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It's All Fun and Games Until a Loan Defaults

Tiffany Santhavi

Saving for retirement is the responsible thing to do, but what happens if you need a little extra dough and the only "cash" you have is in your retirement account? A common feature many retirement plans have is participant loans. This sounds like a great idea to encourage employees to save for retirement by giving them a way to access their money if they need to. That's the theory, anyway … until something goes wrong.

Let's say Catherine would like to take a special vacation for her 40th birthday. It's the big 4-0, so she decides to dip into her retirement savings to take this once-in-a-lifetime trip. She requests a loan from her retirement account, gets the money, and goes on this amazing vacation to Scotland. After her trip, she returns home happy and relaxed and completely forgets about the loan she took out. When her paycheck did not reflect the loan repayment, Catherine did not notice. Actually, Catherine completely forgets about the loan until she receives a notice from the plan's recordkeeper at the end of the year, stating that it is issuing a Form 1099-R for the full amount of her loan due to lack of payment. Catherine storms into the HR Director's office and asks why the payments were never taken from her paycheck. Apparently, while Catherine was on vacation, her company's HR Director was also out on personal leave and the substitute did not set up the loan payments in the payroll system.

Why did the recordkeeper issue the Form 1099-R?

As a result of Catherine not making payments on her loan, she now has a deemed distribution in the amount of the loan, plus accrued interest. A deemed distribution treats the loan as a taxable distribution from the plan, requiring a Form 1099-R to be issued to report the income to the participant, but the participant is still obligated to repay the loan. The loan also remains a plan asset until such time as Catherine takes a distribution of her account and the loan is offset. Additionally, if Catherine is younger than 59 ½, an additional 10% early withdrawal penalty will apply. If the plan provides for a cure period, Catherine may have until the end of the calendar quarter following the calendar quarter in which the unpaid repayment was due to bring things up to date to avoid the deemed distribution. However, in this case, that time has passed. Because the failure to pay wasn't corrected in time, Catherine has a deemed distribution that triggered the Form 1099-R.

What happens now?

The plan sponsor knows that it made an error by not initiating the loan repayment through payroll deduction. It now has three options:

1. Tell Catherine, “Too bad;” she has to pay the taxes. She should have noticed the payments were not being taken out of her paycheck sooner.
2. Fix the failure through the IRS Employee Plans Compliance Resolution System (EPCRS) Voluntary Correction Program (“VCP”). As discussed in option 3 below, the plan sponsor can self-correct the failure. However, only by correcting the loan through VCP will the plan sponsor be able to apply to the Department of Labor’s Voluntary Fiduciary Correction Program and receive a ‘no action’ letter. This is a consideration that should be weighed when deciding if this method of correction is appropriate.
3. As of April 2019, the plan sponsor may fix the failure through the EPCRS Self-Correction Program (“SCP”), using one of the following options:
    1. The participant can make a lump sum payment equal to the missed payments, plus accrued interest;
    2. The remaining balance of the loan, including accrued interest, may be reamortized over the remaining payment schedule of the original term of the loan (or an extended term not exceeding the maximum five-year repayment period); or
    3. A combination of either of the above methods.

The plan sponsor can pay the accrued interest as part of the correction outlined above to help make the situation right with the participant. Additionally, remember that even when a plan sponsor uses SCP, it is important to document that correction in a memo along with the supporting documentation showing the steps taken. This documentation should also be provided to the participant as they have been issued the Form 1099-R and may need it to explain why they may not have declared this income on their taxes.

How important is the VCP filing of the loan correction and the protection of the ability to go to the DOL under VFCP? In typical lawyer fashion, we need to say, “It depends.” On a practical basis, the effect of DOL involvement in a loan problem would be for it to declare the loan to be a prohibited transaction, raising the potential of excise taxes equal to 15% of the loan interest, pyramiding for all years during which the loan is outstanding. A VFCP filing forestalls this. There is also a very small possibility that the plan could be disqualified if a prohibited transaction loan is left unresolved.

In most cases, the potential excise tax liability for a single loan is not significant. However, there may be times where the risk and the liability are higher. If you are concerned, seek legal counsel.

Things to Keep in Mind

If a loan was taken and payments were <u>never</u> made, this may not be considered a bona fide loan. This could again raise the specter of DOL involvement and classification of such a loan as a prohibited transaction. In this circumstance, however, the risks and liabilities are higher than those discussed above, particularly if the borrower is an owner or other highly compensated employee. If that situation arises, seek legal advice.

Even though we now have the beautiful SCP option, it is important to help clients put in place procedures to process and track loans to avoid deemed distributions. You should also monitor loans you administer for your clients closely to catch loans <u>before</u> they go into default.

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