

Plan Loan Failures and Deemed Distributions

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The Issue

Many employers make participant loans available in their retirement plans. When a plan makes loans available, there are two important statutory requirements to consider: §72(p) dealing with taxability of participant loans and §4975(d) dealing with prohibited transactions. This column focuses on the tax rules under §72(p).

A plan loan is a taxable distribution unless the loan satisfies the exception under §72(p)(2) which sets limits on the amount of a nontaxable loan and the repayment of the loan. Participants may receive a nontaxable loan of up to 50% of their vested account balance not to exceed \$50,000. A minimum loan up to \$10,000 can be made that exceeds the 50% rule as long as the excess is secured with additional collateral. The participant loan, by its terms, must be repaid within five years. Both the dollar limit and the repayment period may be exceeded if the loan is for the purchase of a primary residence. Principal and interest must be paid in substantially level payments at least quarterly.

The Problem

The most common plan loan failures relate to:

- 1) loans that exceed the maximum dollar amount,
- 2) loans with payment schedules that do not meet the time or payment limits, and
- 3) defaulted loans due to failure to make required payments.

Each of these will cause the loan (or portion thereof) to become a "deemed" distribution for tax purposes. A deemed distribution differs from other distributions in that the participant is taxed as if the distribution were received, but the treatment of the loan as a distribution does not excuse the participant from the obligation to repay the loan. A failure to repay the loan may result in additional tax consequences and, in some cases, a prohibited transaction.

If a participant loan is in excess of the maximum amount allowed, only the excess portion is taxable. For example, a \$60,000 non-principal residence loan would trigger a \$10,000 deemed distribution. If a participant loan does not satisfy the 5-year, quarterly payment requirement, the entire loan is taxable, including a loan that is within the dollar limit. For example, a non-principal residence loan for \$5,000 with a 6-year repayment period is made. Since the 5-year repayment term limit is exceeded, the entire \$5,000 is taxable even though it is within the dollar limit. Similarly, if the loan was properly set up as a 5-year loan but provided for five annual payments, the entire \$5,000 is taxable as a deemed distribution. When a loan goes into default, whether from participant or

administrator error, a deemed distribution of the entire unpaid loan balance plus accrued interest results.

The Fix

If the plan contains language that reflects the loan limits under §72(p)(2), the violations discussed will also cause a plan to become disqualified, resulting in adverse tax consequences to the employer and employees under the plan; however, employers may get relief from these adverse consequences through the Employee Plans Compliance Resolution System (EPCRS) by correcting the failures. The Voluntary Correction Program (VCP) can be used to correct these mistakes.

Revenue Procedure 2006-27 adds three new corrections for plan loan failures which, when made through VCP, removes the §72(p) deemed distribution tax reporting requirements. These corrections are only allowed if the normal maximum period for repayment of the loan has not expired. 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.

Where a plan loan has exceeded the dollar limit, correction will be permitted if there is a payment to the plan based on the excess loan amount. If loan repayments were made before correction, the prior repayments may be applied either:

- 1) to interest on the excess so the participant only repays 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 would equal the outstanding balance remaining on the original loan excess on the date that corrective repayment is made.

Where a plan loan has a payment schedule that is greater than allowable by law, the loan can be reamortized over the remaining period of the proper maximum payment period measured from the original date of the loan. For example, a participant loan has a repayment period of six years. Two years later it was discovered that the loan should have been repaid over five years. To correct the error, the outstanding loan balance is reamortized over the remaining 3-year period. Correction is not available where the statutory term of the loan has expired. In that case, VCP can be used to report deemed distributions in the current year.

Finally, for loans that are deemed in default, correction can be:

- 1) a lump sum payment equal to what should have been made to the plan, plus interest,
- 2) reamortization of the outstanding balance of the loan over the remaining payment schedule of the original term of the loan, or
- 3) a combination of either of the above methods.

Additionally, in certain situations involving defaulted loans (e.g., where the employer did not start payroll withholding for repayment of the loan), the employer may be required to pay a portion of the repayment made by the employee in order to correct the defaulted loan.

Making Sure It Does Not Happen Again

Employers need to have a system in place to ensure that plan loans are administered in compliance with the plan document and any separate written loan policy. Employers should work with plan administrators to ensure the administrators have sufficient participant loan information to verify that the proper loan payments are being made timely. However, keep in mind that, despite all of your good efforts, mistakes can happen. In that case, the IRS can help you correct the problem and retain the benefits of your qualified plan and delay or eliminate the need for reporting deemed distributions.