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CORRECTING 401(K) PLAN LOANS UNDER EPCRS

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Participant loans from 401(k) plans must satisfy certain rules under section 72(p) of the Internal Revenue Code (the "Code") to prevent the loan from being treated as a taxable distribution (sometimes called a "deemed distribution"). The amount of the loan generally cannot exceed 50% of the participant's vested account balance up to a maximum of $50,000 (with reductions for certain previous outstanding loans), the participant must be required to make level amortized payments at least quarterly, and the loan term may not exceed five years from the date the loan is funded unless the participant uses the loan to purchase his or her primary residence (in which case a longer period from the date of funding is allowed).

It is not uncommon for plan sponsors to discover that one or more of these rules have not been followed in administering the plan. Failures to follow the terms of the plan document and the requirements of Code section 72(p) can result in the loan being treated as a taxable distribution to the participant as well as resulting in the potential disqualification of the plan.

When such a mistake is discovered, what can be done? Under certain circumstances, the Internal Revenue Service ("IRS") permits this type of plan loan failure to be corrected under the Employee Plan Compliance Resolution System ("EPCRS"). To obtain relief from the negative tax treatment under Code section 72(p), a submission under the Voluntary Correction Program ("VCP") is required. Such relief cannot be obtained under the Self Correction Program ("SCP"). The fee for the VCP submission is generally based on the number of plan participants; however, when the loan failure is the only failure being submitted and it involves no more than one quarter of the participants, the revenue procedure provides for a 50% fee reduction.

To facilitate and streamline the VCP submission process with respect to certain plan loan errors, Revenue Procedure 2013-12 permits the use of a model document (Schedule 5 under Appendix C) which allows plan sponsors to check the appropriate boxes and fill in all of the necessary information regarding the failure that occurred, the proposed correction methods and the description of steps taken to ensure that the failure does not recur. The plan sponsor may also request relief from reporting participant loans as deemed distributions or the plan sponsor may request to report the loans as deemed distributions in the year of correction rather than the year of the failure. Such relief will not be granted unless expressly requested in the submission. Generally, for a plan loan to be eligible for relief from reporting loans as deemed distributions, employer action must have caused the failure and the correction must be made within the maximum time period for repayment of the loan (generally five years from the date the loan is funded).

Guidance regarding the appropriate correction methods for plan loan failures is provided in Section 6.07 of Revenue Procedure 2013-12. If using Schedule 5, the plan sponsor can check the box regarding the proposed correction method. For example, with respect to a loan that is in default (after expiration of any applicable "cure period") the participant may:

- make a lump sum payment for the missed installments adjusted for earnings;
- reamortize the outstanding loan balance; or
- use a combination of both of these.

In addition to correction of defaulted loans, plan loan failures that can be corrected under Schedule 5 include loans that exceed the maximum loan amount permitted under Code section 72(p), loans that exceed the maximum payment period specified under Code section 72(p), and loans that do not provide for substantially level amortization with payments not less frequently than quarterly. Schedule 5 may not be used to request relief from reporting a deemed distribution with respect to failures involving plan loans to key employees or self-employed individuals although such relief may be requested by filing a detailed written attachment describing the relief requested and the reason why such relief should be granted.

When a plan sponsor permits participant loans to employees under a plan that does not provide for plan loans, the plan sponsor may, under certain circumstances, utilize the plan amendment correction method under SCP. Although generally a VCP submission is required in order to obtain relief by plan amendment under EPCRS, Revenue Procedure 2013-12 provides such relief under SCP in this situation. The plan sponsor may amend the plan document retroactively to provide for the plan loans that were made available, if the amendment complies with the applicable provisions of 401(a). Plan sponsors wanting to self correct by plan amendment under these circumstances should carefully review Section 4.05(2) of Revenue Procedure 2013-12 and Appendix B, Section 2.07.

Not all plan loan errors can be corrected under EPCRS. For example, a loan from a plan to a disqualified person that does not meet the requirements of Code section 72(p) may be a prohibited transaction unless the loan meets certain other requirements. Loans that are prohibited transactions are generally subject to excise taxes on the amount involved. The disqualified person must pay back all amounts outstanding on the loan and pay the excise tax under Code section 4975 which applies until the loan is repaid in full. The IRS does not provide relief from this excise tax under EPCRS.

Plan sponsors should be sure to evaluate whether a particular loan failure may result in a fiduciary violation under The Employee Retirement Income Security Act of 1974 ("ERISA"). The Department of Labor has established the Voluntary Fiduciary Correction Program which permits the voluntary correction of certain fiduciary violations of ERISA. Plan sponsors should consider utilizing the Department of Labor's correction program under appropriate circumstances.

While such correction programs can provide valuable relief when these failures arise, plan sponsors should employ best practices to avoid such failures. Such practices should include reading and understanding the requirements of Code section 72(p) as well as reading and understanding the plan loan provisions of the Plan document. In addition, the IRS recommends in its 401(k) Plan Fix-It Guide that plan sponsors establish loan procedures that include the following:

- a system for determining the participant's maximum loan amount during the approval process that includes consulting the participant's account balance and prior loan history
- a written policy for determining the terms of the loan, including the interest rate
- the use of written enforceable loan agreements
- a cure period for payments
- a requirement for documentation that a loan is being used to purchase a primary residence in order to approve a loan term greater than five years
- procedures for monitoring timely repayment and analyzing and allocating the appropriate amounts to participant loan balances
- a system for monitoring the terms of loans to disqualified persons to avoid prohibited transactions

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