Participant Loan Failures: Self-Correction vs. VCP Correction

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Your Presenters Today

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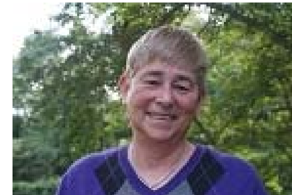
- Facilitator:
  Maureen Pesek

- Question Board Moderator
  Joanne Pecina



During the Webinar

- All attendees’ lines are muted
- Question board available and monitored
- Mr. Forbes will post answers to questions on ERISApedia.com
- Slides are available from GoToMeeting and/or ERISApedia.com
- Recording of webinar will be available on ERISApedia.com

CE Credit

- ERPA/ASPPA/NIPA
  - Will receive certificate by email in several days
  - ERPA will take longer (please be patient)
  - Please check spam folder
- Any questions, email: support@erisapedia.com

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Typical IRS Loan Failures

- Plan sponsor fails to withhold loan repayments
- Loan in excess of plan limits
- Loan exceeds duration requirements
- Plan document doesn't provide for participant loans
- Participant fails to complete the necessary loan documents

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

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

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

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

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

VCP correction

- A plan may file an application under VCP to resolve the operational failure, and either:
  1. Obtain relief from the deemed distribution and the potential premature distribution tax, or
  2. Delay the deemed distribution to the year of correction (rather than the year in which the deemed distribution occurred)

VCP correction requirements

- 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 payment schedule; or
  3. a combination of 1. and 2.
- If the loan term was less than 5 years, the plan can reamortize over the full 5-year period
- 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

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 VCP 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

VCP procedures

- **Deadline for correction:** The 5-year loan repayment period
- **Streamlined VCP procedure available to correct plan loan failures:**
  - The plan administrator can use the checkbox style along with Form 14568-E (Schedule 5) to file under VCP
- **Reduced filing fee for VCP applications involving plan loan failures:**
- If the only failures are plan loan failures, the filing fee is linked to the number of loan failures

P's w/ loan failures	Compliance fee
13 or fewer	$300
14-50	$600
51-100	$1,000
101-150	$2,000
Over 150	$3,000

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 416(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.

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)(ii) 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)*

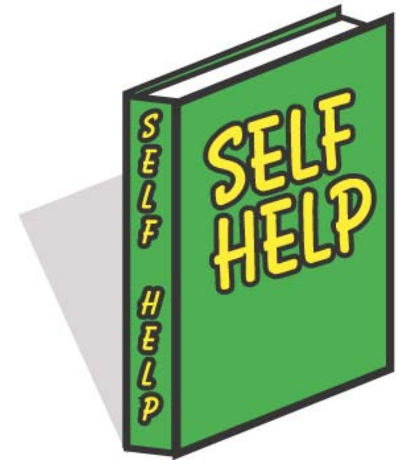
☐ Plan sponsor

☐ Affected participants

Is self-correction available?

- IRS does not specifically identify a correction methodology under SCP for an employer’s failure to withhold loan repayments,
  - An employer can self-correct such a failure by simply following the statute and treating the defaulted loan as a deemed distribution
  - The participant also would be subject to the 10% premature distribution tax
- Unless the failure involves a number of participants, employers often are unwilling to pay the IRS sanction under VCP and incur the cost of filing
- Many employers are unwilling to incur the costs to alleviate the participant’s tax consequences when the participant’s inaction contributed to the failure

Steps for self-correction



- The plan would treat the loan as a deemed distribution
- Institute steps to prevent the failure from recurring (e.g., regular review of outstanding loans against the payroll)
- Arguably, the employer also deposits the (usually minimal) amount of interest which accrued as a result of the failure to withhold
- The employee remains liable for repayment of principal and interest pursuant to the loan note until loan is repaid or offset

Participant’s tax obligation

- The IRS correction procedure primarily focuses on resolving the plan’s qualification and the participant’s tax issues
- The procedure does not require the employer to help the participant with his/her taxes
- The employer, however, may assist the participant with his/her tax obligation, but the IRS would regard that as wages subject to withholding

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

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 recent 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)*

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

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

VCP: Correcting a loan in excess of plan 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.

Loan in excess of plan 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

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

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

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 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

Plan does not provide for loans

- Although most plans provide for participant loans, some plans do not
- If a plan made a loan without authorizing language, it would be failing to comply with the terms of the plan document
- A plan sponsor may correct such a failure under SCP
- Generally, if a correction requires a plan amendment, the correction must be undertaken under VCP and the employer must pay a sanction
- In the case of a situation where a plan made a loan without a provision permitting loans, the employer can simply adopt a loan provision retroactively

Participant fails to complete loan documents

- Most likely scenario is an owner requests proceeds of the loan be distributed and will handle paperwork later
  - Paperwork never completed
- IRS could disqualify plan because the plan made an improper distribution
- DOL could treat as a breach of fiduciary and/or PT for failing to comply with document; or loan is inadequately secured
- Self correction?
  - Execute documents; tighten procedures; educate trustee

Audit CAP

- Under Audit CAP, a loan that is treated as a deemed distribution because it fails to comply with 72(p)(1) is reported on a Form 1099-R
- If requested by the participant, the plan may report it on a Form 1099-R for the year of the correction
- The VCP correction methods for 72(p)(2) failures are also available under Audit CAP
  - However, the amount tax which could have been collected with respected 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

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

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

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?

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

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

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

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

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

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

Fair market interest rate

- DOL regulations require that a participant loan have a reasonable interest rate
  - Unreasonable interest rate results in a PT
  - No safe harbor
- Interest rate too high would be treated as an additional contribution
  - Raises 415, deduction, and nondiscrimination issues
  - PT issues
- Interest rate too low would be treated as a PT
- Correction: pay PT excise tax; change interest rate determination

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

ERISA correction of loan failures

- A participant loan to a plan participant who is a party in interest
  - At origination, the loan qualified for ERISA's statutory exemption for plan loan programs because the loan complied with applicable plan provisions, which incorporated the requirements of section 72(p)
  - During the loan repayment period, the Plan failed to properly withhold a number of loan repayments from the participant's wages
  - The failure to withhold is a breach causing the loan to become non-compliant with applicable plan provisions, which incorporated the requirements of section 72(p)
- Plan must make correction under the VCP program

Plan Corrections eSource – Coming Soon

Organization: Type of Failure
Format: Questions, Answers, Examples

- Effects of Plan Disqualification
- EPCRS, Correction Principles
- Self-correction program
- Voluntary Correction program
- Audit CAP
- Eligibility corrections
- Coverage and minimum participation failures
- Nondiscrimination and cross-testing
- Vesting Failures
- Top-heavy failures
- 401(k) plan failures
- Safe harbor 401(k) plan failures
- 415 limit failures
- Participant loan failures
- Joint and Survivor Annuity rule failures
- Distribution failures
- Compensation failures
- Correction by amendment
- Plan restatements and amendments, including Scrivener's errors
- Orphan plans
- Merger and acquisitions
- Calculating earnings on corrective contributions
- Delinquent participant contributions
- Prohibited transactions
- Late filings of Forms 5500, 5500-SF, 5500-EZ, 8955-SSA
- 403(b) plan failures
- 457 plan failures
- Correction forms

THANK YOU