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IRS approves 401(k) plan contribution tied to student loan repayment

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Employers and employees alike acknowledge that the burden of student loan repayment often derails employee retirement savings. Student loan repayment benefits have emerged as attractive hiring and retention tools, but these benefits have historically been taxable to employees and done little to uplift lagging 401(k) deferral rates.

In a private letter ruling issued on August 17, 2018,[1] the IRS approved an employer's proposal to offer a "student loan repayment nonelective contribution" under its 401(k) plan. Although it cannot be relied upon as binding legal authority by parties other than the employer that requested it, the ruling provides welcome guidance to plan sponsors seeking an innovative and cost-effective way to provide employees with the opportunity to save for retirement on a tax-deferred basis while repaying their student loans. As set forth in further detail below, the ruling sets forth specific criteria that the IRS found relevant in approving the proposed nonelective contribution. The ruling also signals that other types of student loan repayment benefits may be permissible under retirement plans. Plan sponsors should carefully review the ruling and other IRS guidance when considering plan amendments to provide student loan repayment benefits.

Summary of private letter ruling

The unidentified plan sponsor maintains a 401(k) plan, which provides an employer matching contribution equal to 5% of an eligible employee's compensation if the employee elects to defer at least 2% of his or her compensation to the plan on a pre-tax basis. The plan sponsor requested a ruling as to whether amending the plan to provide a nonelective employer contribution conditioned upon an employee's student loan repayment would violate what is known as the "contingent benefit" prohibition.[2] The contingent benefit prohibition generally precludes a 401(k) plan from conditioning benefits (other than matching contributions) upon an employee's election to defer a percentage of his or her compensation to the plan in lieu of receiving that compensation

[1] https://www.irs.gov/pub/irs-wd/201833012.pdf

[2] See Internal Revenue Code Section 401(k)(4)(A) and Income Tax Regulation 1.401(k)-1(e)(6).

as taxable wages. The IRS approved the proposed nonelective contribution structure, which contained the following features:

- The plan would provide a 5% employer nonelective contribution per pay period for any eligible employee who made a student loan repayment equal to at least 2% of his or her compensation during that pay period. The nonelective contribution would be made for each pay period during which an employee made a sufficient student loan repayment, even if the employee did not consistently make student loan repayments throughout the plan year.
- The nonelective contribution would be offered in addition to the plan's matching contribution, and would be provided regardless of whether an employee made any elective deferrals.
- Although an employee could continue making elective deferrals while receiving the nonelective contribution, the employee could not receive a matching contribution in addition to the nonelective contribution with respect to any pay period. If an employee was prohibited from receiving a matching contribution due to receipt of the nonelective contribution, the plan would make a "true-up" contribution. The true-up contribution (equal to 5% of the employee's compensation) would be paid for any week an employee failed to make a sufficient student loan payment but did make an elective deferral equal to at least 2% of his or her compensation.
- The nonelective contributions and true-up matching contributions would be subject to the same vesting schedule as matching contributions. Also, the nonelective contribution would be subject to all plan qualification requirements, including eligibility, distribution rules, contribution limits, and coverage and nondiscrimination testing.
- The proposed student loan repayment contribution program would be completely voluntary, meaning an employee would need to elect to enroll, and once enrolled could opt out of the program on a prospective basis. All employees eligible to participate in the plan would be eligible for the program. The nonelective contribution and true-up contribution, if applicable, would be made as soon as practicable after the end of the plan year.
- The nonelective contribution will not be treated as a matching contribution for purposes of Internal Revenue Code Section 401(m) testing, but the true-up contribution will be included for any testing or other requirement under that Code provision.
- The plan sponsor had not extended, and would not extend, student loans to employees who were eligible to participate in the student loan repayment contribution program.

In finding that the nonelective contribution structure did not violate the contingent benefit prohibition, the IRS noted that the nonelective contribution was conditioned on an employee making student loan payments outside of the plan (rather than being conditioned on the employee making elective deferrals). The IRS also found relevant the fact that employees could still make elective deferrals to the plan while participating in the student loan repayment contribution program. This meant the nonelective contribution was not conditioned upon employees having to choose between the employer making or not making contributions for them under the program in lieu of regular taxable wages.

Next steps: providing 401(k) student loan repayment benefits

While the private letter ruling should provide plan sponsors comfort to move forward with adopting a student loan repayment contribution program, several unanswered questions remain:

- It is not clear whether the IRS would permit student loan repayment contributions to be offered under retirement plans other than 401(k) plans.
- The IRS did not state that the plan sponsor would need to adopt certain student loan repayment substantiation requirements. This raises the question of how far plan sponsors should go to substantiate employee student loan payments. Although copies of bank statements showing that a participant made certain payments would appear to suffice, those kinds of statements can be vulnerable to forgery. By contrast, it could be unnecessarily burdensome to require direct proof of payment from student loan providers, or to arrange for direct payment of student loan payments through an employer's payroll system.
- It may be administratively impractical for plan sponsors to monitor employee student loan payments and determine whether those payments qualify for student loan repayment contributions without the assistance of a competent administrator. Any service agreements should be carefully reviewed to determine whether the administrator can effectively monitor changes that frequently manifest themselves in an employee's student loan repayment history, such as deferment, loan forgiveness, payment restructuring and refinancing, and defaults.
- It is possible that student loan repayment contributions could be made more frequently for highly compensated employees who may have greater ability to make student loan repayments equal to a certain percentage of their compensation. The IRS did not specify whether plan coverage and nondiscrimination testing could be manipulated to prevent student loan repayment contributions from causing plan testing failures.
- It is not clear whether a plan could make a student loan repayment contribution conditional upon an event other than an employee making a student loan payment, such as an employee refinancing his or her existing student loans under a refinancing program offered by the employer.

Plan sponsors who want to explore or adopt student loan repayment benefits that differ materially from the student loan repayment nonelective contribution outlined in the August 17, 2018 private letter ruling should consult with legal counsel to ensure that the benefits will not interfere with plan qualification requirements.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

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