BPM

Voluntary Correction Program: How to Correct 401(k) Plan Loan "Failures"

08.24.17

"To err is human; to forgive is divine," as the familiar saying goes. But the IRS will forgive errors involving 401(k) plan loans only when you use the Voluntary Correction Program (VCP). Correcting your plan mistakes through the VCP preserves the plan's tax-favored status. One of the biggest areas that trip up plan sponsors is plan loans. There are three primary "failures" involving plan loans that require an IRS remedy: loan defaults, loans exceeding prescribed limits, and loan terms that exceed repayment limits.

1. Loan defaults

When a participant defaults on a plan loan, one of two things happens. The first (and least desirable for the participant) possible outcome is that the IRS treats the loan as a "deemed distribution." The participant must report the amount on IRS Form 1099-R. In addition, the IRS taxes the participant accordingly — including a 10% penalty if the participant is younger than 59½.

The preferable scenario is that the participant makes amends by repaying the owed interest and principal, or the plan reamortizes the loan within prescribed term limits. In either case, the plan will need to use the VCP process to notify the IRS.

2. Loans exceeding prescribed limits

When a participant exceeds plan loan limits, the IRS permits correction if there's a payment to the plan based on the excess amount. You can apply the payment one of three ways:

1. To interest on the excess so the participant repays only the excess loan amount,
2. Only to the amount of the loan not exceeding the dollar limit so that the participant repays the excess loan amount (plus interest), or
3. Pro rata against the loan excess and the maximum loan amount, so that the corrective repayment equals the outstanding balance remaining on the original loan excess on the date that corrective repayment is made.

Avoiding the excess loan amount "failure" requires careful monitoring of loan activity, especially when participants take multiple loans. Plan participants can take a plan loan for the lesser of $50,000 or 50% of the participant's nonforfeitable account balance.

However, when multiple loans are involved, the IRS reduces the $50,000 by the difference between the highest outstanding balance of all of the participant's loans during the 12-month period ending on the day before the new loan, and the outstanding balance of the participant's loans from the plan on the date of the new loan.

Let's look at an illustration furnished by the IRS: Joan has a vested account balance of $100,000 and took a plan loan of $40,000 on January 1, 2016, to be paid in 20 quarterly installments of $2,491. On January 1, 2017, when the outstanding balance is $33,322, Joan wants to take another plan loan. The difference between the highest outstanding loan balance for the preceding year ($40,000) and the outstanding balance on the day of the loan ($33,322) is $6,678. Because the new loan plus the outstanding loan cannot be more than $43,322 ($50,000 - $6,678), the maximum amount that the new loan can be is $10,000 ($43,322 - $33,322).

3. Loan terms that exceed repayment limits

The third common failure category is loans that fail to satisfy payment schedule requirements. Participants must pay off loans within five years, and make payments no less frequently than quarterly. The consequence of violating these limits is severe: The IRS treats the entire loan amount as a deemed distribution, including accrued interest.

The good news is that, if you use the VCP program, the participant might escape the penalty, if the error is recognized within five years after the loan's issuance. However, the IRS "reserves the right to limit the use of the correction methods to situations that it considers appropriate, for example, where the loan failure is caused by employer action."

Making the correction

No matter which type of plan loan failure, you'll need to file the VCP's Form 8950 ("Application for Voluntary Correction Program (VCP)") and Form 8951 ("User Fee for Application for Voluntary Correction Program (VCP)") to make a correction. There's a user fee that is paid along with the submission that generally is determined based on the number of plan participants. Of course, it's better to not have the problem in the first place. Review your plan document's loan language and transactions with your employee benefits advisor. Better safe than sorry.

BPM is one of the largest California-based accounting and consulting firms, ranking in the top 50 in the country. It has served the San Francisco Bay Area's emerging and mid-cap businesses, as well as high-net-worth individuals, since 1986. Our Employee Benefits team consists of professionals with extensive knowledge of ERISA guidelines and deep expertise performing employee benefit plan audits. We can help you craft a smooth-running plan that serves your employees while mitigating associated risk. For

© 2020 BPM

more information or for a free expert consultation, contact Jenise Gaskin at (925) 296-1016, Michelle Ausburn at (707) 524-6588 or visit us at bpmcpa.com/ebp.

Accounting implications of a loan default

When a 401(k) participant defaults on a plan loan and is treated as having a deemed distribution, the plan must maintain two sets of records for a period of time under certain circumstances.

When a plan loan is secured by the participant's account balance, and/or the participant is not entitled to an in-service distribution, the recordkeeper cannot officially offset the loan before there's a distributable event. The loan continues to be considered a plan asset, and interest must continue to accrue, even though it will never be distributed.

Why? Because the participant's account balance, including any defaulted loans and accrued interest, is included with all other participants' accounts for purposes of top-heavy tests. The bottom line: Be sure to consult with an ERISA accounting expert in the event of a loan default.

© 2020 BPM