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IRS Rules That Student Loan Program under 401(k) Plan Does Not Violate the Contingent Benefit Rule, but Important Compliance Issues Are Left Unanswered

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Research shows that student loan debt is now second only to mortgages in consumer debt. More than 44 million Americans owe collectively $1.5 trillion in student loan debt, with the average student in the Class of 2016 owing over $37,000. Many of these individuals cite their outstanding student loans (or the loans they have taken out to finance their children's education) as a significant reason for not saving more through their employer's retirement program. At the same time, numerous studies demonstrate that many — if not most — American workers are financially ill prepared for retirement.

This situation appears to be crying out for a solution and, in fact, some assistance has come recently from what some would consider an unlikely source: the IRS. The help is in the form of a private letter ruling (the "PLR") that may pave the way for employers to provide a new type of student loan repayment benefit to their employees — as part of the company 401(k) plan.

The IRS released the PLR on August 17, 2018 (PLR 201833012, issued May 22, 2018) in response to an employer's request to amend its 401(k) plan to include a voluntary student loan program, under which it would make contributions to the accounts of participants making student loan repayments. Specifically, the employer requested a ruling on whether amending its plan to provide a nonelective contribution conditioned upon an employee's student loan repayment would violate the "contingent benefit rule" in Internal Revenue Code (the "Code") §401(k)(4)(A). That Code section prohibits conditioning employer-provided benefits in a Section 401(k) arrangement (except for matching contributions) on whether an employee elects to make elective deferral contributions. The IRS ruled that the student loan repayment program, as described in the PLR request, would not violate the contingent benefit rule. This program and the contingent benefit rule are more fully described below.

The Student Loan Repayment Program

The pre-ruling version of the employer's 401(k) plan provided employees with the opportunity to elect to contribute a portion of their compensation to the plan each payroll period as pre-tax or Roth 401(k) elective deferrals, or after-tax employee contributions (collectively, "elective contributions"). If an employee makes an elective contribution during a payroll period equal to at least 2% of their compensation, the employer makes a matching contribution to their plan account equal to 5% of the employee's compensation during the pay period. The matching contributions are made each pay period.

In the request for a private letter ruling, the employer proposed to amend the plan to offer a voluntary student loan program (the "Program"), under which the employer would make a nonelective contribution on behalf of an employee conditioned on the employee making student loan repayment. Specifically, if an employee makes a student loan repayment equal to at least 2% of compensation during a pay period, the employer will contribute to the employee's plan account a nonelective contribution equal to 5% of their compensation for the pay period. Employees are not required to make a student loan repayment each pay period; rather, employees can opt in and out of the Program on a prospective basis. An employee participating in the Program would at all times remain eligible to make elective contributions, but would not be eligible to receive matching contributions on those elective contributions. That is, employees cannot receive matching contributions in addition to nonelective contributions in the same pay period.

To the extent an employee is ineligible for a matching contribution due to receipt of a nonelective contribution, the plan will make a "true-up" contribution to the employee's account. The true-up contribution is equal to 5% of the employee's compensation and is paid for any week the employee made elective contributions, but did not make a 2% of compensation (or more) student loan payment.

Under the Program, all employees eligible for the plan are eligible to enroll in the Program. Nonelective contributions and matching contributions are subject to the same vesting schedule. Nonelective contributions are subject to all plan qualification requirements, including eligibility, the distribution rules, contribution limits, coverage and nondiscrimination testing. While true-up contributions are subject to ACP testing under Code §401(m), non–elective contributions are not. Matching and true-up contributions are paid as soon as practicable after the end of the plan year, provided the employee is still employed on the last day of the plan year (unless the termination is due to death or disability). The employer will not extend any student loans to employees who participate in the Program.

Law and Analysis

With respect to the contingent benefit rule, Code §401(k)(4)(A) provides that:

> A cash or deferred arrangement of any employer shall not be treated as a qualified cash or deferred arrangement if any other benefit is conditioned (directly or indirectly) on the employee electing to have the employer make or not make contributions under the arrangement in lieu of receiving cash. The preceding sentence shall not apply to any matching contribution (as defined in section 401(m)) made by reason of such an election.

Similarly, Income Tax regulations §1.401(k)-1(e)(6) provides that:

> A cash or deferred arrangement satisfies this paragraph (e) [Additional requirements for qualified cash or deferred arrangements] only if no other benefit is conditioned (directly or indirectly) upon the employee's electing to make or not make elective contributions under the arrangement. The preceding sentence does not apply to (A) any matching contribution (as defined in section 1.401(m) 1(a)(2)) made by reason of such an election.

Thus, the contingent benefit rule prohibits conditioning other employer-provided benefits (such as health and welfare benefits, vacation benefits or nonqualified benefits) on whether an employee makes elective deferral contributions. This sole exception to this rule is for employer matching contributions.

In ruling that the Program would not violate the contingent benefit rule, the IRS particularly took into account the following two factors:

- Per plan terms, the nonelective contributions are conditioned solely on whether a plan eligible employee makes a sufficient student loan repayment, and
- Similarly, because an employee is able to make student loan repayments and receive nonelective contributions, regardless of whether the employee makes elective contributions, the nonelective contributions are clearly not conditioned on whether the employee makes an elective contribution under the 401(k) plan.

The IRS also noted that its "ruling is based on the assumption that the [employer] will not extend any student loans to employees who will be eligible for the program."

Simply put, the IRS determined that under the Program, the nonelective contribution would not to any extent be linked to an employee's choice under a cash or deferred arrangement to receive a plan contribution in lieu of taxable wages. Rather, only matching contributions are conditioned on elective contributions, and this is permissible under the law. Certainly, the nonelective contributions are conditioned on making loan repayments to an entity outside of the plan, but there is no prohibition against this under the law.

Impact of the IRS Ruling

The IRS ruling is generally welcome news for employers seeking to help their employees who are burdened by student loan debt to save more for retirement. A program structured along the lines of what is described in the PLR is close to cost-neutral, as the nonelective contribution essentially replaces the matching contribution. This is to be contrasted with a student loan reimbursement program which amounts to an additional cost to employers and, for that reason, may be less desirable.

At the same time, a PLR-type student loan repayment program is more expensive for employees than making elective contributions to a 401(k) plan. This is because deferrals are made from pre-tax income while the student loan repayments are made from after-tax dollars. In this instance, employees need to determine how much they are willing to pay to reduce their student loan debt, taking into account the benefit to be derived from the employer nonelective contributions.

In addition, it is reasonable to assume a student loan repayment program along the lines described in the PLR will be utilized predominantly by nonhighly compensated employees. Further, since loan repayments and nonelective contributions will not count towards the ADP and ACP nondiscrimination tests, respectively, it certainly could be that offering such a program may adversely impact a 401(k) plan's ability to satisfy testing. If this were to occur, it would have the effect of reducing the amounts highly compensated employees can contribute to the plan.

While the IRS ruling is good news, its application is limited. In particular, a PLR is strictly limited to the taxpayer requesting it. (See Code §6110(k)(3).) Therefore, the ruling cannot be relied upon by others, and it cannot be cited as precedent. This means that to the extent the ruling provides comfort to other employers seeking to offer a student loan repayment program in connection with their 401(k) plan, the level of comfort is directly related to the extent to which the program is similar in design to the one under consideration in the PLR.

Also, the ruling also leaves open a number of issues, such as the following:

- Would it be permissible to design a student loan reimbursement program under which the nonelective contribution is subject to eligibility, vesting and distribution rules that differ from other employer contributions under the plan?
- How are the nonelective contributions to be tested for coverage and nondiscrimination?
- Can a student loan repayment program be offered under a safe harbor 401(k) plan?
- Can a student loan repayment program be offered under a non-401(k) plan?
- To what extent, if at all, must the employer verify that the payments are actually being made pursuant to a bona fide student loan? And, if employer responsibility exists in this regard, must/should the employer require payroll withholding and direct payment to the lending institution?

Notwithstanding the PLR's limitations and the important compliance issues it leaves unanswered, it can be reasonably anticipated that the ruling will get attention from employers who want to help their employees save for retirement while properly managing the burden of often substantial student loan debt. Offering a student loan repayment program in a 401(k) plan could also prove to be an effective tool in attracting and retaining talent. Therefore, employers who are interested in such a program should be encouraged by the ruling to explore it with the assistance of their qualified plan advisors, in order to properly address the important compliance issues highlighted above.

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