

Self-Correction of Participant Loan Failures: A brand new world!

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Correcting Elective Deferral Failures
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Participant Loan Failures



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Typical IRS Loan Failures

- Plan sponsor fails to withhold loan repayments
- Loan in excess of limits (50%/\$50,000)
- Loan exceeds duration requirements (5 years)
- Plan document doesn't provide for participant loans
 - Exceeds number of loans permitted
- Plan fails to obtain spousal consent



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Failure to withhold loan repayments

- Most common failure with respect to participant loans is the failure to make the loan payments timely or at all
 - Most plans now provide for payroll deduction
 - Although it simplifies administration, it adds more parties to the transaction
- The regulations provide a grace period for a missed payment and if the missed payment is made within the grace period, the IRS considers the issue resolved and there is no consequence
 - Maximum grace period is that missed payment must be made up no later than the last day of the following plan year quarter
 - Plan may provide for a shorter grace period
 - Look to loan policy

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Failure to withhold loan repayments

- Frequently the participant fails to make-up the missed payments within the grace period
 - Consequence: the entire unpaid loan (not just the missed payments), including accrued interest is treated as a deemed distribution (i.e., taxable to the participant)
 - Premature distribution tax is applicable unless participant is 59½
- Unless the participant incurs a distributable event (e.g., termination of employment), the participant continues to have the responsibility of paying off the loan
 - Payments made by a participant after a deemed distribution create a basis in the account

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Taxation matter

- The failure to make loan payments is more of a taxation matter than a qualification issue
- Because the failure is so common and because it causes significant tax consequences to the participants (frequently NHCEs), the IRS established correction methods that can avoid the tax consequences to the participant



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Causes of the failure

- Causes of the failure:
 - Payroll company fails to withhold
 - ER fails to communicate withholding requirement to payroll company
 - Change of payroll company
 - Change of plan trustee
- Although participants are in the best position to identify the failure and prevent the failure from continuing beyond the grace period, the participants rarely alert the employer of the failure
- Consequently, the failure continues beyond the grace period during which the failure could be corrected

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Old Rules: VCP Correction

- Employer would need file under VCP for relief from issuing 1099-R in the year of failure
- If a plan wants relief from the deemed distribution and the premature distribution tax, the participant must
 1. make a lump sum payment of the missed payments,
 2. reamortize the outstanding loan balance, including accrued interest, over the remaining portion of the 5-year repayment schedule; or
 3. a combination of 1. and 2.
- The employer also will need to make an interest payment to the plan equal to the additional interest that had accumulated as a result of the failure (at a rate equal to the greater of the plan loan interest rate or the rate of return under the plan)
 - Usually, this amount is minimal
- **Alternative VCP Correction.** Request permission to issue 1099-R in the year of correction
- If you don't go through VCP or Audit CAP: Plan must issue Form1099-R for year of failure

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New Self-Correction for Defaulted Loan

- Fact Pattern
 - Loan complies with Code §72(p)
 - Loan defaulted because of failure to timely pay (withhold)
 - Corrected within maximum repayment period (normally five years)
- Correction
 1. Employee must make lump sum payment for missed payments,
 2. The plan reamortizes loan and accrued interest over remaining loan term (or five-year limit), or
 3. Combination of 1 & 2
- The employer pays the the interest that accumulates as a result of such failure (generally determined at a rate equal to the greater of the plan loan interest rate or the rate of return under the plan)

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Example

- Ed obtains a 5-year loan for \$15,000 from the plan on January 15, 2017
 - Monthly payments of \$280 withheld from wages
- Employer failed to implement payroll withholding
 - Administrator discovered after 8 missed payments
- Plan can correct the failure under SCP by:
 - Reamortizing the loan must interest accrued over remaining 4 years and 4 months, or
 - Ed can make a lump sum payment of \$2,240 and the plan continues the loan
 - Combination of 1 and 2
- Employer would need to make a payment to plan of interest that accumulated on the late payments

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Alternative Self-Correction

- Plan can issue a Form 1099-R in the year of correction (as opposed to the year of failure)
 - Interest continues to accrue until plan treats the loan as a deemed distribution
 - “Any applicable income tax withholding amount that was required to be paid in connection with the failure (Treas. Reg. §1.72(p)-1, Q&A-15) must be paid by the employer”

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Requirements to Self-Correct

- Plan must have in place practices and procedures “reasonably designed to promote and facilitate overall compliance in form and operation with applicable Code requirements”
- If failure is “significant”
 - Must correct by end of second plan year after year of failure (and before audit)
 - Must have “favorable letter”



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Retroactive Self-Correction

- Participant defaulted on loan
 - Deemed distribution, not offset
- 1099-R issued prior to April 19, 2019
- Can we reverse 1099-R with self-correction?
- It is unlikely the IRS would allow the plan to “undo” the 1099-R for deemed distribution prior to the effective date of new EPCRS

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Prompt Recordkeeper

- We don't find out about defaulted loan until after recordkeeper has defaulted it and issued 1099-R
- What can we do?
 - Talk to the recordkeeper
 - It now doesn't make sense to be “quick on the draw” to default loans
 - At least give the participant the opportunity to correct
 - 2019 1099-R forms can be “reversed”



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Who Is Responsible? employer fails to withhold participant loan repayments

- The issue is debatable and the answer depends on the facts of a particular situation
- A Tax Court case sheds some light on this issue
- Employer's failure to withhold loan payments raised two issues:
 - the tax consequences to the participant, and
 - whether the employer has any liability
- *Leonard v. Commissioner*,
 - T.C. Summary Opinion 2004-11 (2004)



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Failure to withhold loan payments (cont.)

- The case focuses on the first issue, but the decision seems to suggest a possible answer to the second issue
- Facts: A participant obtained a loan that was to be repaid through payroll deduction
 - A few days after obtaining the loan, participant transferred to another division of the employer
 - Because of the transfer, the company never withheld any of the loan payments
- Prior to the close of the loan grace period, the company sent a letter to the participant informing the participant of the missed payments and indicating that the plan would treat the loan as a deemed distribution unless he made-up the missed payments
 - However, the plan used incomplete address information
- The plan later treated the loan as a deemed distribution and issued a Form 1099-R
- Later, the IRS assessed the taxes on the deemed distribution, including the 10% premature distribution tax
- The participant argued that he should not be taxable on the deemed distribution because he:
 - never received his quarterly benefit statements,
 - letter notifying him of the delinquent payments, and
 - Form 1099-R

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Failure to withhold loan payments (cont.)

- The court concluded that even if it accepted all of the participant's arguments, the participant nonetheless failed to comply with the quarterly amortization requirement and did not make-up the payments within the permitted grace period
 - In other words, it's the participant's loan and he is responsible for getting it paid
- The case illustrates the IRS's and the court's strict interpretation of the loan rules
- The IRS appears unwilling to accept any excuses or retroactive corrections of missed payments (beyond the plan's grace period)
- If the loan payments have not been withheld (irrespective of who is at fault) and the participant has not made-up the missed payments within the plan's grace period, the loan is taxable to the participant

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Preventative measures



- Since the participant is in the best position to identify the failure and avoid the deemed distribution, the employer could incorporate a provision in the loan policy and the loan note that places the responsibility for making certain the loan payments are withheld with the participant
- The provision also would require the borrower to notify the employer if payments were not withheld
- If the participant did not notify the employer of a failure, the participant would be subject to the adverse tax consequences

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VFC Programs

- If an employer wants to also resolve a loan failure under the DOL's Voluntary Fiduciary Correction Program, the employer must have a VCP compliance statement
- I have never heard of anyone resolving a loan failure under VFC
 - Practitioners focus on the EPCRS corrections



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Other Loan Failures

- For the following loan failures the plan can't use SCP to avoid issuing a Form 1099-R:
 - Loans in excess of loan limits (e.g., 50%/\$50,000)
 - Loan terms in excess of maximum repayment period (normally five years)
 - Level amortization
- Under VCP or Audit CAP:
 - Can resolve failure and ask for forgiveness of deemed distribution

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VCP: Correcting a loan in excess of limits

- A plan that permits a participant to obtain a loan in excess of the loan limits of Code §72(p)(2)(A) can correct the failure by having the participant make a corrective payment to the plan of the excess loan amount
 - Generally occurs when participant obtains a second loan or refinances
- Assuming the loan repayments were made in accordance with an appropriate amortization schedule, the plan may apply the repayments in one of three ways:
 1. Solely to reduce the portion of the loan that did not exceed the loans limits. Accordingly, the corrective repayment would equal the excess loan amount and the interest thereon.
 2. To pay the interest on the excess loan amount, with the remainder of the repayments being applied against the loan amount that did not exceed the loan limits. Accordingly, the corrective repayment would equal the excess loan amount.
 3. A combination of 1. and 2.

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Loan in excess of limits

- After the corrective payment has been made, the plan would reamortize the remaining loan amount over the remaining period
- A plan that implements one of these correction methods will not need to treated the excess loan amount as a deemed distribution nor subject the participant to the premature distribution tax



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Example

- In January, 2017, Cathy obtains a \$22,000 loan
 - After Cathy has made 5 monthly payments, the plan discovered that because of the refinancing rules that Cathy's loan exceeded the limits by \$2,000
- To correct the loan failure the plan has three options:
 - Apply the loan payments to the permissible loan amount of \$20,000 and have Cathy make a corrective payment to the plan of \$2,000 plus interest to the date of the correction
 - Apply the loan payments first to pay the interest on the \$2,000 and then apply the balance of the payments to the permissible loan amount, and have Cathy make a corrective payment to the plan of \$2,000
 - Apply the loan payment pro-rata to both the permissible and excess loan amounts, and make a corrective payment of the remaining balance of the \$2,000 loan
- In each case, the plan would reamortize the loan over the remaining period

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Loan exceeds the duration requirement

- With the exception of a home loan, the loan term cannot exceed five years
- The requirement is very straight forward and rarely is violated
- If an error occurs, it is because an employer applies the wrong starting point
 - The five years should be measured from the date the participant receives the loan proceeds and not from the first payroll date

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Example

- On January 31, 2017, Ben obtains a \$10,000 loan with a final payment date of February 28, 2022
- On June, 2017, the plan notices the error
- Plan files under VCP to avoid the need to issue the Form 1099-R
 - **Correction.** The plan reamortizes the loan with a final payment date of January 30, 2022
- A plan that implements this correction method will not need to treat the loan which fails to satisfy the duration limit as a deemed distribution nor subject the participant to the premature distribution tax

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VCP Application: Form 14568-E

D. Defaulted loan(s) (where the loan terms satisfied the requirements of IRC Section 72(p)(2), but default(s) occurred because loan payments were not made in accordance with the terms of the loan)

Plan Year	Number of Participants Affected	Total Number of Loans in Default

Section II - Eligibility for Use of Form 14568-E

- A. Yes** **No** Is any affected participant either a key employee (as defined in IRC Section 4160(i)(1)) or an owner-employee (as defined in IRC Section 401(c)(3)?
If "Yes," proceed to Section II B.
If "No," skip Section II B and proceed to Section II C.
- B. Yes** **No** Is the purpose of this request limited to permitting the plan sponsor to report the loan as a deemed distribution in the year of correction instead of the year of the failure?
If "Yes," complete Section III and then proceed directly to Section IV D. (Sections IV A, B and C do not apply.)
If "No," **STOP-do NOT use this Form 14568-E.** Any request for relief should be made by filing a detailed written attachment to Form 14568, Model VCP Compliance Statement, describing the relief requested and the reasons why such relief should be granted.
- C. Yes** **No** Will correction be completed before the maximum period for repayment of the loan (pursuant to IRC Section 72(p)(2)(B)) has expired? (Note: The maximum period is determined from the original date of the loan. Generally, this period is five years from the original date of the loan, except for home loans as described in IRC Section 72(p)(2)(B)(ii).) The original date of the loan is considered to be the date the participant received the proceeds from the loan.

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Form 14568-E

C. Correction for defaulted loans with terms that complied with the requirements of IRC Sections 72(p)(2)(A), (B) and (C): (check the box that applies)

1. A lump sum repayment will be made to the plan in an amount equal to the additional repayments that the affected participant would have made to the plan if there had been no failure to repay the plan, plus interest accrued on the missed repayments.

2. The outstanding balance of the loan, including accrued interest, will be reamortized over a remaining period that does not extend beyond five years from the date of the original loan. If the original loan was a home loan described in IRC Section 72(p)(2)(B)(i) the reamortized loan balance will be paid over the remaining period of the original loan.

3. The Applicant will use a combination of the methods described in #1 and #2 above, as follows:

Determination of Interest Accrued on Missed Repayments (check the box that applies)

Plan loan rate _____ (insert rate)

Rate of return of investments under plan _____ (insert rate)

Note: This option may only be used if the rate of investment return under the plan equals or exceeds the plan loan rate.

The interest rate for missed payments was determined as follows:

The additional unpaid interest will be has been (check one) paid by the: (check the box that applies)

Plan sponsor

Affected participants

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Alternative to VCP: Self-Correction Option

- For any 72(p) loan failure, a plan may issue a Form 1099-R in the year of **correction** (rather than the year of failure)
 - Interest will continue to accrue until loan is treated as a deemed distribution or offset
 - Employer is responsible to pay for any income tax withholding
- This self-correction option is available for:
 - Loan defaults **not** corrected under the SCP correction method (i.e., reamortization; lump sum payment)
 - Loans in excess of limits, loans in excess of loan periods, or level amortization failures **not** corrected under VCP or Audit CAP

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Loan Correction Chart (72(p) failures)

Failure	Correction that avoids 1099-R (SCP vs. VCP)	Correction Method	Alternative SCP Correction (1099-R in the year of correction)
Loan default (failure to withhold)	SCP	(1) Reamortization, (2) Lump sum payment of missed payments, or (3) Combination of (1) and (2)	Yes
Loan in excess of limits (50%/\$50,000)	VCP	Corrective payment of the excess loan amount	Yes
Loan payment term in excess of maximum repayment period (5 years)	VCP	Reamortization	Yes
Level amortization failure	VCP	Reamortization	Yes

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Failure to obtain spousal consent

- QJSA plan didn't obtain consent from spouse to make loan
 - Correction: Notify the participant and the spouse and obtain retroactive consent
 - If plan can't obtain consent, may resolve under VCP or Audit CAP
- Plan limited number of loans to a participant (e.g., one loan) but made loans to a participant in excess of that limit
 - Fix: Retroactively amend plan to conform to operations
- Both problems can be self-corrected
 - No deemed distribution (Form 1099-R)

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Plan does not provide for loans



- Although most plans provide for participant loans, some plans do not
- **Plan Document Failure.** If a plan made a loan without authorizing language, it would be failing to comply with the terms of the plan document
 - **SCP.** A plan sponsor may correct such a failure under SCP
 - **Plan Amendment.** Generally, if a correction requires a plan amendment, the correction must be undertaken under VCP and the employer must pay a sanction
- **Correction:** Employer adopts a loan provision retroactively. However, this correction does not apply unless:
 1. the amendment satisfies Code §401(a),
 2. the plan as amended would have satisfied the qualification requirements had the amendment been adopted when plan loans were first made available, and
 3. plan loans were available to either all participants, or solely to one or more participants who were NHCEs.

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Loans exceed number of loans permitted

- **Loan limit.** Plan limits the number of loans a participant may obtain. Plan permits the participant to exceed the plan loan limit
- **Plan Document Failure.** Loans in excess of plan limits would be a failure to comply with the terms of the plan document
 - **SCP.** A plan sponsor may correct such a failure under SCP
- **Correction:** Employer amends the loan provision retroactively. However, this correction does not apply unless:
 1. the amendment satisfies Code §401(a),
 2. the plan as amended would have satisfied the qualification requirements had the amendment been adopted when plan loans were first made available, and
 3. plan loans were available to either all participants, or solely to one or more participants who were NHCEs.

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Audit CAP Correction Options

- If requested by the participant, the plan may report it on a Form 1099-R for the year of the correction
- SCP and VCP correction methods for 72(p)(2) failures are also available under Audit CAP
 - However, the amount tax which could have been collected with respect to the deemed distribution are part of the maximum payment amount in calculating the sanction payment
- Audit CAP sanction factors in whether the failure is due to employer or to participant

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Loan failures under ERISA (DOL)

- Failure to deposit loan repayments into the plan on a timely basis
- Use of an interest rate other than a fair market interest rate
- Loan failed to comply with the plan document for amount, duration or level amortization
- **Plan document incorporates the 72(p) requirements and the plan fails to withhold payments**



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Timely deposit of loan repayments

- The DOL regulations require employers to deposit loan repayments on the earlier of (1) as soon as it is reasonably possible to segregate the repayments from the employer's own assets, or (2) 15th business day of the following month
 - Note: The IRS and DOL generally consider that an employer should deposit the loan repayments within a matter of days from the date they are withheld
 - Safe harbor for small plans: 7th business day following the date they are withheld



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Failure to comply with the plan asset regulations

- Treated as a prohibited transaction and a breach of fiduciary duty
- DOL position is that there is a prohibited loan between the plan and the employer
- Rev. Rul. 2006-38 provides guidance on how to calculate the amount involved in the PT
- Form 5500 reporting
 - Schedules H and I



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VFCP correction

- Pay to the plan the Principal Amount (loan repayment) plus the greater of (a) Lost Earnings on the Principal Amount or (b) Restoration of Profits resulting from the employer's use of the Principal Amount
- The Loss Date for such contributions is the date on which each contribution reasonably could have been segregated from the employer's general assets
- DOL permits ER to use Code §6621(a)(2) interest rate, rather than calculating lost earnings
 - Online calculator
 - Using the online calculator for self-correction?

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Correction

- The correction for the late deposit of loan repayments is for the employer to deposit the loan repayments in the trust
- Lost earnings on the late deposits will also need to be allocated to the accounts of affected plan participants
- If the deposit dates for both the loan repayments and lost earnings differ, earnings on the lost earnings will also need to be included
- Correction should be completed before filing the Form 5500
- Then the Form 5500 will reflect that the late deposits have been corrected and are not outstanding, thereby reducing the plan's risk for audit

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VFCP correction

- Submitting under VFCP provides applicants with the assurance that the DOL will not recommend the plan for audit or for the fiduciary breaches associated with the delinquent deposits
- Under ERISA, the DOL is required to assess a civil penalty for fiduciary breaches equal to 20% of the amount recovered as part of a settlement or litigation

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VFCP correction (cont.)

- To receive relief under VFCP from the fiduciary breach, the employer must correct the failure by
 - transferring the delinquent loan repayments from the employer's general assets into the plan's trust, and
 - providing affected participants with lost earnings on their late deposits
- Under VFCP, applicants have the benefit of relying on the DOL's online calculator to compute the lost earnings, which greatly simplifies the interest rate to use for this purpose

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Prohibited transaction excise tax

- Delinquent deposits result in a prohibited transaction Code §4975
- Because the employer is treated as a "disqualified person" under Code §4975, the DOL views the employer as using the amount of the plan assets represented by the participant contributions for its own business purposes
- The penalty on a prohibited transaction is 15% of the lost earnings associated with the late deposits
- The excise tax penalties are paid to the IRS by submitting Form 5330
- The DOL's VFCP allows for a waiver of the related excises taxes on delinquent deposits in certain circumstances

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Prohibited Transaction excise tax relief

- Relief on the prohibited transaction excise tax associated with the late deposit of the loan repayments is available, provided
 - (i) the delinquent deposits were made not more than 180 days after the payroll withholding date (determined using calendar days, rather than business days),
 - (ii) the applicant has not taken advantage of VFCP and its related excise tax relief during the three (3) year period prior to the VFCP submission, and
 - (iii) notice is provided to "interested parties" (and the appropriate regional office of the DOL's Employee Benefits Security Administration) within sixty (60) calendar days following the date of the VFCP submission
- The notice requirement doesn't apply where the amount of the excise tax is less than \$100
 - To meet this exception, the applicant must agree to pay the excise tax to the plan and have it allocated to affected participants in the same manner as plan earnings
 - Proof of payment must also be included with the VFCP application, as well as either a completed copy of Form 5330 or written documentation containing the same information

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VFCP vs. Self-correction

- Delinquent deposit of loan repayments are not required to be corrected through VFCP
- Employers who do not correct under VFCP won't be able to rely on the DOL online calculator for purposes of calculating lost earnings
- In this case, the general practice is to use the greater of (i) the plan's actual rate of return (EPCRS) or (ii) the Code §6621 underpayment rate (i.e., the rate calculated on DOL's online calculator)
- Also note that the PT excise tax relief provided under VFCP will not be available when self-correcting

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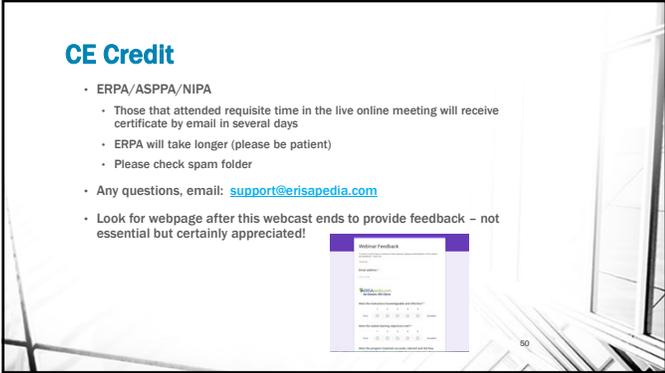
LOANS FAILURES: PLAN PROVISIONS FOR AMOUNT, DURATION, OR LEVEL AMORTIZATION

- A plan extended a loan to a plan participant
- The loan was a prohibited transaction that failed to qualify for ERISA's statutory exemption for plan loan programs because the loan terms did not comply with applicable plan provisions, which incorporated the requirements of section 72(p):
 - (i) The amount of the loan,
 - (ii) The duration of the loan, or
 - (iii) The level amortization of the loan repayment

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