ANSWERS TO QUESTIONS PRESENTED IN THE

PARTICIPANT LOAN FAILURES: SELF-CORRECTION VS. VCP CORRECTION

WEBCAST HELD ON 12/19/2017 PRESENTED BY STEPHEN W. FORBES

1. Participant in a 401k plan with an outstanding loan terminates employment. Promissory note and loan procedures state immediately due and payable within 60 days. Provider waits until remaining account is distributed before loan is offset and 1099-R is issued. Is this permissible if participant leaves the money in the account beyond the year of termination?

**No. If the Promissory note and the loan procedures state that the loan is due and payable within 60 days following termination of employment, the loan needs to be paid off or offset within the time period. If the loan is offset, the plan needs to issue a Form 1099-R for that tax year.**

**If the plan wants the loan to continue beyond termination employment, it will need to change the promissory note and its loan procedures. Furthermore, the participant would need to continue payment of the loan.**

1. Can the maximum cure period extend beyond the 5 years? What if the deemed loan failed to have a 1099R issued timely, as in two years ago? What is the fix?

**The IRS is very strict an inflexible regarding the 5-year requirement. They feel they have no authority to modify the statute. Having said that, I believe that if payments were missed during the last quarter of the 5-year period, the regulations regarding a grace period would permit the participant to make up the missed payments by the end of the following plan year quarter.**

**The plan would need to issue a late Form 1099-R to the participant. The employer would be subject to a small penalty for issuing a late Form 1099-R. The plan could file under VCP and request the correction of issuing the Form 1099-R for the year of correction rather than the year of failure.**

1. Some of the large platforms will grant a 5 year loan but not start the payments for 30 or maybe 60 days. This causes the loan to be outstanding for > than 5 years when you look at the date of the loan to when the final loan payment was made. Do you consider this a 72(p) failure?

**The IRS generally interprets the 5-year rule very strictly. Therefore, the IRS may consider a loan with a repayment period of 5 years and several weeks as a violation of the 72(p) requirements and a deemed distribution. To avoid issues with payroll administration, some plans amortize loans over 58 or 59 months.**

1. Do the missed payments (made prior to the end of the grace period) have to include additional accrued interest due to the late repayment?

**The regulations do not require the participant to add any additional interest with respect to payments made up within the grace period.**

1. Under the VCP procedure in the event of missed loan payments, does the employer's required payment of unpaid interest get allocated to the participant's account?

**EPCRS does not address this issue. However, assuming the loan is treated as a participant-directed investment, the reasonable approach would be to allocate the additional interest to the participant’s account.**

1. How does the interest the employer is required to pay, differ than the accrued interest that is required to be re-amortized into the new participant loan?

**The interest rate for the interest the employer is required to pay and the interest on the reamortized loan probably should be at a similar interest rate. The interest that the employer pays is to make-up for the fact that the loan repayments were not in the participant’s account generating earnings for the participant.**

**Example. Assume the plan was to withhold $200/monthly to repay Mary’s 5-year participant loan. Assume further, the plan failed to withhold the payments for 12 months. The plan may correct the failure to withhold the loan repayments by reamortizing (with a current date as its starting date) the loan over the remaining 4 years. However, to make the plan whole, EPCRS requires the employer to pay interest on the amount of the missed payments. See EPCRS 6.02(6).**

1. Are you saying that accrued interest is paid to the plan twice? Once with the re-amortization over remaining period and again by the Employer?

**No. The interest for the reamortization is determined from the date the plan reamortizes the loan. The interest that the employer pays is to make-up for the fact that the loan repayments were not in the participant’s account generating earnings. See EPCRS 6.02(6) and 6.07(3).**

1. To clarify the original question of the maximum cure period, can it extend to five years, plus the quarter after the quarter the payment was first delinquent?

**I believe that would be a reasonable interpretation of the loan regulations. See answer to question 2.**

1. If the plan has individually directed accounts, when the ER makes the accrued interest payment on the loan, where does this interest go? Entirely to the participant's account or is it spread pro-rata to all of the participants. Allocating the interest entirely to the participant would seem "like a reward" for not making the loan re-payments in a timely manner.

**Assuming the loan is treated as a participant-directed investment, the additional interest would be allocated to the participant’s account. If the loan were treated as a general trust fund investment (rare), the additional interest would be allocated to the trust as additional earnings. The additional interest is generally a very small amount and it is intended to make-up for the fact that the loan payments could have been in the participant’s account generating additional earnings.**

1. Is it true, the employer has to make reparations for the accrued interest on missed payments? I previously thought it was the participant's responsibility.

**Yes the employer is responsible for the interest on the missed payments. See EPCRS 6.02(6).**

1. Form 14568-E item B seems to be used only when requesting that deemed distribution be in year of correction, NOT for avoiding deemed distribution

**You are correct. Section I.D. is used for purposes of avoiding the deemed distribution.**

1. Plan allows for 1 loan - Participant is allowed a 2nd loan in error - When this is identified, 1st loan has been paid off so only 1 outstanding - Correction?

**That particular error is not addressed in EPCRS but the correction the plan followed would be the correction I would have recommended. Alternatively, the plan could have followed the correction for a plan making a participant loan without plan authorization. In such a situation, the plan can amend retroactively to provide for loans. In this situation, the plan could have amended retroactively to permit two loans.**

1. Can you use the stream-lined form if you want to correct without it being a deemed distribution?

**Yes.**

1. If the loan payments are deducted, but the employer doesn't send them in (with or without the contributions) and it has been over the quarter ending to make up - is this corrected with lost earnings (with the contributions) or with the loan self-correction program?

**If the loan repayments have been withheld from the participant’s paycheck but not remitted, the plan doesn’t have a loan failure (i.e., no deemed distribution issue). The payments were properly withheld by a plan fiduciary so the issues are not under Code 72(p). Instead, the employer has violated the plan asset regulations by not remitting the loan repayments timely (the same rules that apply to delinquent deposit of 401(k) deferrals). The employer needs to remit the payments, pay the greater of the Code 6621(a)(2) interest or the lost earnings to the plan, and pay a prohibited transaction excise tax. The employer potentially is subject to the breach of fiduciary excise tax. The employer can avoid the excise taxes by filing under the Voluntary Fiduciary Correction Program (DOL). It is important to note that the DOL has an online calculator for determining the Code 6621(a)(2) interest.**

1. On self-correction for an active participant, once the loan is deemed a distribution, the participant still is required to pay off the loan in after-tax source. So as far as recordkeeping, you may show the first loan as deemed distributed but don't you have to re-issue the balance as an after-tax to allow the employee to continue to make payment?

**I am not certain I understand the question. I will restate the rules regarding repayment of a defaulted loan. If a plan treats a loan as a deemed distribution, the participant remains liable until it is either repaid or offset. If the participant repays the defaulted loan, the repayments are after-tax money and need to be recorded as such. If this does not answer your question, please contact me.**

1. Does the accrued interest that the employer is required to pay back to the plan get paid towards the participant's loan - or to the plan suspense account?

**Assuming it’s a participant directed loan, the additional interest would go to the participant’s account.**

1. Is there a benefits, rights and features issue if the plan does not allow loans to terminated participants? In theory, all (or virtually all) former employee participants would be NHCE, thus possibly making non-discrimination for benefits rights and features testing difficult to pass.

**The rules regarding loans to former employees is one of the most misunderstood and misapplied loan rules. The DOL takes the position that the prohibited transaction regulations (specifically, the “reasonably equivalent basis” rule) does not permit a plan’s loan program to exclude from eligibility all former employee participants. See DOL Advisory Opinion 89-30A. However, the DOL does permit an employer to limit loans to former employees who are parties-in-interest. Most former employees are not parties-in-interest which generally accomplishes the employer’s wishes. Therefore, the plan’s loan program should be worded carefully to comply with the DOL regulations.**

**As for the nondiscrimination issue, the regulations provide the following: Most former-employee participants who are parties-in-interest are “former HCEs.” Thus, restricting loans to parties-in-interest might mean only former employees who are former HCEs may receive a loan. The availability of loans is a feature the plan must make available on a nondiscriminatory basis. Treas. Reg. 1.401(a)(4)-4. However, under a special rule, the plan may test whether a loan feature is nondiscriminatory by treating as employees, the former employees who are parties-in-interest. Treas. Reg. 1.401(a)(4)-10(c). This special rule allows a plan to limit loans to former employees who are parties-in-interest, but not to other terminated participants.**

1. What happens when the employer deducted the loan payments, but failed to remit them to the trust and the grace period has expired. Do they need to file under VCP?

**See the response to question 14. The failure is not a loan failure. Instead, it’s a plan asset regulation failure.**

1. One of the VCP corrective options is to re-amortize the outstanding loan balance. Is there a difference between re-amortizing and refinancing?

**Although they may result in similar payments, the loan regulations have specific rules regarding refinancing loans.**

1. What about loan that exceeds 5 years and is discovered after that 5 years has passed?

**Under the statute, the plan should issue a Form 1099-R for the year the loan was issued because it violated the rules at the outset of the loan. The plan also may correct by filing under VCP and having the loan treated as a deemed distribution in the year of correction. If the loan has already been repaid, some administrators may simply tighten up their procedures to avoid future such failures and consider the matter closed. That’s a judgment call the employer will need to make.**

1. What if the wrong interest rate was used to generate the amortization table?

**This failure is not addressed in EPCRS, however, I would recommend reamortizing the loan with the correct interest rate. If the incorrect interest rate was higher than the correct rate, I would allocate the additional interest to pay down the loan. If the rate was lower than what should have been charged, the plan should include the “missed” interest as part of the reamortization.**

1. How far back can you retroactively correct for this error? Only within year of error…the error of loans not being allowed, then amending to allow.

**Other than the normal limitation on corrections under SCP, EPCRS does not impose a deadline for this type of correction. If the plan determines that the error is significant, the deadline is the second plan year following the year in which the error occurred. For insignificant errors, EPCRS does not impose a deadline. See EPCRS 9.02.**

1. Can a plan sponsor educate themselves on how to file a VCP then do it themselves?

**Yes. Unfortunately, the procedure can be difficult to follow and an application includes a number of forms with which you need to familiarize yourself. In our new book, I plan to include a step-by-step instruction on how to file a typical VCP application for a loan failure.**

1. What if the participant’s payroll frequency changes from monthly to biweekly and the original loan paperwork is all noted as monthly payments. Can that be re-amortized without going VCP?

**The plan should be able to reamortize the loan without filing under VCP. However, the plan must move quickly to avoid missed payments.**

1. How is 'small plan' defined for the 7 day rule?

**The same way a small plan is defined for filing a Form 5500.**

1. Please advise what documents are required to evidence a participant loan. Is a signed promissory note required? What about record keepers that use on-line loan processing with no signature required from the participant?

**The plan should have some form of promissory note and some form of pledge agreement securing the participant’s account as collateral. Some plans combine the two forms into one form. As long as it satisfies legal requirements for electronic signature, the recordkeeper can use electronic signatures for loans.**

1. Assume that loan payments are withheld from the participant's payroll, but the employer does not deposit them on a timely basis. The delay in depositing the payments goes beyond the cure period. Is the loan in default?

**No. See answer to question 14.**

1. Please repeat about under $100 doesn't have to file Form 5330? Is that what Steve said?

**Yes. See VFCP:**

**C. De Minimis Excise Tax**

**The IRS requested a modification to the requirement in the related class exemption that employers notify interested persons in writing of transactions corrected under the VFC Program. Specifically, the IRS requested that the notice requirement not apply in those instances when the excise tax otherwise due under section 4975 of the Code would be less than or equal to $100.00. The IRS requested that the amount of the excise tax otherwise due be contributed to the plan, and that the contribution be allocated to the plan's participants and beneficiaries in a manner consistent with the plan's provisions for allocating earnings. The Department has adopted this request, which is discussed further in the preamble to the amendment to PTE 2002-51 published simultaneously with this Notice.**

1. DOL is sending a lot of letters, urging sponsors to file. Amounts are small. Just reply - hey, self-corrected and form 5330 filed?

**The DOL recommends that employers who are delinquent in depositing deferrals or loan repayments file under VFCP. Filing under VFCP is definitely the safest approach. However, to avoid the time and expense of filing, many employer have simply followed the correction steps of VFCP but not filed. If they receive a letter from the DOL, they simply send them the documentation of their correction steps and the DOL seems to be satisfied.**