401(k) Student Loan Matching Programs — Private Letter Ruling 2018-33012

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Much has been written about the impact student loan debt is having on the American economy. According to the *Wall Street Journal*, student loan debt is currently in excess of $1.5 trillion, the average debt is $34,000 per person, two million loans have defaulted over the last six years and 1,400 more defaults are occurring daily.[1] A new type of 401(k) contribution program is being touted as a way employers can help their employees pay off their loans and still save for retirement. But how do these programs work and when do they make sense?

Background

The American economy has been expanding for 10 years, and unemployment is at historically low levels. Employers must compete to fill open positions and retain existing workers. Increasingly, an employer-sponsored program to help employees with student loan payments is viewed as an important tool in recruitment and retention of workers. In addition, it is likely such a program can have a positive impact on employee productivity, due to the potential for reducing financial stress associated with student loan debt.

Some employers have adopted student loan repayment plans. Under these programs, the employer simply makes payments on behalf of the employee directly to the company servicing the employee's student loan. There are various third-party vendors facilitating this type of program.

Student loan repayment plans, however, can be expensive and should be considered in the context of the total benefit package provided to employees. And, it should be noted that the loan payments made by the employer are treated as taxable compensation to the employee. This means the employee must pay income tax on the employer payment amounts, and payroll systems must be integrated to take into account the additional compensation associated with those payments. It also means that both the employer and the employee will be responsible for payroll taxes (FICA/FUTA) on these amounts. This further drives up the employer's cost. An additional concern is that the program may be perceived as unfair to employees who do not have any student debt to repay and, as a result, receive no benefit from the program.

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The Emergence of Student Loan Matching Programs

Recently, a new type of loan assistance program has emerged, namely, a Student Loan Matching Program (SLMP). Under this type of program, contributions are made to the employee's 401(k) account that "match" his or her student loan payments. These contributions are never subject to payroll taxes and are only included in income when distributed from the plan (unlike student loan repayment plans). In addition, SLMP contributions are typically made in lieu of regular matching contributions, which means that all employees can receive an equivalent benefit.

However, under IRS regulations the SLMP contributions are not treated as true matching contributions; rather, they are classified as employer nonelective contributions. This technical difference can cause problems in plan design. For this reason, plan sponsors should carefully consider their goals for the program and the demographics of their workforce before adopting an SLMP.

Private Letter Ruling 2018-33012

The current interest in SLMPs was generated by IRS Private Letter Ruling 2018-33012 (the "PLR"), which was issued by the IRS on May 22, 2018, and released to the public on August 17, 2018.[2] A private letter ruling is an opinion issued to an individual taxpayer in which the IRS analyzes the tax consequences of a particular set of facts. The taxpayer who made the request is the only one who can rely on the analysis. Nevertheless, tax professionals look to private letter rulings for insights into IRS thinking on the tax laws. Private letter rulings are released anonymously by the IRS, but it has been widely reported that Abbott Laboratories (Abbott) requested the ruling with respect to its 401(k) plan.

The PLR describes how Abbott proposed to amend their 401(k) plan to add the SLMP feature. Under the plan's regular matching formula, employees who make at least a 2%-of-pay elective deferral contribution during a payroll period receive a matching contribution equal to 5% of compensation. The proposed SLMP contribution mirrors the regular matching formula. In other words, an employee who makes a student loan repayment equal to at least 2% of his or her pay during a payroll period receives a 5%-of-pay nonelective contribution.

Under the Abbott SLMP, an employee must sign up for the SLMP contribution and, by doing so, would become ineligible for the regular matching contribution. The employee can opt in or out of the SLMP contribution at any time and at all times would be permitted to make elective deferrals. Moreover, if an employee opts in but doesn't actually make a student loan repayment equal to 2% of compensation during a payroll period, that employee receives a so-called "true-up" matching contribution equal to 5% of compensation. To receive the true-up matching contribution or the SLMP contribution, the participant would need to be employed on the last day of the plan year. The regular matching contribution, however, is not conditioned on last day employment.

Based on this plan design, Abbott requested a very narrow ruling from the IRS: specifically, whether the SLMP contributions violated the so-called contingent benefit rule. This rule arises from IRC §401(k)(4)(A), which prohibits conditioning — directly or indirectly — any employer provided benefit (other than matching contributions) on whether an employee makes or doesn't make an elective deferral contribution.

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The purpose of the contingent benefit rule is to prohibit plan sponsors from manipulating the 401(k) or 401(m) tests by conditioning a very desirable employee benefit (e.g., vacation days, group life insurance, disability benefits, etc.) on whether the employee contributes or does not contribute to the plan. The theory is that some benefits are particularly valuable to rank-and-file employees who would be forced to contribute to the plan to qualify for the benefit. This could improve the NHCE average deferral percentage which, in turn, would make it easier to pass the ADP test.

In the context of the PLR, the analysis of how the contingent benefit rule might apply focused on whether the SLMP contributions were in some way contingent on whether the participant made or didn't make elective deferral contributions. The PLR notes that the SLMP contributions are conditioned on whether an employee makes a student loan repayment rather than an elective deferral. Additionally, employees who opt into the program remain eligible to make elective deferral contributions. Consequently, employees are not required to make or not make deferrals to qualify for SLMP contributions. The IRS held that, under these circumstances, the contingent benefit rule would not be violated by the SLMP contributions.

Issues to Consider in Implementing an SLMP

Although Abbott received a favorable ruling from the IRS in regard to the contingent benefit rule, there are other challenges that must be considered before implementing an SLMP. The SLMP contributions are classified as nonelective contributions for purposes of nondiscrimination testing under IRC §401(a)(4) and coverage testing under IRC §410(b). Whether those tests can be satisfied will depend on who actually receives the SLMP contributions, how much each person receives, and the demographics of the plan (i.e., the breakdown between participating HCEs and NHCEs). The application of these tests in a diversified population cannot easily be predicted, as it will depend on who opts in to the SLMP feature and their status as either an HCE or NHCE. The following example illustrates the potential concern.

Assume XYZ Medical Clinic (XYZ) has 100 employees, 20 of whom are doctors who are classified as XYZ's only HCEs. Many of the doctors have large student loan balances from college and medical school. XYZ adds a SLMP feature to the XYZ 401(k) plan. 15 of the doctors and 15 of the NHCEs opt in and receive SLMP contributions. Assuming the only nonelective contributions for the year are the SLMP contributions, this arrangement would likely fail coverage testing. This is due to the fact that 75% of the HCEs (15/20) are benefiting as compared to less than 19% of the NHCEs (15/80). Even if the coverage test could be satisfied, passing the general test for nondiscrimination under IRC §401(a)(4) is likely to be challenging as well. An easy way to avoid this problem is to exclude HCEs from eligibility to receive SLMP contributions. This approach, however, might exclude the very people the employer hopes to benefit as would be the case with the XYZ Medical Clinic.

Another concern with adding an SLMP feature is the potential detrimental impact on the 401(k) and 401(m) tests (also known as the ADP and ACP tests). In this case a problem may arise because the employees receiving SLMP contributions are NHCEs who, as a result of the program, are no longer receiving regular matching contributions tested under the ACP test. This may lower the NHCE average making it more difficult to pass the test. In addition, some of these same employees

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may reduce or eliminate their elective deferral contributions, making it harder to pass the ADP test.

An additional concern is how to draft plan language to allocate the SLMP contribution. In a customized individually designed plan, it should be a rather straight-forward process to write language to add an SLMP feature. Those using pre-approved plans could take one of two approaches. The first would be to use the individual allocation group method that most preapproved plans include as an option. In this instance, each participant would be placed in his or her own individual allocation group. The employer would then adopt a resolution at year end designating the SLMP contribution for each participant. However, this could be unwieldy for a larger employer. As an alternative, an employer might find it easier to simply draft custom language for the preapproved plan. In most cases, a determination letter on the custom language could then be requested if the changes were not extensive.

It is also important to consider the anti-cutback rules found in IRC §411(d)(6) when amending a plan's allocation formula. The IRS position is that a plan amendment to change the plan's allocation formula is an impermissible cutback if adopted after a participant has satisfied the conditions for sharing in a particular year's contribution. The IRS believes this is true even if the contribution is discretionary.[3] There is some debate as to whether the IRS position is correct in this regard. Nevertheless, caution would dictate implementing the SLMP feature in a way that adheres to the anti-cutback rules.

Administration of the program must also be considered. How are employers going to verify that the employee actually made the student loan repayment? One way would be to mandate that the employee's payments to the company servicing the loan are made by payroll deduction and submitted by the employer. Otherwise, there would need to be a substantiation policy. Hiring a third-party vendor to administer the program is another option. In any case, substantiating that the loan payment was actually made is an important element of plan administration.

Legislative Proposals

Congress is also interested in the student debt issue and its effect on retirement savings rates. On May 13, 2019, Senator Ron Wyden (D-OR) introduced the Retirement Parity for Student Loans Act of 2019 (RPSLA).[4] Under RPSLA, if certain requirements are satisfied, matching contributions made with respect to student loan repayments are tested under the ACP test. (However, student loan payments are not treated as elective deferrals for purposes of the ADP test.)

Given the election cycle, it is not likely Congress will pass RPSLA in the current session of Congress. However, similar provisions have been included in the Retirement Security and Savings Act of 2019, co-sponsored by Senator Rob Portman (R-OH) and Senator Ben Cardin (D-MD).[5] This demonstrates that student loan 401(k) matching programs have bi-partisan support in Congress and are likely to be included in the next generation of pension reform.

Conclusion

Adding an SLMP feature to a 401(k) plan can be a very valuable benefit. Unlike student loan repayment plans, SLMP contributions are not subject to FICA/FUTA taxes and are only taxable to the

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employee when withdrawn from the plan. An SLMP benefit permits employees to build a retirement nest egg, while at the same time paying down their debt. It is also perceived as a more equitable approach since participants without student loans can receive a regular matching contribution, in lieu of an SLMP contribution, simply by contributing elective deferrals to the plan. However, designing a SLMP that will work within the constraints of the IRS regulations requires careful planning and may not always be achievable, depending on the demographics of the workforce.

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[1] *Wall Street Journal*, June 7, 2019.

[2] PLR 201833012, May 22, 2018.

[3] See IRS Technical Advice Memorandum 9735001, February 20, 1997.

[4] S. 1428, (116th Congress, 1st session).

[5] 1431, (116th Congress, 1st session).

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