Final 72(p) Regulations

Background

Deemed Distribution

- A loan is a deemed distribution at the outset if:
  - It exceeds the 72(p) limit (to the extent it exceeds the limit)
  - The term of the loan exceeds 5 years (except for personal residence loan)
  - The loan does not call for level amortization of principal and interest with payments at least quarterly
- A loan becomes a deemed distribution if a participant defaults and does not timely cure the default

AMOUNT LIMITATION

- All outstanding plan loans cannot exceed lesser of:
  - $50,000 with adjustments; *or*
  - Greater of
    - 50% of vested account balance
    - $10,000

Limits Based on Vested Account Balance

Vested Account Balance	Maximum Loan Amount
$120,000	$50,000
$100,000	$50,000
$70,000	$35,000
$20,000	$10,000
$15,000	$10,000 but need additional security

EXAMPLE

- Account balance = $30,000
- Vested account balance = $24,000
- Loan limit = $12,000

- Participant obtains $15,000 loan
- Deemed distribution = $3,000
- Participant must repay entire loan
- Obtains basis for repayment of deemed distribution

$50,000 LIMIT/ LOOKBACK RULE

- Reduce $50,000 limit by the amount by which
  - The highest outstanding loan amount within previous 12 month period
  - Exceeds current loan balance

- Does not apply to 50% limit

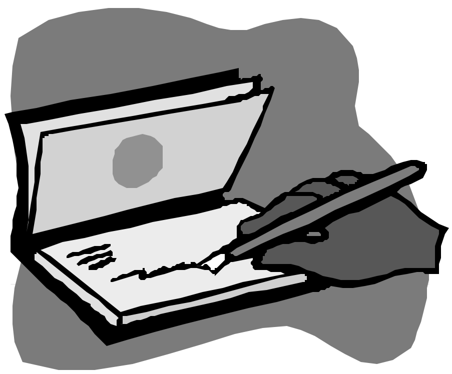
EXAMPLE

- EE has a vested account balance of $80,000 on 4/1/01
- EE obtains loan on 4/1/01 – $40,000
- Balance on 4/1/02 – $33,000 (i.e. EE has paid $7,000 of principal during the year)
- EE wants another loan 4/1/02 when vested account balance is $90,000

EXAMPLE (CODE §72(p) CALCULATION)

- $50,000
  - 7,000 (40,000 - 33,000)
  43,000
- 4/1/02 loan limit = lesser of $43,000 or 50% X $90,000 = $43,000
- 4/1/02 outstanding loan = $33,000
- Participant can borrow $10,000

LEVEL AMORTIZATION



- Amortize principle and interest at least quarterly
- Missed payment will cause 72(p) violation
- Most common cause of deemed distributions

GRACE (CURE) PERIOD

- Plan can provide a grace period for missed payment
- Maximum: Last day of following calendar quarter
- Plan may use smaller grace period (e.g., 90 days or 30 days)
- Good to have some grace period. Otherwise, one day late = deemed distribution

EXAMPLE

- Participant misses 8/15/02 payment
- Plan uses maximum grace period
- Loan is in default: 12/31/02

POST-DEFAULT (PHANTOM) INTEREST

- Interest still accrues after deemed distribution. Interest accrues until the loan is repaid (perhaps by offset).
- The interest does not give rise to another deemed distribution
- However, phantom interest is still relevant

Effect of Phantom Interest on Additional Loan

- Although interest not accrued for purposes of deemed distribution
- Plan must consider defaulted loan + phantom interest for loan limit on additional loans
- Plus, interest still accrues for plan accounting

REPAYMENT OF DEFAULTED LOAN

- To repay entire loan, EE must repay loan + phantom interest
- EE obtains basis for repaid defaulted loan
- Not after-tax EE contributions — not subject to ACP test

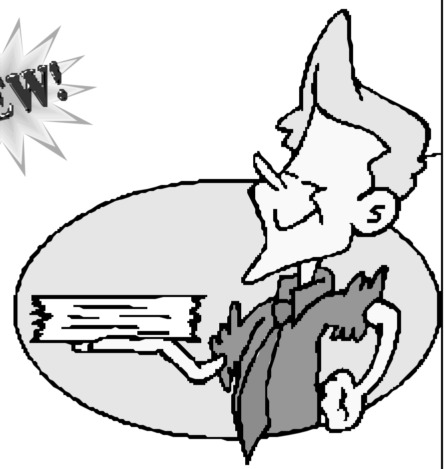
Deemed Distribution vs Loan Offset

- Deemed distribution is taxable event.
- Participant cannot roll over a deemed distribution
- Deemed distribution happens when loan violates 72(p)
- Loan still exists and accrues interests after deemed distribution

- Loan offset is foreclosing on security interest
- Loan offset is functionally equivalent to taking a distribution from the plan and using the distribution to replay the loan
- Loan offset requires distributable event
- Loan is extinguished after loan offset and no longer accrues interest

Final Regulations

Conditions for new loan after deemed distribution



- Newly finalized regulations
- After deemed distribution, if old loan not repaid (either through actual payment or loan offset), then any new loan is a deemed distribution unless there is payroll withholding or additional collateral

Cause of deemed distribution irrelevant

- Makes sense if deemed distribution comes from a default in payments
- Could be because loan exceeded $ limit, or 5 years, or wasn't properly evidenced

Limit on new loans after deemed distribution. Example

- Janet, with a $50,000 vested accrued benefit in her company's 401(k) plan, borrows $15,000 on 4/30/03.
- She doesn't make the 10/30/03 loan repayment or any payment thereafter.
- The loan goes into default 3/31/04 and the company issues a 1099-R for the deemed distribution. However, it can't offset the loan because there is no distributable event.

Example continued

- 7/1/04, Janet wants a new plan loan. The new loan, plus the old loan, plus the phantom interest is less than half her vested balance.
- The new loan is immediately a deemed distribution unless:
  - Janet repays the old loan plus phantom interest before getting the new loan;
  - Payments on the new loan will come from payroll deductions; or
  - Janet pledges extra security outside the plan (e.g., her home) as security for the new loan.

Don't change your mind

- If participant changes mind, it can trigger a deemed distribution
- Example (continued). Janet agreed to payroll withholding and takes a new loan 7/1/04. 2/1/05, after finding she has trouble making ends meet, Janet revokes the withholding agreement. 2/1/05, the then existing balance of the new loan is a deemed distribution.

Loan Refinancing Under Newly Finalized Regulations

- EE uses replacement loan to repay another loan
- Replacement loan has repayment date more than 5 years after original loan
  - New regs make clear that date can be extended up to 5 years after original loan, or longer for a home loan
- Even though one loan replaces other loan
  - EE considered to have two loans
  - Two loans may not exceed limits

Refinancing Example

- EE: $30,000 account balance
- Outstanding loan:
  - Paid down to $8,000
  - 4 years left in repayment period
- EE requests $15,000 w/ 5 year repayment
- Will use loan proceeds to pay off $8,000 loan

- EE has two outstanding loans $15,000 + $8,000
- Violates loan limits

SPECIAL AMORTIZATION

- First loan disregarded if new loan due 5 years from original loan
- First loan disregarded if EE repays first loan within original 5 year period, and EE repays replacement loan during normal repayment period

Refinance OK

- EE borrows $10,000 @ 8% on 5/1/03, due 5/1/06. Payment $314
- 2/1/04 balance is $7,000. EE wants new loan.
- EE borrows $10,000 @ 7%, paying off old loan and taking $3,000 cash. New loan due 5/1/08. Payment $240

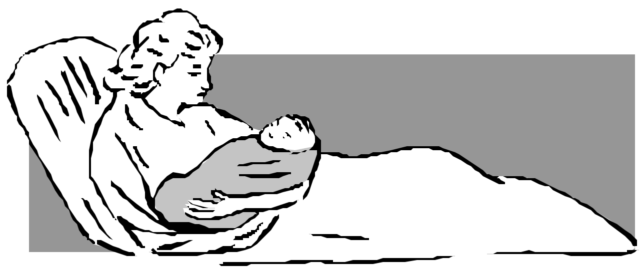
- EE borrows $10,000 @ 8% on 5/1/03 due 5/1/08. Payment $203
- 2/1/04 balance is $8,300. EE wants new loan.
- EE borrows $20,000 @ 7%, paying old loan and taking $11,700 cash. New loan due 5/1/09. Pays $430 until 5/1/08, and thereafter $231.

Leave Of Absence under Newly Finalized Regulations

- Plan may suspend loan payments for leave of absence
- One year maximum suspension
- Interest continues to accrue
- Does **not** extend 5 year repayment period
- Participant must repay within 5 years from original loan
  - Can extend to full 5 years
- EE must repay loan and accrued interest by end of 5 year period
  - Can use same payments with a balloon at the end
  - Can increase payments to avoid balloon

EXAMPLE

- EE obtains loan with 5 year repayment 2/1/03
- After 2 years, EE takes 18 month maternity leave
- Plan suspends loan repayment for 12 months
- EE must repay loan by 2/1/08
- Can increase installments or have balloon



MILITARY LEAVE OF ABSENCE

- Plan may suspend for military service
- Entire period of military service, not just 1 year
- Military service does **not** count against 5 year repayment period
- Interest continues to accrue during suspension at 6%
  - **Creditors (including plans) may not charge more than 6% while EE is on military duty**
  - **Soldiers And Sailors Civil Relief Act**
- EE must repay loan and accrued interest by end of 5 year period not counting the military service. Can use full 5 years even if original loan was shorter. Balloon or increase payments.

Military Leave Example

- Mario obtains a participant loan 3/1/03, due 3/1/07
- Mario enters service 9/1/03 and returns to work 9/1/05
- Plan provides loan is suspended while Mario is in service
- Interest rate drops to 6% while Mario serves
- When Mario returns, can extend loan to 3/1/10

USERRA Options

- Drop in interest rate is mandatory
  - Can use a higher rate only with a court order that debtor can afford it
  - Change in rate does not trigger deemed distribution
  - Return to normal rate when participant leaves service
- Loan moratorium is optional. Plan need not grant payment suspension to anyone or longer suspension to military

AGGREGATION OF PLANS/EMPLOYERS

- Employer must aggregate all plans to apply 72(p) rules
- Related employers treated as single employer in applying 72(p)
- Example: Alpha and Beta are in a controlled group, and each sponsors a 401(k) plan. John participates in both plans and has a loan with a deemed distribution from the Alpha plan. A new loan from Beta will be a deemed distribution unless Alpha repaid, other security, or payroll withholding

LIMITS ON NUMBER OF LOANS

- Plan may impose limits
- Proposed regs: 2 new loans per year
- Final regs: NO LIMIT
- Allows credit card loans

- Allows multiple loans to repay loans

NO IRS LIMIT ON NUMBER OF LOANS

- Kim borrows $10,000 from plan on 2/15/03. Loan calls for 20 quarterly payments of $612.
- 5/15/03, Kim borrows $612. Quarterly payment on new loan is $37.
- 8/15/03, Kim borrows $649. Payment $40
- 11/15/03, Kim borrows $689. Payment $42
- Prop regs said 8/15 and 11/15 loans were deemed distributions.
- Final regs say 8/15 and 11/15 loans are OK so long as 72(p) followed.

Effective Date

- Final loan regs effective 1/1/04
- However, since the proposed regs were never in effect and the limit on the number of loans is not in the Code, you can start making extra loans now
- Make sure plan permits more than two loans
- Make sure you follow 72(p)