PLAN PARTICIPANT LOANS AND THE TERMINATED EMPLOYEE

Although loans to retirement plan participants significantly increase administrative activities and responsibilities, many employers include them as a retirement plan feature. In many cases, participant loans are available from 401(k) and profit sharing plans. They are included as a plan feature to encourage participation; particularly on the part of lower paid employees who might not otherwise be willing to set aside a portion of their earnings for a long period of time. When designing, redesigning, or administering a participant loan program, the employer must focus on how the program operates when a participant with a plan loan terminates employment.

Should Former Employees' Participant Loans Continue After Employment Termination?

This basic question needs to be answered at the time the plan loan program is being created or modified. If the answer is "no" (and it often is), the terms of the loan will probably include an acceleration clause that causes the loan to become fully due and payable upon termination of employment. This provision not only minimizes administrative effort and expense; it also avoids post termination loan defaults that result in higher taxable distributions due to additional unpaid accrued interest. According to federal law, loan acceleration provisions cannot apply to a former employee who remains a "party in interest." ERISA defines a "party in interest" to include 50% owners, officers, directors, and plan fiduciaries. Similarly, a loan policy can be designed to prohibit granting new loans to former employees, unless the former employee is a party in interest.

Payroll Deductions Issues

Many Plan Loan Policies require that all plan loans be repaid via payroll deduction. Occasionally, employers think they can force immediate repayment from a former employee on the grounds that payroll deduction is no longer possible. This practice is prohibited by applicable federal regulations. It is permissible to prohibit former employees (other than *parties in interest*) from taking out new plan loans, however, and the plan loan may include an acceleration clause as noted above. If the loan repayment is not accelerated, suitable arrangements must be made to allow the debtor to continue to repay the loan.

However, the Loan Agreement can be structured to allow the Plan Administrator to require more collateral for participants who cannot repay the loan by payroll deduction. In addition, if a former employee defaults on his or her loan payments, the loan is deemed a taxable distribution and can be immediately offset against the former employee's other plan benefits, resulting in minimal risk to the plan.

Plan Discrimination Concerns

According to federal regulations, a qualified plan that offers participant loans must do so on a basis that does not discriminate based on race, color, age, sex, religion, or national origin. In addition, the program must be designed and operated in a way that does not discriminate in favor of Highly Compensated Employees (as defined in the Internal Revenue Code). This is why, for example, a Plan Loan Policy cannot require a loan minimum of more than $1,000. Also, the law sets a ceiling equal to half of the participant's vested plan interest; but includes a $50,000 overall maximum loan amount. Often, Plan Administrators who are aware of the rules prohibiting discrimination in favor of Highly Compensated Employees worry that denying loans or accelerating loan repayments for former employees *except for parties in interest* might be considered discriminatory. They reason that most

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parties in interest are former Highly Compensated Employees and allowing them to continue their loan repayments will be discriminatory. Fortunately, there is a special rule in the discrimination regulations that allows the formerly employed *parties in interest* to be treated as if they were not Highly Compensated for testing purposes.

----------- DEFINED BENEFIT PLANS ------------

IRS PUTTING SPECIAL EMPHASIS ON FUNDING DEFICIENCIES COMPLIANCE

The IRS announced in March that they are initiating a special "compliance check" for employers that disclose a plan funding deficiency for a Defined Benefit Plan on their Form 5500 filing. The IRS points out that a "compliance check" is not the same as an audit. This means, for example, that if the employer wishes to submit a plan correction matter to the IRS under their Employee Plans Correction Resolution System, they are free to do so, even though this is not permitted while the plan is "under examination."

The IRS letter asks questions concerning the reported funding deficiencies and requests additional information. While the exact language is not divulged, the IRS is checking to be sure that the following has occurred:

- The funding deficiency has been or will be corrected,
- Form 5330, the form transmitting the excise tax for the deficiency, was timely filed,
- The excise tax equal to 10% of the funding deficiency has been paid.

Any employer receiving such a letter is urged to respond completely and promptly because the IRS says, "Non-responders could be later audited." One of the explanations provided by employers getting the compliance check is that no funding deficiency exists. This is because the contribution to fund the deficiency was made after the Form 5500 filing, but within the permitted 8½ months following the end of the plan year. This can easily happen, given that the deadline (ignoring extension) for filing the Form 5500 is 7 months after the plan year end, while 8½ months is allowed for making the payment.

If an employer believes that there is a reasonable chance that an unpaid minimum funding obligation will be paid within the 8½ month period following a plan year, it may be prudent to obtain an extension of time for filing Form 5500 so that the employer can avoid filing a Form that reports a nonexistent funding deficiency. NRS routinely requests extensions for filing Form 5500 in these situations.

REMINDER: EGTRRA RESTATEMENT FOR DEFINED BENEFIT PLANS

As mentioned in previous newsletters, all defined benefit plans that use pre-approved documents are required to restate their plan document to include new preapproved language that reflects recent laws and regulations. Called the 'EGTRRA restatement," named after one of the recent laws, the restatements are required no later than April 30, 2012. If an employer wishes to submit the plan document to the IRS for their review and approval for any reason (such as because custom non-approved language was added), the submission must occur no later than April 30, 2012 in order to preserve the right to make retroactive corrections as may be required by the IRS. NRS clients will be receiving plan specific communications regarding their plan restatement later this month or early in June.

For more information or to request a proposal, please visit our website at www.NRServices.com, or for sales support, please contact:

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