposed on July 31, 2000 and finalized on December 3, 2002.

Suspension of Loan Repayments During Leave Of Absence for Military Service.

If a plan suspends loan repayments during a period of military leave, such suspension would not result in a deemed distribution* provided:

- Repayments resume upon completion of military service.
- Loan is repaid during the original term of the loan, plus the period of military service (which could extend beyond one year).
- The interest rate during the period of military service does not exceed 6%.

If the original loan term is less than 5 years, loan repayments may be revised at the end of the military leave to extend the repayment schedule to 5 years from the date of the original loan (e.g., if the original term is 3 years).

Loans After A Deemed Distribution*

Loans after a deemed distribution:

- Are generally allowed, provided the plan enters into an agreement with participant or beneficiary that repayment for the new loan be by payroll withholding or the plan receives collateral, in addition to the participant's or beneficiary's account balance under the plan.
- May not be practical as an option under a plan that allows loans to terminees.
- May be an issue for service providers who do not accept additional collateral (in addition to account balance).

In the explanation to the final regulations, in order to satisfy Code section 72(p), the plan may condition a new loan on a participant's disclosure of prior loans, e.g. a certification.

* A *deemed distribution* occurs at the time the requirements of Code section 72(p) are not satisfied in form or operation. This may occur at the time the loan is made or at later time. The amount includible in income as a result of the deemed distribution is required to be reported on Form 1099 for the year in which the deemed distribution occurred. Here are some examples of deemed distributions:

1) Failure to make installment payments when due (including grace periods) in accordance with the terms of the plan.
2) When the loan limits are exceeded. In this case, the excess amount is a deemed distribution.
3) When the repayment period exceeds the maximum 5-year period and it is not a residence loan. In this case the entire loan amount is a deemed distribution.

Loan Refinancing

Loan refinancing includes situations in which one loan replaces another loan. When refinancing a loan(s), a participant can:

- Continue the prior loan with reduced repayment amounts without extending the repayment period, or
- Borrow additional amounts to be repaid over a new 5-year period from the date of refinancing, if the refinanced loan is repaid in substantially level installments, not less frequent than quarterly over a period not exceeding 5 years (longer for certain home loans) and the original loan repayments continue in level installments over the remaining period of the original loan.

Regulatory stipulations require that:

- Both the prior loan and the refinancing loan are treated as outstanding at the time of refinancing and must meet the loan limits and other requirements of Code section 72(p).
- If the original loan is for less than 5 years, the term may be extended to a term of 5 years from the date of the original loan.

In dealing with client situations, loan refinancing may be an attractive alternative to multiple loans (which involve greater tracking and complexity).

Multiple Loans

The final regulations permit an unlimited number of loans. However, industry experience has shown that the majority of plans offering multiple loans allow only two loans. The practical reality is that multiple loans increases the complexity of payroll deductions of loan repayments from the plan sponsors' perspective and complicates the recordkeeping from the retirement providers' perspective.

In client situations, it is important to remember that some service providers limit the number of outstanding loans and/or limit the number of loans that can be applied for during a given plan year. Moreover, a refinanced loan to the extent of any increase in the amount of the outstanding balance counts as a separate loan for purposes of Code section 72(p) and any plan imposed limit on the number of loans.

This summary briefly describes the final regulations effective for loans made on or after January 1, 2004. The final regulations contain specific examples of how these rules are applied. For other loan rules please refer to your plan document or contact your plan consultant.

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