

Helping Employees Without Hurting Your Business: Legal Considerations in Making Employee Loans

By [Jennifer Velencia](#)

May 20, 2011

Occasionally, we receive inquiries from clients who would like to make loans (or create a policy for making loans) to their employees. Typically, these clients want to make loans for one of the following purposes:

- To recruit new employees (for example, loans to pay relocation expenses)
- To encourage further education (for example, loans for relevant coursework)
- To assist employees experiencing financial hardship
- To assist employees in purchasing a home

Ideally, the documentation for loans (or loan policies) designed to benefit employees would be simple and easily prepared. The problem is that employee loans usually fall into the category of "consumer credit." While this definition varies by statute, "consumer credit" usually means a loan to an individual for personal, family, or household purposes.

Unfortunately, consumer credit is a highly regulated area of the law at both the state and federal levels. The following is a list of just some of the potential legal considerations in making employee loans:

In determining whether to make loans, does the employer plan to pull credit information on employees? If so, the employer must comply with the federal Fair Credit Reporting Act (the "FCRA"). To comply with the FCRA, a lender must certify to the credit reporting agency that it has a valid purpose for requesting the information. The lender must also provide an adverse decision notice to the consumer if the lender bases its decision to deny credit on any information obtained from the credit report.

Has the employer adopted a policy designed to prevent claims of discrimination? The federal Equal Credit Opportunity Act ("ECOA") prohibits creditors from treating one applicant less favorably than another because (i) of color, religion, national origin, sex, marital status, or age, (ii) the applicant receives some type of public assistance, or (iii) the applicant has asserted rights under a credit protection law. In addition to prohibiting discrimination, ECOA (and its implementing regulations) limits what information creditors can collect on the application, establishes the credit approval, denial, and revised offer notification process, sets forth when creditors must take action on requests for credit, and imposes recordkeeping requirements. A carefully drafted employee loan policy which clearly sets forth, among other things, eligibility criteria, may help an employer avoid claims of discrimination.

Is the loan documentation written in plain language? Subject to certain exceptions, the Pennsylvania Plain Language Consumer Contract Act (the "Plain Language Act") applies to contracts whereby a consumer (i) borrows money, (ii) buys, leases or rents personal property, real property, or services for cash or on credit, or (iii) obtains credit. If applicable, the Plain Language Act contains tests for readability and disclosure requirements.

In documenting the loan, are any disclosures required? The federal Truth in Lending Act and its implementing regulations (commonly referred to as Regulation Z) apply to individuals or businesses that offer or extend credit when: (i) the credit is offered or extended to consumers; (ii) the offering or extension of credit is done regularly; (iii) the credit is subject to a finance charge or is payable by a written agreement in more than four installments; and (iv) the credit is primarily for personal, family, or household purposes. The threshold for determining whether credit is extended "regularly" depends on the number of loans made per year. Generally, when Regulation Z is applicable, a creditor must make certain disclosures in connection with the loan.

Will the employer charge interest? If applicable, the Pennsylvania Loan Interest Protection Law (commonly referred to as Act 6) sets forth maximum rates of interest. Generally, the maximum lawful rate of interest for the loan in a principal amount less than \$50,000 is six percent. On the other hand, if the loan is interest free, the "imputed

interest rules” contained in the Internal Revenue Code may require that some portion of amounts repaid be characterized as interest in the hands of the employer.

Will the loan be repaid through payroll deductions? If an employee agrees to repay the loan through payroll deductions, the employer must comply with Pennsylvania’s Wage Payment and Collection Law, which requires that deductions be for the convenience of the employee. Care should also be taken to obtain written deduction authorizations and to ensure that the deductions will not violate applicable wage and hour laws.

Is the employer willing to accept limitations on enforcement and collection? Enforcing and collecting on a consumer debt is much more difficult than enforcing and collecting a commercial debt. For example, under Pennsylvania law, a confession of a judgment is unenforceable in a consumer transaction. Furthermore, lenders must take care to comply with any applicable federal and state collection laws, such as the Fair Debt Collection Practices Act. One way to ease the burden of complying with collection laws is to use a debt collection agency.

If the loan will be forgiven upon satisfaction of certain conditions, what are the income tax consequences? Forgiveness of an employee’s debt may generate income to the employee for federal income tax purposes. With respect to the employer, if the debt is forgiven, the employer will need to determine whether the debt was business debt or non-business debt. This determination will affect the type of deduction (ordinary or capital) available to the employer.

As the above list of considerations suggests, consumer credit is a highly regulated area of the law. These laws are complex and sometimes counterintuitive. The penalties for violating these laws are harsh and may include **treble damages, criminal penalties, and an award of attorneys’ fees**. For these reasons, we suggest that employers who wish to make employee loans seek our assistance before making any such loans.

© 2010 McNees Wallace & Nurick LLC

This document is presented with the understanding that the publisher does not render specific legal, accounting or other professional service to the reader. Due to the rapidly changing nature of the law, information contained in this publication may become outdated. Anyone using this material must always research original sources of authority and update this information to ensure accuracy and applicability to specific legal matters. In no event will the authors, the reviewers or the publisher be liable for any damage, whether direct, indirect or consequential, claimed to result from the use of this material.