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Comment

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Bank Credit Lines Can Be Useful For Qualified Retirement Plans

Under some circumstances it can be advantageous for qualified retirement plans to obtain bank lines of credit to finance benefit distributions or participant loans, or to fund transfers from one investment subfund to another at the direction of participants.

When a plan maintains its own cash and cash equivalents to provide liquid assets for such distributions, it necessarily sacrifices yield.

If a line of credit is in place, a trustee may obtain loans quickly to meet substantial unexpected distributions and, consequently, the trustee can reduce the plan's holdings of cash and equivalents from a conservative level to one which better reflects its recent experience.

The freed-up cash and equivalents can then be invested in higher yielding investments.

In addition, a line of credit may give the fiduciary some temporal flexibility in selling plan investments when funds are needed for distributions or when investments in one plan subfund are to be liquidated and the proceeds reinvested in another.

In such situations, a drawing under a line can quickly fund the distribution (or transfer) and

stocks or other assets of the plan may, instead of being dumped, be sold in a more orderly fashion in order to repay the loan.

Lines of credit can also address concerns of defined contribution plans offering subfunds which invest in publicly-traded employer stock on a non-leveraged basis.

When participants direct the sale of employer shares in their account in order to transfer the proceeds to another investment available under the plan, a plan trustee can use a line of credit to borrow against the proceeds expected to be realized from share sales.

Close Attention Needed

The borrowing is then repaid when shares are actually sold and the sales proceeds are received. The result can be a reduction in the time needed to process and implement participant directions.

In the past, plans have obtained de facto lines of credit. In 1980, when the Department of Labor issued Prohibited Transaction Class Exemption 80-26, a class exemption which permits parties in interest to extend credit to plans under certain limited conditions and without any compensation, the department noted that some institutional plan trustees were extending credit in the form of overdraft privileges to plan cli-

A CREDIT can give flexibility in selling investments when distributions are needed.

ents where securities purchased for the plan but proceeds from the sale of other investments had not yet been received to fund the purchases.

Currently, structuring fee-based lines of credit for qualified plans requires close attention to requirements of the Employee Retirement Income Security Act and Internal Revenue Code requirements.

Since the retirement income security act's section 402 (a)(1) requires that a plan be maintained in accordance with a written instrument and section 404 (a) (1) (D) requires a plan fiduciary to act in accordance with the governing plan documents, the plan documents must provide the trustee with authority to establish a line of credit and to borrow under the line.

Since plans have probably thus far not commonly used fee-based lines of credit, the plan documents should clearly permit the transaction in order to avoid any claim against a trustee or lender that the transaction violated the act.

Asset Pledge

Moreover, if borrowings are to be collateralized under the line, the plan documents must authorize the trustee to pledge plan assets.

If the purpose of the line of credit is to enable a trustee to borrow against proceeds expected to be received from sales of shares of stock from participant accounts, the plan documents should provide for the allocation of any gain or loss which the plan may realize or suffer should the price of stock against which a borrowing has been made change between the date for processing participant directions and crediting or debiting participant accounts and the date on which the stock is actually sold from the accounts.

Retirement income security act sections 404(a) (1) (A) (ii) and (B) require a fiduciary to act prudently in managing a plan and to incur only reasonable expenses in administering the plan.

If a line of credit is intended to enable the trustee to reduce the plan's cash and equivalents and permit investments of the freed-up cash at greater yields, the trustee and the potential lender may wish to document that the additional income which the plan can reasonably expect from those investments is at least equal to the estimated expenses of arranging for the line.

Also, a trustee may wish to approach several potential lenders in order to demonstrate that the lender actually selected is charging competitive rates.

Other Restrictions

The plan fiduciary and potential lender must also consider the restrictions which the pro-

hibited transaction rules of the retirement income security act may place on the structure of the line of credit.

The act's section 406(a)(1)(B) prohibits a "party in interest" from extending credit to a plan. Section 3(14) defines a party in interest to include a plan fiduciary (which includes a plan trustee), a service provider to the plan, the plan sponsor and any affiliates or subsidiaries of any such persons.

Since a plan trustee and a plan sponsor are parties in interest, neither of them can provide a fee-based line of credit to the plan.

Since a service provider to a plan is also a party in interest within the meaning of section 3(14), the trustee and any potential lender should insure that neither the lender nor any subsidiary or affiliate is furnishing other services to the plan.

Key Consideration

However, the Qualified Plan Asset Manager PTCE 84-14 may permit a lender which is already a service provider to extend credit to the plan if the plan trustee qualifies as a plan asset

A TRUSTEE could borrow against the proceeds expected from share sales.

manager and has discretionary authority as to the disposition of plan assets under its control.

Finally, the party in interest rules in the income security act's section 406(a)(1)(B) prohibit a plan sponsor from a guaranteeing or collateralizing the obligations of a plan under a line of credit, since that section prohibits indirect as well as direct extensions of credit by a party in interest except under limited circumstances not applicable here.

It should be borne in mind that if the structure of the line of credit violates the prohibited transaction rules, excise taxes can be imposed under IRS Code

section 4975 and the Labor Department may also impose fines under the retirement income security act.

The unrelated business income tax rules of code sections 511-514, and specifically the "debt-financed property" rules of code section 514, while not relevant for structuring purpose, may influence the manner in which a plan will use a line of credit and should therefore also be considered.

It is important to bear in mind in considering the implications of a line of credit that the unrelated business income tax rules involve only the possible imposition of the graduated corporate income tax on some income of the plan, which is otherwise a tax-exempt entity, rather than penalty taxes, loss of tax exempt status or a per se retirement income security act violation.

Measure of Proper Action

The Labor Department has recently stated unofficially that a plan's incurrence of the unrelated business income tax is not itself a violation of the income security act's prudence rules but is only a factor to be considered in determining whether a fiduciary has acted improperly.

Under the unrelated business income tax rules, the income of a plan from its passive investments ordinarily does not generate income. However, there is an important exception for income from leveraged passive investments, which are characterized as "debt-financed property" and the income from which is subjected to the rules.

IRS Code section 514(b)(1) defines "debt-financed property" as property which an exempt organization holds to produce income and with respect to which "acquisition indebtedness" exists at any time during a taxable year.

Code section 514(c) defines "acquisition indebtedness" as indebtedness which the exempt entity incurs in acquiring an item of property, indebtedness which it incurs prior to acquiring an item of property if the in-

debtedness would not have been incurred but for the acquisition, or indebtedness which it incurs after the acquisition if the indebtedness would not have been incurred but for the acquisition and the incurrence of the indebtedness was reasonably foreseeable at the time of the acquisition.

If "acquisition indebtedness" exists with respect to an item of property during a year then all or a portion of the income or gain realized by the holder dur-

IF A LINE of credit is in place, a trustee may obtain loans quickly to meet unexpected distributions and move the plan's holdings of cash and equivalents into high-yield investments.

ing the year from the property is subject to the unrelated business income tax.

Rules Not in Play

Generally, the debt-financed income rules will not come into play where a plan borrows under a line of credit to fund distributions in anticipation of selling other investments or receiving contributions.

IRS Code section 514(a) is concerned with the incurrence of indebtedness to fund the acquisition of property and by its terms does not apply to borrowings which are used to pay general obligations of an exempt entity.

Moreover, unlike code section 265(a)(2), which denies a deduction for the interest cost incurred in carrying tax-exempt obligations, code section 514 does not apply to debt which merely permits an exempt entity to continue to own an investment, so long as an incurrence is not foreseeable when the asset is

acquired.

Neither code section 514(c) nor the regulations contain provisions which purport to allocate an exempt entity's indebtedness to its investment property in the absence of some direct or indirect connection between an acquisition of property and the incurrence of the debt.

In 1987, the Internal Revenue Service issued private-letter rulings which appear to recognize that section 514 does not come into play in this area.

In those rulings, the IRS held that an exempt organization was not subject to any unrelated business income tax where it occasionally obtained short-term borrowings to make distributions or to purchase new investments in anticipation of receiving contributions or proceeds from the sale of other investments.

Less Leniency

It is possible that the IRS might take a less lenient position with respect to asset purchases which are coincident in time with borrowings under a line of credit for distributions if the borrowings are quite frequent and the plan holds little or no cash or cash equivalents which could have been used to fund the purchases.

In such a case, the IRS might contend that a portion of such borrowings should be treated as having been directly or indirectly used to purchase the new investments for purposes of code section 514 and that the investments are debt-financed property.

On the other hand, it could be argued that the plan's investment portfolio is not being increased by reason of such loans. However, in the absence of further guidance from the service the lesson might be that a plan's line of credit should not become its sole source of cash if it wishes to be absolutely certain that it will not have to pay any unrelated business income tax. □