United Retirement Plan Consultants

National network. Local experts.

Jill Fridley
Counsel
545 Metro Place South
Dublin, Ohio 43017
614-923-8834
jill.fridley@UnitedRetirement.com

Reasonable Interest Rates for Participant Loans

A large percentage of retirement plans offer participant loans. In recent years, these loans have become the subject of increased attention by the Department of Labor (DOL) and the Internal Revenue Service (IRS). The regulations promulgated by both agencies require that certain conditions be satisfied in order for the provision of such loans to be permitted without any financial or other penalties. This includes the requirement that the loans bear a reasonable rate of interest. How to determine what is "reasonable" has been a frequent question among plan practitioners and sponsors. Although there is no clear standard, this article seeks to provide clarification on the factors that plan sponsors should consider. Part 1 will provide an overview of the rule; Part 2 will discuss DOL and IRS guidance; and Part 3 will offer steps plans sponsors should take to determine reasonable interest rates.

Part 1: An Overview of the Rules for Reasonable Interest Rates

In general, to be reasonable, the interest rate should reflect prevailing market rates for similar loans. Many plan sponsors rely on the prime rate as a benchmark and provide participant loans at a rate of prime plus either 1% or 2%. Whether an interest rate is reasonable is a question of fact, which requires plan sponsors to consider factors that are specific to the plan and its participants. Accordingly, relying *solely* on the prime rate as the default rate may result in unreasonable interest rates. Instead, plan sponsors must be able to provide a justification for their interest rate selection. This means that reliance on a benchmark such as the prime rate is not in itself a violation of the rules, but that plan sponsors should also consider additional factors specific to the plan. Specifically, the analysis should consider:

- Prevailing regional rates (unless the plan is administered on a nationwide basis);
- Current economic conditions;
- The creditworthiness and collateral offered; and
- The rate of return for participant loans compared to the overall return on the plan's investments.

The rules governing participant loans are established by the DOL and IRS. Generally, qualified plans are governed by the rules promulgated by the IRS; ERISA plans must comply with the DOL's regulations; and ERISA qualified plans (which is often the case) must comply with both sets of regulations.

DOL Regulations regarding Participant Loans

Under ERISA, plan loans are prohibited unless certain exemptions are met, as provided under Section 408, including that interest rates are reasonable. Under Section 408(b)(1)(e)(4), an interest rate is reasonable if "the loan provides the plan with a return commensurate with the interest rates charged by persons in the business of lending money for loans which would be made under similar circumstances."

The Section provides three examples for determining reasonableness, which demonstrate that the rates should be local (suggest calling two local banks), current (must reflect current economic conditions), and not artificially limited (ERISA preempts state usury laws). If a loan does not meet the exemption requirements, including those related to interest rates, it will be treated as a prohibited transaction and may subject the plan to certain financial or other consequences.

IRS Regulations regarding Participant Loans

Qualified plans must comply with the Internal Revenue Code (IRC), and there are two important statutory requirements: §72(p) (taxability) and §4975(d) (prohibited transactions). Generally, participant loans are deemed a taxable distribution unless certain conditions are satisfied, including a reasonable interest rate. If the exemption conditions are not satisfied, the loan will be deemed a distribution, subject to tax consequences.

Plan sponsors must also consider whether the loan is a prohibited transaction. In general, a plan loan to a party in interest (including a plan participant) is a prohibited transaction, but a participant loan is exempt as long as certain requirements are met, including a reasonable interest rate. If the exemptions are not met, the loan will be treated as an *actual distribution* from the plan rather than a deemed distribution under §72(p) discussed above. Such treatment could have serious consequences, including the potential disqualification of the plan.

Part 2: Relevant IRS & DOL Guidance

The potential consequences of violating the above-regulations, coupled with the lack of a clear "reasonableness" standard, have led many plan practitioners and sponsors to seek additional guidance from the DOL and IRS. Guidance provided by each agency demonstrates that both rely on similar policies in the adoption and enforcement of the rule.

IRS Guidance. Unlike the DOL regulations, the regulations provided in the IRC are silent on the definition of a "reasonable rate of interest." However, the IRS recently provided guidance on the matter in its Retirement News for Employers Winter 2012 newsletter. The newsletter included the three examples listed in the DOL regulations and provided that an interest rate is reasonable if it is equal to commercial lending interest rates under similar circumstances. The IRS then suggested the following two questions be asked to determine reasonableness:

1. What current rates are local banks charging for similar loans (amounts and duration) to individuals with similar creditworthiness and collateral?
2. Is the plan rate consistent with the local rates?

Further guidance may be found by reviewing the IRS examination manual which directs IRS auditors to consider the rate of return of the loans against the plan's overall rate of return on its investment and provides that when a large percentage of the plan's assets are invested in the participant loans, the overall rate of return may be unreasonable.

In September of 2011, prior to issuing the official guidance provided in the Winter 2012 newsletter, an IRS representative provided information during a phone forum that indicated the IRS was relying on a default standard of "prime plus 2%" to determine reasonableness or interest rates. The comment was unofficial, and the guidance provided in the newsletter took the position that determining reasonableness is a question of fact and there is no "safe harbor" rate. This is in line with the DOL's position.

DOL Guidance. Other than the definition and examples provided in the regulations, the DOL has provided very little recent additional guidance on how to determine the reasonableness of interest rates. Arguably, the most insight on how to apply the rule can be gleaned by looking at the Supplemental Information provided in the Federal Registrar when the rule was first made final in 1989, which provides the following:

1. The rate determination should be based on the "prevailing rate standard" provided in Advisory Opinion 81-12A
2. A reasonable rate should never be below the prevailing market rate, but the low level of risk associated with participant loans can be considered to permit rates that reflect commercial loan rates that would fall within the *narrow range of the prevailing rate*.
3. Participant loans should be treated as a benefit to the plan, rather than primarily as a benefit to the participants.
4. The DOL will not provide a departmentally-established "safe harbor" interest rate because to do so would run counter to the view that participant loans be treated as an investment subject to the same standards of ERISA as any other investment (e.g., the prudence and exclusive benefit rules).
5. Although there is no "safe harbor," plans administered on a nationwide basis may rely on a national interest rate when administrative costs justify doing so. In all other situations, the prevailing market rate must be based on appropriate regional factors.

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Part 3: Steps for Plan Sponsors to Determine Reasonable Rates

The regulations and guidance provided by the DOL and IRS suggest that the "reasonableness" of an interest rate hinges on the determination of the prevailing market rate for similar loans. As an industry standard, most plans use the prime rate as a starting point. It may not be appropriate for plan sponsors to rely *solely* on a default benchmark rate. Rather, the determination of "reasonableness" is a *question of fact* that requires plan sponsors to analyze the circumstances specific to the plan.

Accordingly, the use of a benchmark such as a prime rate is not in itself a violation of the rules, but plan sponsors must be able to demonstrate their rationale behind the rate selection. Plan sponsors can justify their selection by conducting an analysis of certain factors specific to the plan and carefully documenting and maintaining records of the process. The analysis should include a review of: (1) comparable commercial loans; (2) current market conditions; (3) artificial limitations; and (4) the rate of return.

Comparable Commercial Loans. Plan sponsors should review a sample of comparable commercial loans relevant to the community. The comparison must be performed on a regional basis, unless the plan is administered nationwide *and* administrative costs justify the use of a national rate. For some loan types (particularly mortgages), there are several websites, applications, and surveys available for comparing local interest rates. However, when no such information is available, plan sponsors may be required to call local banks for a quote, as suggested in the examples provided in the DOL regulations.

The comparison should also consider the creditworthiness and collateral offered, as well as the amount and duration of the loans. Some of these factors may result in participant loans being considered a low-risk loan. The DOL takes the opinion that such factors should not be relied upon to justify the granting of loans *below prevailing market rates*, but can be considered to reflect commercial loan rates that would "fall within the *narrow range of the prevailing rate*."

Current Market Conditions. The analysis of comparable loans must also consider relevant current market conditions. Any benchmarks used should reflect market changes (hence the popularity of relying on prime rates). Further, the plan sponsor should conduct periodic reviews of the interest rate to ensure it continues to reflect current market conditions. Anytime a participant loan is refinanced, the interest rate should be updated.

Artificial Limitations. The DOL has refused to provide a "safe harbor" for interest rates and contends that departmentally-established rate would run counter to the view that participant loans be treated as an investment subject to the same standards of ERISA as any other investment (*e.g.*, the prudence and exclusive benefit rules). Through the guidance provided in its Winter 2012 newsletter, it appears the IRS takes the same approach. Accordingly, artificially limited rates may be unreasonable. This applies to state usury laws, which are preempted by ERISA. An exception exists, however, for participants taking a leave of absence for military service, which limits the maximum interest rate charged during that time to 6%.

Rate of Return. Because participant loans are to be treated as an investment option for plans, rather than as a benefit for participants, plan sponsors must also consider the rate of return of the loans against the plan's overall return on its investments. The DOL has provided that a participant loan as an investment would not be prudent if it provided the plan with less return, relative to risk, than comparable investments available to plan. The IRS takes the view that when a large percentage of the plan's assets are invested in participant loans, the overall rate of return may be unreasonable.

Maintain Records of Procedures used to Determine Reasonable Rates of Interest

Most importantly, whatever steps a plan sponsor takes to determine the reasonableness of interest rates, the process should be well-documented. By keeping thorough records of this process, a plan sponsor should be able to demonstrate a justification for the selection of the interest rates for participant loans under the plan.