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Student Loan 401(k) Matches Could Still Trigger IRS Ire

By **Amy Lee Rosen**

Law360 (September 20, 2018, 7:46 PM EDT) -- The Internal Revenue Service made waves recently by clarifying that a 401(k) plan sponsor may provide matching employer contributions based on employees' student loan repayments, but such programs could still run afoul of regulations if they discriminate in favor of highly compensated employees.

The Internal Revenue Service recently addressed the policy challenge of student debt in the context of retirement planning. (AP)

The private letter ruling, PLR-131066-17, was released in August and said offering student loan repayment nonelective contributions would not violate the “contingent benefit” prohibition of the tax code, which says a 401(k) plan may not condition any other benefit upon the worker’s participation or nonparticipation in the benefit plan. Such a contribution must be given based on the elective deferrals made by all eligible participants.

However, the ruling did not address nondiscrimination testing, which is a separate requirement that says in order for a benefit plan to receive tax-favored status, the plan must not discriminate in favor of highly paid workers and other key employees as it relates to benefits, contributions or eligibility. If a plan fails nondiscrimination testing, then a benefits plan fails to be compliant, which puts workers and employers at risk of receiving IRS penalties.

Brian Dougherty, a partner at Morgan Lewis & Bockius LLP, told Law360 he thought the private letter ruling's conclusion that the plan did not violate the contingent benefit test was pretty straightforward, but the real significance fell on an area that was independent of the IRS ruling itself.

“The real issue here is whether the structure satisfies the applicable nondiscrimination requirements and what impact it may have,” Dougherty said. “You have to design this very carefully.”

In the private letter ruling, the sponsor’s original plan allowed an employee to choose to contribute some of her or his pay as pre-tax or Roth 401(k) elective deferrals, or as after-tax employee contributions, and if someone contributed at least 2 percent, then the company would match at 5 percent. The proposed plan the IRS examined gave employees the option to make a student loan payment, or SLR, nonelective contribution equal to at least 2 percent of eligible compensation during a pay period, after which the employer would make a corresponding 5 percent contribution to the benefit plan on behalf of the employee for that pay period.

Dougherty said if the nonelective contribution instead varied with the size of the loan repayment, there may be nondiscrimination problems because new highly paid participants might be able to repay their loans at a greater percentage of pay and get a bigger nonelective contribution.

The way to avoid this wrinkle is to just make the employer match a fixed 5 percent for everybody, Dougherty said. And while he personally has not seen his clients start to change their plans to offer this, Dougherty said that if he were speaking to a client about setting this up, he would encourage following the same sort of design to try to minimize the nondiscrimination problems that may arise.

Eric Winwood, a partner at Baker Botts LLP, told Law360 the private letter ruling is a welcome development because of the increasing significant debt burden related to student loans, but he was hesitant to advocate immediately starting to offer a student loan program in a 401(k) unless a company's employees were clamoring for such an option.

“Personally, I think companies should stay aware of this guidance moving forward and stay on the lookout for more comprehensive guidance or market standards that arise with respect to implementing such a student loan program into their 401(k)s,” he said. “The nondiscrimination testing effects of the 401(k) student loan program could cause problems and/or give rise to negative consequences, because the program is a separate benefit that has no effect on the more traditional 401(k) discrimination tests.”

For example, if most of the workers who participate in the student loan repayment program are not highly paid individuals, the benefit plan may pass nondiscrimination testing. But if the non-highly paid workers aren’t counted for purposes of 401(k) discrimination testing, the results may be skewed so that it looks as if more of the highly paid employees are only gaining the benefit and thus could potentially fail the discrimination testing, he said.

Instead, Winwood advocated for a wait-and-see approach until more comprehensive guidance is issued or market standards arise.

Russell D. Chapman, a special counsel at Littler Mendelson PC, said it remains to be seen if other retirement packages will offer student loan benefits, but he told Law360 he thinks the nondiscrimination testing will be one roadblock, especially if a company has a concentration of college graduates in highly compensated positions and a large non-highly compensated workforce of non-college graduates.

“I have not personally had any clients ask about this development, but the concept is still very new,” he said. “Other attorneys in the firm have had several inquiries, but due to the highly compensated work force for some clients, nondiscrimination testing would likely not pass.”

Chapman said another technical challenge that would arise from this option would be administrative, since companies would have to track student loan repayments. While most salary reduction contributions are tracked through a payroll system, most of which are computerized and automatically separate out the wages from the deferral contribution, with student loan repayments an administrator would have to get paper records, he said.

“Another technical question I have is exactly how it is determined whether the participant paid a student loan in the amount of 2 percent compensation for the pay period,” Chapman said. “Is this based on the total payment, principal reduction or a payment of a late charge or some other basis?”

What is interesting about this private letter ruling is this is first time the IRS has weighed in on the policy challenge of student debt in the context of retirement planning, according to Rachel Faye Smith, a partner at Goodwin Procter LLP.

“This employer contribution is intended to compensate for the plan match that would have been made if the employee had contributed to the 401(k) plan instead of repaying his or her student loan,” she said. “The novel element of this ruling is that by including the student loan benefit program as part of a 401(k) plan, the IRS has extended tax-favored treatment to this employee benefit.”

Smith recommended companies be cautious about adopting a student loan benefit plan that deviates from the features approved in the PLR because the PLR technically applies only to the company that solicited the ruling. So it is unknown how the IRS may treat a different but similar plan that allows an employer to make a nonelective contribution to a 401(k) plan conditioned on the worker making a student loan repayment.

Smith told Law360 the ruling is important because it indicates the IRS recognizes that student loan repayments are a direct threat to retirement savings and demonstrates that the agency is open to interpreting law in a way that will facilitate tax-advantaged student loan programs.

“We are hopeful that this PLR is a harbinger of broader IRS guidance on student loan benefit programs in qualified retirement plans,” she said.

--Editing by Tim Ruel and John Oudens.