Comments on Proposed Regulations under Section 72(p)

November 13, 2000

Carol D. Gold, Director
Employee Plans Division
Internal Revenue Service, Room 6526 (CP:E:EP)
1111 Constitution Avenue, N.W.

Washington, D.C. 20224

Re: **Comments on Proposed Regulations under Section 72(p)**

Dear Ms. Gold:

The American Society of Pension Actuaries (ASPPA) and its members welcome the publication of the Proposed and Final Regulations under section 72(p) of the Internal Revenue Code (Code). ASPPA is a national organization of approximately 4~~3~~,000 members who provide actuarial, consulting, administration, legal and other professional services for qualified plans and tax-sheltered annuities. ASPPA's members and their clients are committed to compliance with the legal requirements affecting these plans and arrangements. On behalf of ASPPA and its members, we respectfully submit the following comments on the Proposed Regulations under Code section 72(p), published on July 31, 2000 (Proposed Regulations).

SUMMARY OF ISSUES

This letter addresses a broad range of issues, which are described in greater detail below. Our comments can be summarized as follows:

1. Specific comments on the Proposed Regulations that address:

- Q&A 9(b): Leave Of Absence – Military Service; and
- Q&A 19(b)(2) and (3): Additional Security f~~F~~or Subsequent Loan Following Deemed Distribution.
- Q&A 20: Refinancing and Multiple Loans.

2. Comments identifying the following areas in the Final Regulations that need to be addressed or clarified by further guidance:

- Q&A 1: Assignment;
- Q&A 10a: Cure Period;
- Q&A 15: Withholding on Deemed Distributions;
- Q&A 19: Accrued Interest Following Deemed Distribution;
- Effective Dates; and
- Effect of Controlled Group or Affiliated Service Group on Participant Loans.

3. Comments on the effect of The Electronic Signatures Act.

I. Specific Comments On Proposed Regulations.

Q&A 9(b):

Leave Of Absence – Military Service

The Proposed Regulation provides that the obligation to repay a participant loan may be suspended during military service without causing a deemed distribution. Following suspension of the payment obligation, the term of the loan may be extended so long as the loan is paid in full by the end of the period equal to the original loan term plus the period of military service, and the frequency and amount of payments are not less than required under the terms of the original loan. Although the term of the loan may be extended to include the period of military service, the Proposed Regulation requires that interest accrued during military service must also be paid within the extended term. This necessarily means that the amount of each loan payment following military service must be larger than the payment prior to military service. This could work a hardship on servicemen if they are not able to make larger payments on a participant loan following a return from military service. We suggest that the Proposed Regulations be modified to allow the loan term to be extended following military service for the period required to pay the loan in full (including interest accrued during military service), assuming payments are made with the same frequency and in the same amount as before military service.

We note that, while the Proposed Regulations permit the extension of the loan term following a period of military service, no extension is permitted for any other leave of absence. We believe the same rule should be applied to any participant on a bona fide leave of absence. The requirement to repay the loan in full by the end of the original loan term could easily result in hardship and a deemed distribution for participants returning from bona fide leaves of absence who are not able to make higher loan payments upon their return.

In addition, Q&A 9(a) of the Final Regulations permits the suspension of loan payments only if a participant is on a leave of absence without pay or at a rate of pay less than the required periodic installments. Participants could, conceivably, be on leaves of absence with reduced pay at a rate higher than the required periodic installments and still not have the ability to make loan payments during the leave of absence. We request that the Proposed Regulations be modified to allow the suspension of loan payments if a participant is on leave of absence with a rate of pay less than 60% of their pay prior to the leave of absence.

Q&A 19(b)(2) and (3):

Additional Security For Subsequent Loan Following Deemed Distribution

The Proposed Regulation provides that participants must provide additional security following a deemed distribution to obtain a subsequent loan. Additional security may be provided in the form of an arrangement for payroll withholding or other security in addition to the participant's accrued benefit. In practical effect, this means that a participant who has terminated employment must provide additional security, while a participant who remains employed may meet the subsequent loan security requirements through a payroll withholding arrangement. This would seem to place a heavier burden on participants who are no longer employed. In other guidance, IRS has ruled that participants who have terminated employment may not be treated differently than participants who remain employed (See, Rev. Rul. 96-47). This rule might also violate the requirements of Code section 4975(d)(1) and ERISA section 408(b) that loans be made available to all participants and beneficiaries on a reasonably equivalent basis. Lastly, the regulations do not allow for other arrangements commonly used by commercial lenders to assure timely payment, such as direct electronic payment from the borrower's bank account.

We suggest that subsequent loans be permitted, subject to the limitations on the amount of a subsequent loan, so long as the participant's account is sufficient to secure repayment, without requiring additional security. The limitations on the amount of a subsequent loan and the provision in Q&A 19(b)(1) that the amount of a deemed distribution is taken into account in determining the amount available are sufficient to prevent repeated loans followed by defaults, without the additional security requirements. We also note that the costs of determining whether security in addition to the participant's account balance is adequate, documenting such security interests, and pursuing foreclosure in the event of nonpayment make these types of arrangements completely unworkable for most plans as a practical matter.

Q&A 20:

Refinancing and Multiple Loans.

The Proposed Regulation provides rather complicated rules for determining whether an existing loan is considered "outstanding" at the time of a refinancing for purposes of determining whether the $50,000/50% limit is exceeded. An existing loan is not treated as "outstanding" when it is refinanced if the new loan is treated as two loans – the existing loan plus a new loan of the amount over and above the existing loan – and both pieces meet the level amortization and term requirements. It would be simpler and more effective to treat both loans as "outstanding" on the date of a refinancing, without regard to the payment terms of the new loan. This clear rule would appear to be more effective in preventing abuse.

The Proposed Regulations also provide that a deemed distribution occurs if a participant takes more than two loans in a calendar year. First, there does not seem to be any statutory basis for this rule. Second, there is a timing question – does a request for a loan trigger a deemed distribution, or can a third loan be requested on December 1 with a check cut on January 1 without resulting in a deemed distribution. Third, it is not clear how this rule operates in connection with a refinancing.

The "multiple loan rule" also seems to provide an opportunity for participants to evade restrictions on in-service distributions. If the penalty for taking more than two loans in a year is deemed distribution treatment, a participant could take multiple loans during a year and effectively receive an in-service distribution. Overall, it may be simpler, more effective and more understandable to participants, sponsors and administrators to eliminate the multiple loan rule and simply rely on the $50,000/50% limitation to deter abuse.

II. Need For Additional Guidance.

ASPPA applauds IRS efforts to provide guidance in this area, including the Proposed Regulations. However, there are still a number of areas that need to be addressed or clarified by further guidance from the IRS. We believe it is important that the Treasury Department and the IRS develop comprehensive rules governing deemed distributions under Code section 72(p) which are specific and clear and can be understood by plan participants, in-house benefits staff, and human resources personnel, as well as professional pension advisors. Accordingly, we request further guidance and clarification with regard to the following issues raised by the Final Regulations under Code section 72(p).

Q&A 1

Assignment

The regulations state that “any assignment or pledge of interest” of a plan asset as security for a loan, is considered to fall under the loan rules. This regulation should be expanded to state the circumstances under which a policy loan on a whole life insurance policy owned by the plan will be considered a participant loan subject to Code section 72(p). Specifically, if a policy loan is obtained and the proceeds are used to pay premiums on the policy, is that considered a participant loan?

In addition, we suggest that the last sentence of Q & A 1(a) be classified to read as follows:

> “For the purpose of section 72(p) and this section, a loan made from a contract that has been purchased under a qualified employer plan (including a contact that has be distributed to the participant or beneficiary other than a life insurance contract or an annuity contract that fails to satisfy section 401 (g)) is considered a loan made under a qualified employer plan.”

Q&A 10a

Cure Period

The regulations should be clarified to state whether the plan administrator is permitted to establish a cure period on a loan-by-loan, *ad hoc* basis after the loan has been made, whether there must be a uniform cure period for all participants, and whether the cure period must be set forth in writing. If the cure period must be in writing, must it be included in the Summary Plan Description, the written loan policy, or is including a cure period in the loan documents sufficient?

We also suggest that the maximum cure period be extended. Regular commercial lending practices may allow a cure period of up to a year. As a practical matter, most plans are administered on an annual basis and it would greatly reduce the accounting costs and the opportunities for errors under the deemed distribution rules if loans could be reviewed for defaults and deemed distributions on the regular plan administration cycle. We recommend that the regulations be modified to permit a maximum cure period of up to one year. This longer cure period could be limited so that it applies only if it is determined at the time a payment is missed that the borrower has not missed any prior payment required under the loan in the preceding twelve months.

Q&A 15

Withholding on Deemed Distributions

Q&A-15 provides that, to the extent a loan is a deemed distribution when made, it is subject to withholding. Q&A-15 further provides that if a deemed distribution results in income at a date after the loan is made, withholding is required only if a transfer of cash or property is simultaneously made to the participant. Under the regulations, it is not clear that deemed distributions, whether arising at the time the loan is made or at a later date, are not "eligible rollover distributions" within the meaning of Code section 402(c)(4) and, therefore, are subject only to the elective withholding rules (and not to the mandatory withholding rules). See, Reg. section 1.402(c)-2, Q&A-4, and IRS Notice 93-3. Q&A-15 should make it clear that deemed distributions, unlike loan offsets (pursuant to Reg. section 1.402(c)-2, Q&A-9) are subject only to elective withholding because deemed distributions are not eligible rollover distributions.

Q&A 19

Accrued Interest Following Deemed Distribution

Q&A-19 provides that after a loan becomes a deemed distribution, the interest that accrues is disregarded for purposes of Section 72. Does this mean that the interest accrues for all other purposes, such as the amount of the account for purposes of determining if the $5,000 permitted cash-out rule may be used? Q&A-12 should be expanded to make clear that the non-accrual of interest after a deemed distribution has no effect on any other rule such as the $5,000 permitted cash-out rule.

In addition, while the Final Regulations clearly state that interest accruing after a deemed distribution does not become a subsequent deemed distribution, further clarification is needed concerning the accounting treatment for the additional interest. In the case of a loan that is treated as an investment of a participant's individual account, it seems fairly clear that the additional interest accruing does not become taxable to the participant upon a subsequent loan offset or distribution of the loan obligation, so long as the participant has not paid the accrued interest and the accrued interest is written off (i.e., the participant does not receive cash equal to the accrued interest as part of the distribution).

However, further guidance is needed concerning how to account for additional accrued interest when a participant loan is a pooled investment of the trust. In this situation, it is clear that the borrower/participant's plan account must be reduced to offset accrued interest allocable to other participants' accounts. It is not clear how the reduction/offset of the borrower/participant's account is treated under section 72(p) in these circumstances.

We suggest that the regulations be modified to state that, in the situation where the participant loan is not an individual investment of the account from which the loan was made, if a plan administrator offsets assets in a borrower/participant's account to pay unpaid interest due on a participant loan after the loan becomes a deemed distribution and allocates such amount to the accounts of other participants in the plan, then the amount of such deduction is treated the same as if the participant had repaid such interest to the plan. If this change is not made, then the participant who has received a deemed distribution will be required to pay tax not only on the balance of the non-loan assets that are ultimately distributed, but on the amount that was deducted from his or her account to pay interest to other plan participants.

Effective Dates

It would also be very helpful to have further guidance on the application of the regulations under Code section 72 (p) where a deemed distribution would otherwise occur, but Form 1099-R was not timely filed, as well as what constitutes a good faith interpretation of the regulations prior to the stated effective dates.

Effect of Controlled Group or Affiliated Service Group on Participant Loans

Finally, further guidance is need to clarify what aggregation rules apply to controlled groups and affiliated service groups in determining the maximum loan amount available. The regulations should be modified to clarify whether plans of controlled group or affiliated service group members may or must be aggregated for purposes of determining the maximum loan amount available to a participant.

III. Comments On The Effect Of The Electronic Signatures Act.

Under the Electronic Signatures Act, those engaging in transactions must consent to the use of an electronic medium. It is not clear whether this consent requirement means that transactions may be offered only through electronic media on a take it or leave it basis, or that a parallel paper procedure must be offered. The regulations could be read to state that, by requesting a loan, a participant or beneficiary consents to the use of the electronic medium. Clarification is needed as to whether this consent is sufficient under the Electronic Signatures Act or whether plans must offer a parallel paper procedure for participant loans.

These comments were prepared principally by James C. Paul of the ASPPA IRS Enforcement Committee, chaired by Jeffrey C. Chang, with the assistance of Jeffrey C. Chang, Martin M. Heming, Fred Singerman and Cynthia Groszkiewicz. Others participating in the preparation of these comments include the Government Affairs Committee Co-Chairs and the Government Relations Committee Chair.

Please contact us if you have any comments or questions regarding our comments.

Very truly yours,

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