The St. Valentine’s Day Loan Massacre: When Good Loans Go Bad

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Agenda

• Understanding the General Rules
  – IRC §72(p): Exception to Taxation Rules
  – IRC §401(A)(13): Antialienation Exception
  – ERISA §408(b)(1): Exception to Prohibited Transaction Rules

• Deemed Distribution Versus Loan Offsets

• Ways Things Go Very, Very Wrong
  – Case Studies
  – Correction Options

• Wrap-up
Understanding the Rules
(Otherwise, how do you know when you’ve broken them?)
Poll Question #1

Do you believe that loans are –

a) A participant’s right
b) A key component to a successful retirement plan
c) A necessary evil
d) The creation of Satan
e) All of the above
General Rules

• When a participant gets money out of a retirement plan, it’s taxable income (IRC §72)
• No one can assign or alienate their benefit in a retirement plan (IRC §401(a)(13), ERISA §206(d))
• Loans from the plan to people related to the plan are considered to be prohibited transactions (IRC §4975, ERISA §406)
Participant Loans Are the Exception

- If a loan is done correctly:
  - No taxable income to borrowing participant
  - Participant’s benefits can be security for the loan
  - The loan is not a prohibited transaction
- However, if the loan fails to fulfill its requirements, one or more of those problems can arise
Plans Do Not Need to Permit Loans

- Plans must authorize loans explicitly under both IRS and DOL rules.
- The plan may limit loans to lower amounts than are available under the law.
- The plan may place other restrictions on loans than are required under the law.
- General recommendation: RTDD.
IRC Section 72(p)

- IRC §72 controls the taxability of benefits from/in a retirement plan
- As noted above, the general rule is that, when money comes out, the participant pays taxes
- IRC §72(p) is an exception to these rules
- A loan is not taxable to the participant if:
  - It is issued pursuant to an enforceable contract
  - The amount of the loan does not exceed certain limits
  - The term of the loan does not exceed certain limits
  - Loans are permitted by the plan
Enforceable Contracts

- Must demonstrate compliance with §72(p) requirements
  - Amount of loan
  - Date of loan
  - Repayment schedule
- May be in electronic format
  - Employee signature is not needed, so long as agreement is legally enforceable under applicable (i.e., local contract) law without signature (e-sign ok)
Electronic Loan Forms

- If loan documentation is electronic, the electronic medium must:
  - Be reasonably accessible to the participant;
  - Be reasonably designed to preclude anyone but the participant from requesting a loan;
  - Provide reasonable opportunity for the participant to confirm, modify, or rescind the loan before it is made;
  - Provide confirmation of loan within a reasonable time after it is made (by paper or electronic (but not less understandable than written and with advice that written version is available at no charge)).
Loan Limitation

• Loan may not exceed the lesser of:
  – The greater of:
    • 50% of vested interest; or
    • $10,000; or
  – $50,000, reduced by the excess (if any) of
    • The highest outstanding balance of loans during the one-year period ending on the day before the date of the new loan; over
    • The highest outstanding balance of loans on the date the loan was made
More About Loan Limitations

• Applies to **all plans** of the employer in the aggregate (i.e., one loan limit per person)
  – Remember to aggregate controlled group and affiliated service group as one employer

• Security (vested interest) for loan is based only on the plan from which the loan is taken

• Impact of exceeding limit: excess amount is taxable income at the time the loan is taken (more on that later....)
NOTE

• Just because the participant can take a $10,000 loan under IRC §72(p) does not mean that the plan so allows
• It is very unusual for a plan to permit the $10,000 minimum loan
• The loan may only be what is permitted by the plan
What Is the Vested Interest?

• Vested interest should be determined based on the most recent valuation, increased by contributions allocated after the valuation date and before the loan date.

• What about daily valuation?
  – Vested interest is based on the value of the loan being taken.
  – Need to have some kind of administrative procedure to protect against excess loans.
Repayment Requirements

• Maximum period: Five Years
  – Exception: if proceeds used to purchase the participant’s principal residence, can amortize over “reasonable time”
  – “Date of the loan” is the date the check is delivered to the participant
• Level amortization at least quarterly
  – Balloon payments not permitted
What Happens if IRC §72(p) Is Violated?

- It depends on when and how the rule is violated
- If violated because no loan documentation or loan terms (other than the loan amount) violate §72(p), the loan is taxable income when taken
- If violated because amount of loan is excessive, the excessive portion of the loan is taxable income when taken
- 20% withholding rules apply(!!!)
What Happens if IRC §72(p) Is Violated? (cont.)

• If violated because loan payments are not made on time:
  – General rule: current principal value of the loan, plus unpaid interest to the date of default, becomes taxable income as soon as a payment is late
  – Exception: plan may have a cure period of up to last day of calendar month following the month of default
    • Cannot be discriminatory
Other Ramifications of Default

- Loan considered to be outstanding for purposes of calculating any additional loan permitted
  - For this purpose, the loan value is equal to the defaulted loan plus interest accrued thereafter ("phantom interest")
  - E.g., participant defaulted on a loan with a value of $8,000. Later, he wants another loan. Accrued interest on the defaulted loan is $1,000. Outstanding loan for purposes of available new loan is $9,000.
If Participant Has Defaulted Loan

• If not repaid (or offset), **any subsequent loan** is also a deemed distribution, unless:
  – Repayments on subsequent loan are made under payroll withholding arrangement enforceable under applicable law; or
  – Plan receives additional collateral on top of participant’s vested interest
Suspension of Payments for Leave

• Conditions:
  – Participant is on approved leave of absence
  – Compensation from the company to the employee after deductions for income and employment taxes is less than the loan payment would be
  – Leave is for one year or less

• Effect
  – Participant is not in default during leave period
  – Interest continues to accrue
  – At end of leave, participant either repays unpaid amount or reamortizes for remaining portion of five-year period
Suspension of Payments for Leave

- If five-year period ends during leave, remaining balance is taxable at the end of the five-year period (regardless of leave)
Uniformed Service People

• USERRA leave rules
  – Available to anyone in military service
  – Loan payments are suspended during service
    • Not limited to one year
    • Interest continues to accrue
  – At the end of military service, either:
    • Loan is reamortized
    • Maximum term: latest date permitted under normal law (i.e., five-year period) plus the period of military service
Deemed Distribution vs. Loan Offset

**Deemed Distribution**
- Taxable event
- Occurs regardless of whether EE is eligible for distribution
- Not eligible for rollover
- Must maintain loan on books
- Affects vesting, TH, future loans

**Loan Offset**
- Foreclosure on security interest (i.e., offset against participant’s account)
- Offset is actual distribution
  - Reported as distribution on 5500
- Need distributable event
- Eligible for rollover
Repayments After Deemed Distribution

- A deemed distribution does not waive a participant’s obligation to repay
  - Still fiduciary obligation to enforce the loan
- If repay after deemed distribution, repayments are “basis” – not taxed again at distribution
  - Not treated like after-tax employee contributions for purposes of ACP test or §415 limits
Form 5500 Reporting of Defaulted Loans

- If loan is a directed investment of borrowing participant’s account:
  - Reported on Line 2g of Schedule H (or Schedule I) as a deemed distribution
  - Not shown on Schedule G as defaulted or uncollectible loan
  - Included in beginning-of-year assets in year of default, but not in end-of-year assets (or subsequent year assets)
  - If repayments resume, loan is restored in asset list and adjustment made in column (b) of Line 1 of Schedule H or I and as a negative deemed distribution on Line 2g
Loan Offsets

• If loan can be offset in year of default, rather than just deemed distribution, it is treated as an actual distribution
  – Loan considered repaid by offset
  – Vested interest permanently reduced by outstanding loan
  – Can occur upon termination of employment if loan terms provide
Loan Offsets

- If loan was previously “deemed distributed,” no additional reporting needed on Form 1099-R or Form 5500
- If not previously deemed distributed, treated as actual distribution
  - Shown on Form 5500 as distribution
  - 10% premature distribution applied, if under age 59½
Rollover Rules

• Apply for loan offsets, not deemed distributions
  – Participant can deposit offset amount to IRA within 60 days (by tax return due date for years after 2018), and will not have taxable income

• Can do direct rollover of loan to another qualified plan or 403(b) if the recipient plan will accept (cannot do to IRA)
Withholding Rules if Loan Is Part of Distribution

• Calculations of 20% withholding applied to total distribution (including loan)
• Amount of withholding is lessor of:
  – 20% of total distribution
  – Non-loan-offset portion of distribution
Tax Reporting of Loan Offsets

- If no prior taxation on the loan, the entire loan is shown on Form 1099-R as a distribution.
- If loan was previously taxed as a deemed distribution, only the cash distribution is shown on Form 1099-R.
IRC §401(a)(13)

• A plan is not a qualified plan if it permits a participant to assign or alienate his or her account
• English translation: cannot use an account balance for security or pledge it to anyone else
• How can a participant use his/her account as security for a participant loan?
IRC §401(a)(13)(A)

• “[A] loan made to a participant or beneficiary shall not be treated as an assignment or alienation if such loan is secured by the participant’s accrued nonforfeitable benefit and is exempt from the tax imposed by section 4975 (relating to tax on prohibited transactions) by reason of section 4975(d)(1).”

• English translation: It’s ok to use account balance for security if it’s not a prohibited transaction
Final Result

• The good news: If the loan is not a PT, you’re home free (see next section)

• The bad news: If the loan becomes a PT, you may have disqualified your plan (oops!)
Prohibited Transaction Rules

• ERISA §406 and IRC §4975 prohibit a plan from entering into a transaction with a party-in-interest
• A participant is a party-in-interest
• “Transactions” include participant loans
• Ruh roh!!
Prohibited Transaction Exemption

• A loan to a participant or beneficiary is **not** a prohibited transaction if loans:
  
  – Are available to all such participants and beneficiaries on a reasonably equivalent basis;
  
  – Are not made available to HCEs, officers, or shareholders in an amount greater than that which is available to other employees;
  
  – Are made in accordance with plan provisions;
  
  – Bear a reasonable rate of interest; and
  
  – Are adequately secured
Reasonably Equivalent Basis

- Ok to have a loan minimum of $1,000 or less
- If lots of NHCEs with small accounts, a larger amount could imply a discriminatory provision
Nondiscriminatory in Amount

- If complies with the IRC §72(p) limits, not considered to be a problem
- Can limit loans (across the board) to a certain percentage of the vested interest that is less than 50% or a dollar amount that is less than $50,000
In Accordance With Plan Provisions

- Must be specific loan provision in the plan or a separate written loan program or policy
- Must be provided to participants
- Must discuss:
  - Persons authorized to administer the loan program
  - Procedure for applying for a loan
  - Limitations on amount/purpose of loan
  - Acceptable collateral
  - Procedure for determining interest rate
  - Events that constitute default on the loan
Reasonable Interest Rate

• Must be “commercially reasonable,” i.e., what would be charged by those in the lending business for similar loans
  – Best way: sample commercial lenders in re secured loans
  – Remember 6% limit for Service Members
  – What about “Prime + x%”?  
• Cannot violate state usury laws
Risk of Loss

- Responsible fiduciary must consider possibility of risk of loss to other participants
  - If loan is part of segregated account, no impact on other participants
  - If payroll withholding used for payback, risk of loss is minimized
Acceptable Collateral

- Most plans only accept vested interest to avoid having to take ownership of other assets on default
- No more than 50% of vested interest may be used as collateral
  - Determined on loan date
  - No ramifications if account value later decreases
- Accounts subject to QJSA rules require spousal support
What if Plan Violates PT Rules?

- Must repair the problem
  - Loan must be repaid immediately or, if possible, offset by the account balance
  - Excise taxes payable: 15% on interest, pyramided (as is done with late deferrals)
  - Plan can be considered to have violated IRC §401(a)(13) – disqualification?
  - Note: not necessarily taxable income!
Case Scenario #1

- Participant initiates a loan through the online request service on 1/15/18
- HR person receives notification via email that the loan has been initiated, however, prior to getting payroll deductions started the HR person gets distracted and forgets to complete the process
- Loan repayments are not taken out and not discovered until December 2018
Poll Question #2

What options can you recommend to the client?

a) Self-Correction Program (SCP)
b) Voluntary Correction Program (VCP)
c) Voluntary Fiduciary Correction Program (VFCP)
d) Have the loan swim with the fishes
Case Scenario #1

- What are the available options?
  - Correction through VCP
  - Self-correction

- What does self-correction mean?
  - Consider the loan in default and tax participant for unpaid balance including interest to date of default
  - If there is a taxable distribution permitted, the portion of the account equal to loan is considered to be distributed
    - 10% premature distribution tax would apply
    - Account is actually permanently decreased by distributed loan
    - Distribution is shown on Form 5500
Case Scenario

#1

- What also happens if no VCP is filed?
  - If there is no distributable event (deemed distribution)
    - Distribution is for tax reporting purposes only
    - The loan remains an asset of the plan
    - No additional interest accrues for tax, plan reporting
    - Offset occurs whenever distributable event happens
    - Any actual repayment creates “basis” that is paid to the participant on distribution tax-free
Case Scenario

#1

- Benefits of filing VCP
  - VCP application requests IRS to treat loan as if it was not in default (i.e., participant is not taxed) if loan is not past original maturity date
  - If loan is past original maturity date when discovered, then only VCP solution is to tax in current year
Steps Involved for VCP Filing

- VCP Correction: Form 14568-E (AKA Schedule 5)
- Available for all types of loan failures, not just those that are the sponsor’s fault
- Avoids taxation of employees
- Can only correct nonpayment during five-year permissible loan period
- NOTE: used to have lower fees for loan failures, but now subject to regular schedule
Corrective Procedure

• How to properly correct our loan failure:
  – Calculate balance of loan and interest based on nonpayment
  – Calculate what balance of loan and interest would have been had loan been paid on time
  – **Employer** pays differential interest
  – Either:
    • Employee pays differential balance; or
    • Loan is reamortized for remainder of five-year max
Required Data for VCP

- Plan documents for period of failure, including loan policy
- Original loan documents & amortization schedule
- Proof of correction (interest/back payments made)
- Revised reamortization schedule
- Narrative explaining what happened, how fixed, and most importantly – what has changed to ensure it won’t happen again!
Case Scenario #2

- Owner initiates a $50,000 loan in 2014, but never starts any repayments
- In 2019, the client changes TPAs and it is discovered that the loan is outstanding, no accrued interest has been calculated, and no Form 1099-R has been issued
- What correction options do we have?
Poll Question #3

What options can you recommend to the client?

a) SCP
b) VCP
c) VFCP
d) Cement shoes
Case Scenario #2

• Concerns that need to be addressed
  – We are dealing with an owner – not eligible for Form 14568-E (Schedule 5)
    • Could be considered a prohibited transaction and that can disqualify the plan
    • IRS can consider this an egregious failure which would be ineligible for VCP
  – Can the owner repay the full amount owed, plus accrued interest?
  – Do we have any sort of reasonable story for how this happened?
Case Scenario #2

• If we file through VCP, it would have to be a general application – must have a good explanation

• Strong consideration should be given to filing both VCP and VFCP
  – Ability to repay full amount is critical

• If we declare it a PT up front, we can ask for the waiver of the excise taxes as part of the submission
Questions?
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