

Loans from Tax Qualified Retirement Plans

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Table of Contents

I.	INTRODUCTION.....	1
	A. Availability of Loans.	1
II.	I.R.C. § 72(p) LOAN REQUIREMENTS.....	2
	A. Failure to Follow Requirements.....	2
	B. Enforceable Agreement.	2
	C. Terms of Loan.....	2
	D. Loans Outstanding Before August 13, 1982.	3
	E. Limitation on Loan Amounts.....	3
	F. Timing of Loan Payments.....	3
	G. Interest Deduction Issues.	3
	H. Trustee-to-Trustee Transfer of Loans.	4
III.	CONSEQUENCES OF LOAN NOT COMPLYING WITH I.R.C. § 72(p) OR CONSTITUTING A PROHIBITED TRANSACTION.....	4
	A. A Loan in Violation of I.R.C. § 72(p) Limitations Will Be Considered a Distribution.	4
	B. Effect of a Loan Constituting a Prohibited Transaction. I.R.C. § 4975.	6
IV.	IMPACT ON LOANS BY THE RETIREMENT EQUITY ACT—SPOUSAL CONSENT.....	8
	A. A Loan Can Be Secured by the Participant’s or the Beneficiary’s Accrued Benefit or Account Balance.	8
	B. Spousal Consent Required.	8
	C. Offsetting an Accrued Benefit Upon Default.....	9
	D. Spousal Consent Rules.....	9
V.	IMPACT ON LOANS BY THE BANKRUPTCY ABUSE PREVENTION IN CONSUMER PROTECTION ACT OF 2005 ("BANKRUPTCY ACT").....	9
	A. Pre-Bankruptcy Act Law.	9
	B. Bankruptcy Act Application to Participant Loans.	9
VI.	DEPARTMENT OF LABOR REGULATIONS ON PLAN LOANS. 29 C.F.R. § 2550.408b-1.....	10
	A. Reasonably Equivalent Basis.	10
	B. Highly Compensated Employees.	10
	C. Specific Plan Provisions.	10
	D. Reasonable Rate of Interest.	11
	E. Adequate Security.....	11
VII.	TRUTH IN LENDING DISCLOSURES.....	12
VIII.	CONSIDERATIONS AND RECOMMENDATIONS.....	12
	A. When Loan Provisions Can Be Removed.....	12
	B. Plan Administrator and Trustee Must Take Great Care to Assure that Participant Loans Are Adequately Secured.....	12

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I. INTRODUCTION.

A. Availability of Loans.

1. As a general matter, a loan from a plan to a party in interest is a prohibited transaction. ERISA § 406(a)(1)(B), I.R.C. § 4975(c)(1)(B). However, a bona fide loan from a plan to a participant or beneficiary is exempt from the prohibited transaction rules. ERISA § 408(b)(1) and I.R.C. § 4975(d)(1).

2. Bona fide loan.

The loan must be adequately secured; a true debtor-creditor relationship must exist; there must be a reasonable rate of interest charged to the borrower (usually the prevailing rate); a definite repayment schedule must be established; and the availability of loans must be on a non-discriminatory basis. ERISA § 408(d)(1) and I.R.C. § 4975(d)(1).

3. Broad definition of loan.

In addition to direct loans, the indirect receipt of a loan by a participant or a beneficiary is also considered a loan. For example, an assignment or pledging of any portion of a participant's or a beneficiary's interest in a qualified plan is considered to be a loan. Moreover, such an assignment or pledge is prohibited under the non-alienation provisions of I.R.C. § 401(a)(13) and ERISA § 206(d).

4. Restriction on loans from Keogh plans or from S corporation sponsor prior to 2002.

Loans made prior to January 1, 2002 from these types of plans could only be made to participants who were not owner-employees (a more than ten percent owner with respect to a Keogh plan) or five percent or greater shareholders (with respect to a plan sponsor which is an S corporation). Similarly, loans from IRAs are not permitted and can disqualify an IRA.

Effective for years beginning after December 31, 2001, loans from qualified plans to sole proprietors, 10% or more partners, or S corporation shareholders are exempt from the prohibited transaction rules. Note: loans from IRAs continue to be prohibited.

5. DOL Field Assistance Bulletin 2003-1. Plans may restrict loans to the restricted class (e.g., officers, shareholders) under Sarbanes Oxley. This applies to retirement plans of companies with publicly traded stock.

II. I.R.C. § 72(p) LOAN REQUIREMENTS

A. Failure to Follow Requirements.

Plan loans made after August 13, 1982 are treated as distributions unless the I.R.C. § 72(p) requirements are met. Loans made after December 31, 1986 must also comply with TRA '86 loan rules.

B. Enforceable Agreement.

The loan must be evidenced by a legally enforceable agreement (in writing), which may include more than one document. Reg. § 1.72(p)-1, Q&A-3(b).

C. Terms of Loan.

1. Five-Year Limitation.

The term of the loan may not exceed five years. For purposes of this rule, reference is made to the actual terms of the loan document as opposed to the actual amount of time that the loan is outstanding.

- a. Exception for loans to acquire or construct a dwelling unit which is the principal residence of the participant. The loan must be repaid within a reasonable time with reference being made to the time of the loan. Although there is no set rule on time limitations, the IRS has approved a fifteen-year limit (LTR 8514091, 1-11-85). Also, a time and payment schedule must be agreed upon when the loan is made.

- b. Loan must be actually repaid within five-year period.

A loan outstanding at the end of a five-year period cannot be renegotiated. Thus, the outstanding amount will be treated as a distribution. Also, if the loan document indicates a six-year repayment schedule and the loan is actually repaid in two years, this would still constitute a distribution at the time the loan was made.

- c. When a participant is on a leave of absence without pay or at a pay rate that is less than the required loan installments, then the payment period may be suspended during the leave of absence (for a maximum of one year). However, the loan must still be repaid within the five-year period. Reg. § 1.72(p)-1, Q&A-9.

D. Loans Outstanding Before August 13, 1982.

A loan outstanding as of August 13, 1982 does not fall within the five-year requirement if the loan is not renegotiated, extended, renewed or revised after August 13, 1982. If it is renegotiated, *etc.*, the loan must comply with the I.R.C. § 72(p) requirements. Likewise, a loan can only change interest rates pursuant to the pre-TEFRA loan agreement.

E. Limitation on Loan Amounts.

1. Limits on dollar amounts.

Under the § 72(p) requirements, the outstanding balance of all of a participant's loans from all of the plans of an employer (taking into account controlled groups and/or affiliated service groups) may not exceed the lesser of \$50,000 or 50% of the participant's non-forfeitable accrued benefit. Irrespective of this rule, a minimum of \$10,000 may be borrowed (provided that there is adequate outside security for such a loan). I.R.C. § 72(p).

- a. The accrued benefit is based upon the latest valuation, and this valuation can take place at any time during the last twelve months. Also, the fifty percent of the accrued benefit limitation is determined when the loan is made. Thus, a subsequent decrease in the participant's accrued benefit will not result in a violation of the § 72(p) limitations.
- b. \$50,000 limitation is reduced by the highest outstanding loan balance during the 12-month period prior to loan; (*e.g.*, if a participant has a current outstanding profit-sharing plan loan balance of \$35,000 but had a balance of \$40,000 within the twelve months preceding his request for a new loan, the maximum permissible loan amount would be the difference between the \$50,000 limitation and the \$40,000 outstanding balance).

F. Timing of Loan Payments.

Loans from pension and profit-sharing plans must be repaid by level amortization with at least *quarterly payments* over the term of the loan.

G. Interest Deduction Issues.

Interest deductions otherwise permitted on pension or profit-sharing plan loans are eliminated if the loan is made to a key employee or to any employee with respect to amounts secured by elective deferrals to a § 401(k) plan or a § 403(b) tax sheltered annuity. The denial of deduction occurs on and after the first day on which a participant becomes a key employee or the first day on which elective deferrals are pledged. I.R.C. § 72(p)(3).

H. Trustee-to-Trustee Transfer of Loans.

1. A trustee-to-trustee transfer of notes receivable does not cause the loans to cease to qualify under § 72(p). The transfer of notes receivable will amount to no more than a change in the name of the trustee and will not constitute a renegotiation, renewal, modification or extension of the loans within the meaning of TEFRA § 236 or TRA '86 § 1134. PLR 8950008; PLR 8933005.
2. Although a direct trustee-to-trustee transfer of a loan is permitted, a loan may not be rolled-over by the individual from one plan to another. PLR 9043018.

III. CONSEQUENCES OF LOAN NOT COMPLYING WITH I.R.C. § 72(p) OR CONSTITUTING A PROHIBITED TRANSACTION

A. A Loan in Violation of I.R.C. § 72(p) Limitations Will Be Considered a Distribution.

1. If the loan is in violation of any requirement of I.R.C. § 72(p) in either form or operation, the entire amount of the loan will be considered a distribution; however, failure to comply with the § 72(p) dollar limitations on loans will only result in a distribution to the extent that the dollar limitations are exceeded.
2. The Regulations permit the plan administrator to allow a grace period before a loan will be declared in default and the outstanding balance on the loan will be deemed to be distributed from the plan. The grace period cannot extend beyond the last day of the calendar quarter following the calendar quarter in which the required installment was due. Reg. § 1.72(p)-1, Q&A-10(a).
3. The amount of the deemed distribution will equal the *entire* outstanding balance of the loan at the time of the default (including the grace period). Reg. § 1.72(p)-1, Q&A-10(b).
4. A deemed distribution is treated as an actual distribution for purposes of I.R.C. §§ 72(m) and 72(t). Reg. § 1.72(p)-1, Q&A-11(b), (c). However, the distribution is not treated as an actual distribution for qualification purposes. As such, the plan will not be deemed to violate any prohibition on in-service withdrawals merely as a result of a deemed distribution. Reg. § 1.72(p)-1, Q&A-12.
5. In a loan offset, the distribution is treated as a distribution for all purposes, including qualification requirements. A loan offset could occur where a participant requests distribution while a loan remains outstanding and part of the distribution is used to repay the loan. Reg. § 1.72(p)-1, Q&A-13.

6. Deemed distributions and plan offsets are required to be reported on IRS Form 1099-R. Reg. § 1.72(p)-1, Q&A-14. Withholdings must be made if there is a transfer of cash or property (excluding employer securities). Reg. § 1.72(p)-1, Q&A-15.
7. Treatment of repayments.

Repayments of a loan treated as a distribution will be considered non-deductible employee contributions. However, they will not be subject to the annual additions limitations of I.R.C. § 415. *See* IRS Notice 82-22. The amount of a loan included in income is treated as basis. Therefore, when a distribution is subsequently made a portion of the distribution will be tax-free. PLR 9122059. Reg. § 1.72(p)-1, Q&A-21.
8. Favorable tax treatment applicable to distributions (five-year averaging, IRA rollovers and capital gains) is not applicable to a loan which is deemed to be a distribution. Furthermore, the ten percent premature distribution penalty could be applicable to a borrower-participant who is not yet age 59½.
9. As long as the loan is otherwise bona fide, it will not cause a plan to be disqualified for failure to comply with the I.R.C. § 72(p) limitations. The only consequence for failure to comply with these limitations is that the loan will be treated as a distribution. IRS Notice 82-22.
10. After a loan has been deemed distributed under § 72(p), the interest that accrues thereafter on the loan is not included in income. Further, because the loan amount is treated as distributed for purposes of § 72, neither the income that resulted from the deemed distribution nor the interest that accrues thereafter increases the participant's tax basis for purposes of § 72. Reg. § 1.72(p)-1, Q&A-19. Thus, following a deemed distribution of a loan, interest does *not* continue to accrue on the participant's actual ongoing obligation to the plan.
11. The distribution is deemed for tax purposes, but the participant still owes the money to the plan. The combined deemed distribution counts as an outstanding loan for purposes of both the 50% of vested accrued benefit and \$50,000 limitations on loans under § 72(p). Reg. § 1.72(p)-1, Q&A-19(b). Thus, the deemed distribution is considered an outstanding loan with continued accruing interest for purposes of determining any future loans for the participant.
12. Example from Prop. Reg. § 1.72(p)-1 explanation of provisions (published 1/2/98) (*see also* example from Reg. § 1.72(p)-1, Q&A-10) (published 7/31/00).

For example, assume that, after a loan has been made from a defined contribution plan to a participant, a deemed distribution occurs as a result of failure to make timely loan repayments (*e.g.*, the repayments

were not to be made by payroll withholding). The participant's total account then consists of non-loan assets and a receivable for the loan balance. At separation from employment, the participant's vested account balance is reduced (offset) by the loan amount and the remaining account balance is distributed in a lump sum to the participant. In this case, in addition to the income that previously arose as a result of the deemed distribution due to the failure to make timely payments on the loan, the participant would have a taxable distribution at separation from employment for the remaining account balance reflecting the non-loan assets that are distributed in a lump sum (with no tax basis as a result of the prior deemed distribution of the loan amount). The offset of the loan balance (*i.e.*, the offset of the loan receivable by the loan amount) would be disregarded for purposes of § 72 because the loan had previously been deemed distributed as a result of the failure to make timely payments on the loan.

13. Noncompliance loans. Rev. Proc. 2003-44 provides that the failure of a plan to follow its terms with respect to a participant loan, resulting in a deemed distribution under IRC section 72(p) results in an Operational Failure under section 6.07 of Rev. Proc. 2006-27 (the EPCRS procedure). The correction method includes reporting the noncompliant loan as a deemed distribution for the year of the correction, rather than for the prior year that the deemed distribution should have been reported.

B. Effect of a Loan Constituting a Prohibited Transaction. I.R.C. § 4975.

1. As a general rule, a loan which constitutes a prohibited transaction will not result in plan disqualification but, rather, will result in the prohibited transaction penalties being imposed. A loan directly (or indirectly) from the plan to the sponsoring employer would be a prohibited transaction.
2. The first tier prohibited transaction tax is fifteen percent of the amount involved in each prohibited transaction for the period beginning on the date the prohibited transaction occurs and ending on the earliest of:
 - a. When the transaction is corrected;
 - b. When a deficiency notice is issued; or
 - c. The date on which the tax is assessed. I.R.C. § 4975(f)(2). The excise tax for prohibited transactions occurring prior to August 20, 1996 was five percent of the amount involved in the transaction. It was ten percent for prohibited transactions occurring from August 20, 1996 to August 5, 1997, and was increased to fifteen percent for prohibited transactions occurring after August 5, 1997.

3. In Revenue Ruling 2002-43, the IRS stated that the applicable excise tax rate for each prohibited transaction is the rate in effect in the first year that the transaction occurred. The rate is then applicable to all years of the prohibited transaction.
4. Although there is an additional second tier 100% tax if the transaction is not corrected within the applicable period, the disqualified person has an additional ninety days to correct the transaction and avoid the additional tax. I.R.C. § 4975(b).
5. If the loan is not bona fide, there is authority for disqualifying the plan on the basis that it does not exist for the exclusive benefit of the employees. *See Winger's Dep't Store v. Commissioner*, 82 T. C. 869, 5 EBC 1569 (1984). In *Winger's*, the plan loaned substantially all of its assets to the company president without adequate security or proper repayment schedule. The president then loaned the money to the company. Because the unsecured and delinquent loans were in reality made to the sponsoring employer through the sole shareholder and plan administrator, the court concluded that the plan no longer operated for the exclusive benefit of the employees. Thus, the Tax Court upheld the IRS' disqualification ruling. It concluded that disqualification was appropriate, as opposed to other sanctions allowed by ERISA, where the trustee's actions were so adverse to the exclusive benefit of the employees.
6. In TAM 9713002 the IRS disqualified two pension plans after the trustee of the plans, who was also the president and sole shareholder of the sponsoring employer corporation, obtained a series of twenty-three loans from the two plans totaling \$1,150,000, representing ninety-five percent and eighty percent of the total assets of the two pension plans. The IRS ruled that the loans resulted in inadequate diversification of plan assets because large portions of plan assets were invested in one type of loan to a single individual. This resulted in the disqualification of both plans. The loans also constituted prohibited transactions.
7. The 15% and 100% taxes on prohibited transactions are assessed against the disqualified person involved in the transaction, not against the plan. I.R.C. §§ 4975(a) and (b).
8. The amount involved in a loan for purposes of assessment of the prohibited transaction excise tax is the interest on the loan amount, not the entire amount of the loan. Prohibited transaction penalties are paid with the filing of IRS Form 5330.
9. Even loans to employees who are not interested parties can cause problems for a plan. In Rev. Rul. 89-14, the IRS disqualified a plan for permitting loans to plan participants at below-market rates of interest. The IRS ruled that a loan to a rank-and-file employee violated the non-alienation provisions of I.R.C. § 401(a)(13). The moral is that one must be very careful about participant loans.

10. Prohibited transaction excise taxes may be applicable to a loan even if the loan is treated as a taxable distribution under I.R.C. § 72(p). *Medina v. Commissioner*, 22 EBC 2601, 112 T.C. No. 6 (U.S. Tax Ct. Feb. 22, 1999).
 - a. The Tax Court rejected the taxpayer's argument that the loan could not be treated as a prohibited transaction because it was taxed as a distribution under § 72(p). The Tax Court held that the distribution treatment under § 72(p) is solely for income tax purposes and has no effect on the characterization of the loan as a prohibited transaction. The loan continues to be an obligation to the plan and the excise taxes under I.R.C. § 4975 apply unless the exemption requirement under § 4975(d)(1) are satisfied.
 - b. The Tax Court also interpreted the term "*amount involved*" for excise tax purposes. Treasury Reg. § 53.4941(e)-1(b)(2)(ii) defines the amount involved as the *greater of the amount paid* for the use of the money or the *fair market value* of such use. Since the taxpayer had made no payments on the loan, the amount paid was zero. Therefore, the amount involved for purposes of calculating the excise tax was the fair market value of the use of the money (not necessarily the interest rate stated on the note) since that was greater than the amount paid.

IV. IMPACT ON LOANS BY THE RETIREMENT EQUITY ACT—SPOUSAL CONSENT

- A. A Loan Can Be Secured by the Participant's or the Beneficiary's Accrued Benefit or Account Balance.

Generally, this would not be considered an assignment or alienation of plan benefits which would otherwise result in a disqualification of the plan. *See* Reg. § 1.401(a)-13(d)(2). *See also* IRS Notice 82-22. In the event of a default, however, using the accrued benefit to satisfy the default would be considered an in-service distribution, which could lead to plan disqualification. Consequently, additional property should be used as security for the loan.

- B. Spousal Consent Required.

A plan that is subject to the automatic survivor annuity requirement (*e.g.*, all pension plans and profit-sharing plans containing annuity provisions) must provide that no portion of a participant's accrued benefit may be used as security for a plan loan unless the spouse consents within the ninety-day period ending on the date the security agreement becomes effective. I.R.C. § 417(a)(4).

C. Offsetting an Accrued Benefit Upon Default.

If spousal consent to secure a loan with the participant's accrued benefit was obtained at the time the loan was made, it is not necessary to receive the spousal consent to reduce the participant's accrued benefit upon default of the loan. (Reg. § 1.417(e)-1T(d)(ii).) Although the regulations indicate that this result is not altered by the fact that *the participant is married to a different spouse* at the time of the set-off, many commentators have expressed some concern that this provision is inconsistent with the law. If the participant is unmarried, the regulations indicate that it is unnecessary to get the new spouse's consent for securing the loan with the participant's accrued benefit.

D. Spousal Consent Rules.

The spousal consent rules apply to a plan where a *qualified joint* and survivor annuity is required. Thus, they would not apply to a profit-sharing plan which was not subject to the annuity rules.

V. **IMPACT ON LOANS BY THE BANKRUPTCY ABUSE PREVENTION IN CONSUMER PROTECTION ACT OF 2005 ("BANKRUPTCY ACT")**

A. Pre-Bankruptcy Act Law.

Prior to October 17, 2005, if a participant in a qualified plan who has an outstanding plan loan files for Chapter 13 Bankruptcy, the "automatic stay" under the bankruptcy code required the employer to stop withholding loan repayment amounts from the participant's wages. (Note that in cases of Chapter 7 Bankruptcy, plans may continue to withhold loan repayments from the participant's wages after filing for bankruptcy.) As a result, if there are no loan payments for ninety (90) days, the loan would go into default and the bankrupt participant would have a taxable distribution and the possibility of an additional early distribution penalty tax.

B. Bankruptcy Act Application to Participant Loans.

Under the Bankruptcy Act beginning October 17, 2005, when a participant files for bankruptcy, an employer may continue to withhold amounts from the employee's wages for the repayment of loans owed to the qualified plan without violating the "automatic stay". Additionally, the Bankruptcy Act provides that an outstanding loan amount owed to a qualified plan is not dischargeable by an individual in bankruptcy, nor may a Chapter 13 individual bankruptcy reorganization plan materially alter the terms of a qualified plan loan.

VI. DEPARTMENT OF LABOR REGULATIONS ON PLAN LOANS. 29 C.F.R. § 2550.408b-1

On July 20, 1989, the Department of Labor issued final regulations on 29 C.F.R. § 2550.408b-1 entitled: General statutory exemption for loans to plan participants and beneficiaries who are parties in interest with respect to the plan. ERISA § 408(b)(1) provides that plan loans made to parties in interest who are participants or beneficiaries of the plan will not be considered to be prohibited transactions if such loans (a) are available to all participants on a reasonably equivalent basis; (b) are not made available to highly compensated employees in an amount greater than the amount made available to other employees; (c) are made in accordance with specific provisions regarding such loans set forth in the plan; (d) bear a reasonable rate of interest; and (e) are adequately secured. The final regulations provide guidance with respect to the requirements set forth in ERISA § 408(b)(1) for all participant loans granted or renewed after October 18, 1989.

A. Reasonably Equivalent Basis.

Regulation § 2550.408b-1(b) indicates that loans must be made available to all plan participants and beneficiaries without regard to an individual's race, color, religion, sex or national origin. The regulation further states that, in making a loan, the plan may consider only those factors which would be considered in a normal commercial setting by an entity in the business of making similar loans. Such factors could include, among others, the applicant's credit worthiness or financial need. A participant loan program will not fail the requirements of this section if the plan establishes a minimum loan amount of up to \$1,000, provided that the loans meet the adequate security requirements listed below. The DOL has stated that loans should not be limited to active participants. If a plan provides for loans, such loans should be available to all plan participants, including former employees with vested benefits in the plan.

B. Highly Compensated Employees.

Regulation § 2550.408b-1(c)(3) notes that Congress intended that a plan may lend the same percentage of a person's vested benefits to participants with both large and small amounts of accrued benefits. Note: for purposes of the loan regulations, highly compensated employees are determined on a facts and circumstances basis, not under the I.R.C. § 414(q) definition.

C. Specific Plan Provisions.

Regulation § 2550.408b-1(d)(2) states that participant loans granted or renewed on or after the last day of the first plan year beginning on or after January 1, 1989 must be governed by provisions in the plan which include, but need not be limited to:

1. The identity of the person or position authorized to administer the participant loan program;

2. A procedure for applying for loans;
3. The basis on which loans will be approved or denied;
4. Limitations (if any) on the types and amounts of loans offered;
5. The procedure for determining a reasonable rate of interest;
6. The types of collateral which may secure a participant loan; and
7. The events constituting default and the steps that will be taken to preserve plan assets in the event of such default.

Additionally, the plan provisions regarding loans must contain (at a minimum) an explicit authorization for the plan fiduciary responsible for investing plan assets to establish a participant loan program.

D. Reasonable Rate of Interest.

Regulation § 2550.408b-1(e) provides that a reasonable rate of interest is one which provides the plan with a return commensurate with the prevailing interest rates charged by persons in the business of lending money for loans which would be made under similar circumstances. A reasonable procedure must be used to calculate the interest rate. DOL generally believes that the problem is not with rates that are too high, but with rates that are too low. Therefore, when in doubt, push the rate up.

E. Adequate Security.

Regulation § 2550.408b-1(f) states that a loan will be considered to be adequately secured if the security posted for such loan is something in addition to and supporting a promise to pay, which is so pledged to the plan that it may be sold, foreclosed upon, or otherwise disposed of in default of the loan, the value and liquidity of which security is such that it may be anticipated that loss of principal or interest will not result from the loan.

1. The adequacy of security for a participant loan will be determined in light of the type and amount of security which would be required in the case of an otherwise identical transaction in a normal commercial setting between unrelated parties at arm's-length terms. A participant's vested accrued benefit under a plan may be used as security for a participant loan to the extent of the plan's ability to satisfy the participant's outstanding obligation in the event of default.
2. *No more than fifty percent of the present value of a participant's vested accrued benefit may be considered by a plan as security* for the outstanding balance of all plan loans made to such participant. The maximum fifty percent of a participant's vested interest pledged as security for a loan may be considered in a determination of whether the loan is adequately secured.

3. DOL officials have stated that if a participant's vested account balance is used as security, the investment experience *must* apply against the participant's account (*i.e.*, the interest and principal must be credited to the individual account of the borrowing participant).
4. The fifty percent of the account balance used as security must be sufficient to be security for both the principal and the accrued interest of the loan. Therefore, if the loan is only secured by fifty percent of the participant's account, he cannot borrow all of the remaining fifty percent because the loan will not be adequately secured.

VII. TRUTH IN LENDING DISCLOSURES

A plan may be subject to the requirements of the federal truth in lending requirements of disclosure. This would generally be the case where a plan has made twenty-five or more loans or five or more loans secured by a dwelling. 15 U.S.C. § 1601, 12 C.F.R. § 226.2(a)(17).

VIII. CONSIDERATIONS AND RECOMMENDATIONS

A. When Loan Provisions Can Be Removed.

If it is thought that permitting participants to borrow from a pension or profit-sharing plan would become administratively burdensome, the loan provisions can be removed from an existing plan. If the loan provisions are removed, however, any current outstanding loans must be repaid. Alternatively, provisions in the plan can provide for the grandfathering of outstanding loans while prohibiting future loans.

B. Plan Administrator and Trustee Must Take Great Care to Assure that Participant Loans Are Adequately Secured

As noted in V.E., above, the plan administrator and trustee must take great care to assure that participant loans are adequately secured. If a participant borrows more than fifty percent of the participant's vested benefits under the plan (*e.g.*, if the loan is \$10,000 or less) and the loan is secured solely by fifty percent of the participant's vested benefits under the plan, the loan is arguably inadequately secured.