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Pension ANALYST

Compliance Bulletin

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IRS Expands Correction Programs for Plan Loan Errors

The IRS recently issued the first updates to the Employee Plans Compliance Resolution System (EPCRS) since 2003. The EPCRS is a consolidation of the correction programs available to plan sponsors for correcting errors in plan operation, demographics and documents. The updated EPCRS now includes correction methods for common participant loan errors. In addition, the Department of Labor has included loan correction provisions in its latest revisions to the Voluntary Fiduciary Correction Program.

Because Prudential Retirement recognizes that the correction of participant loan errors is an important topic for many plan sponsors, this *Compliance Bulletin* is devoted to discussing the methods now available for correcting these problems. The updates and expansions to the EPCRS, in general, will be discussed in more detail in an upcoming *Pension Analyst*.

Overview

Normally, if a plan administrator discovers that:

- A loan has been granted for more than the maximum permissible amount;
- A loan repayment period exceeds the maximum permissible repayment period; or
- A loan repayment schedule does not meet the level amortization requirements,

the plan must report either the amount in excess of the maximum permissible amount or the entire loan amount, as applicable, as a taxable deemed distribution to the participant in the year the loan was granted, regardless of when the error was discovered or how much of the loan had already been repaid. As a result, the affected participant would most likely have to file an amended tax return and this has been viewed as a harsh punishment for an error that was not usually the participant's fault. Typically, all of these situations are the result of an error in plan administration, rather than participant error.

The revised EPCRS now provides special methods for correcting all of these situations, as well as certain defaulted loan situations, which could normally be "corrected" only by reporting a taxable deemed distribution to the participant. However, these correction methods are *only available* for these plan loan problems if the corrections are made by submitting a formal application to the IRS *under the Voluntary Correction Program (VCP). The IRS did not approve self-correction under EPCRS for using these methods.* In addition, the correction methods under EPCRS are only available if the maximum loan repayment period (e.g., five years for a general purpose loan) has not yet expired.

Generally, if the VCP is used to correct a plan loan error that has resulted in a deemed distribution, that deemed distribution may be tax-reported on IRS Form 1099-R for the year the correction is made (i.e., the

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current year). However, if one of the new VCP correction methods described below is used, no deemed distribution occurs. If the VCP is not used, the deemed distribution of a loan must be tax-reported on IRS Form 1099-R for the year the default or error actually occurred.

Loan Amount Exceeding the Maximum Permissible Amount ($50,000/50% Limit)

Under VCP, this situation may now be corrected simply by the participant repaying the excess amount to the plan. If scheduled repayments were made before the error is discovered and corrected, those repayments may be taken into consideration by applying them:

- To reduce the portion of the loan that did not exceed the maximum permissible amount (so the corrective repayment would equal the original loan excess plus interest);
- To reduce the interest on the loan excess, with the remainder of the repayments applied to reduce the portion of the loan that did not exceed the maximum loan amount (so the corrective repayment would equal the original loan excess); or
- Pro rata against the loan excess and the maximum loan amount (so that the corrective repayment would equal the outstanding loan balance remaining on the original loan excess on the date the corrective repayment is made).

Once the corrective repayment is made, the loan may be reformed to amortize the remaining principal balance over the remaining period of the original loan.

For example, Carrie borrows $55,000 from her account in her 401(k) plan. One year later, the error is discovered (the maximum permissible loan amount is $50,000). This error may be corrected under VCP by repaying the excess amount of $5,000 to the plan. Loan repayments made before the error was discovered that are attributable to the $5,000 excess may be applied 1) towards the remaining loan balance so Carrie repays the entire $5000 and interest; 2) towards the interest on the loan excess, with any remaining payments applied towards the remaining loan balance so Carrie only repays the $5,000; or 3) pro rata against the loan excess and the remaining loan balance so Carrie repays an amount equal to the outstanding balance remaining on the excess on the date the corrective repayment is made. After the corrective repayment is made, the remaining loan balance may be reamortized over the remaining period of the loan.

Loan Repayment Period Exceeding the Maximum Permissible Repayment Period

Under VCP, a loan with a repayment period that exceeds the maximum permissible repayment period (e.g., a general purpose loan that exceeds five years), may be corrected by simply reamortizing the loan balance over the remaining portion of the maximum repayment period.

For example, Bill borrows $10,000 from his account in the XYZ Plan, to be repaid over a seven-year period. This is not a principal residence loan. Three years later, the repayment period error is discovered. At that point, the loan may be corrected by reamortizing the outstanding balance over the two years remaining on the five-year maximum repayment period.

This correction is not available if the maximum permissible repayment period, taking into account any permissible suspension periods, had already expired.

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Loans That Do Not Meet the Level Amortization Requirements

If a plan administrator discovers that a loan was not initially set up to be repaid in substantially level payments, made at least quarterly, that error may now be corrected under VCP by reamortizing the loan balance over the remaining portion of the maximum permissible repayment period in a manner that meets the level amortization requirements.

Accidentally Defaulted Loans

A common loan problem occurs when an employer either does not begin taking loan repayment deductions from a participant's paycheck as scheduled or accidentally stops deducting those payments too soon. These situations may occur when the employer or the plan goes through a merger situation, payroll vendors are changed, an employee is moved from one payroll system to another payroll system, or even when a plan changes its recordkeeper. Where a loan is in default due to payments not being made as scheduled, the error may be corrected under VCP by:

- The participant making a lump sum payment equal to the amount of missed payments, plus accrued interest, and continuing with scheduled loan repayments going forward;
- Reamortizing the outstanding loan balance, including accrued interest, over the remaining payment schedule of the original loan; or
- A combination of these two correction methods.

If the employer is partially at fault for not beginning or continuing repayment of the loan, the IRS may require the employer to pay the additional interest owed by the participant for failure to timely repay the loan.

This correction is not available if the maximum loan repayment period, taking into account any permissible suspension periods, has already expired.

Action Steps

Plan sponsors that discover loan problems such as those described above should discuss the new EPCRS options described in this *Compliance Bulletin* with their legal counsel to determine if the options are appropriate for their situation.

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