

Fiduciary Loan Regulations for 401(k) Plans: Best Practices for Plan Sponsors

Key Issues In Managing Participant Loan Programs and Defaults, Impact of Tax Reform on Loan Offsets, ERISA and IRS Compliance

TUESDAY, AUGUST 7, 2018

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Christen Sewell, Atty, **Covington & Burling**, Los Angeles

William H. Woolston, Partner, **Covington & Burling**, Washington, D.C.

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1.**

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-866-258-2056** and enter your PIN when prompted. Otherwise, please **send us a chat** or e-mail sound@straffordpub.com immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the ^ symbol next to “Conference Materials” in the middle of the left-hand column on your screen.
- Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides for today's program.
- Double click on the PDF and a separate page will open.
- Print the slides by clicking on the printer icon.

Fiduciary Loan Regulations for 401(k) Plans & Best Practices

August 7, 2018

Will Woolston & Christen Sewell

COVINGTON

BEIJING BRUSSELS DUBAI FRANKFURT JOHANNESBURG LONDON LOS ANGELES

NEW YORK SAN FRANCISCO SEOUL SHANGHAI SILICON VALLEY WASHINGTON

www.cov.com

Today's Topics

1. Legal Framework
2. Exclusion of Plan Loans from Taxable Income
3. Administration
4. Common Errors and Corrections
5. Best Practices

1. Legal Framework

1. ERISA & Code Exceptions
2. PTE Requirements
3. Penalties of Non-Compliance

ERISA and Code Exceptions for Plan Loans

■ Prohibited Transaction

- A plan fiduciary may not permit the lending of money to a “party in interest.” ERISA § 406.
- A party in interest includes any employee of an employer whose employees participate in the plan.

■ Anti-Alienation Rule

- Code § 401(a)(13) generally requires that a qualified plan preclude the assignment or alienation of plan benefits.

ERISA and Code Exceptions for Plan Loans

- Prohibited transaction exemption for certain loans to participants. ERISA § 408(b)(1) and Code § 4975(d)(1).
- A loan to a participant that satisfies the requirements of the exemption is not an impermissible assignment of plan benefits. Treas. Reg. § 1.401(a)-13(d)(2).

PTE Requirements

Plan loans must be:

- Available to all participants and beneficiaries on a reasonably equivalent basis
- Not available to HCEs, officers, or shareholders in a greater amount
- Made under specific plan provisions
- Subject to a reasonable rate of interest
- Adequately secured

DOL Reg. § 2550.408b-1

Available on a Reasonably Equivalent Basis

- A minimum loan requirement of up to \$1,000 is disregarded for purposes of this rule. DOL Reg. § 2550.408b-1(b)(2).
- Generally requires that loans be available to all active employees, former employees, and beneficiaries (including alternate payees).
- Could restrict to parties in interest

Not Available on Greater Basis to HCEs

- Program should not operate to exclude large numbers of plan participants.
- Loans may be limited to a maximum percentage of the vested account or to a maximum dollar amount.

DOL Reg. §2550.408b-1(c)

Specific Plan Provisions

Specific provisions, or a separate loan policy referred to in the plan, must cover:

- Who administers the loan program.
- The loan application procedure.
- Limits on the amount or purpose of the loan.
- Collateral requirements.
- Events constituting default.

DOL Reg. § 2550.408b-1(d)

Reasonable Interest Rate

- Must charge a commercially reasonable rate of interest. DOL Reg. § 2550.408b-1(e).
- The DOL has not established a safe harbor plan loan interest rate.
- During a 2011 webinar, IRS reps said that the IRS considers prime plus 2% a reasonable rate.

Security for Plan Loan

- A plan loan must be adequately secured with collateral.
- No more than 50% of the participant's vested account determined immediately after loan origination can be considered loan security for the outstanding balance of all loans to the participant.

DOL Reg. § 2550.408b-1(f)

Penalties for Non-Compliance

- **Prohibited Transaction:** 15% excise tax per year; possible 100% excise tax if not corrected.
- **Plan Disqualification:** Employer loses deduction for contributions; income on trust is taxed; employees are taxed on benefits.

2. Exclusion from Taxable Income

1. Code § 72(p) Requirements
2. Deemed Distributions
3. Loan Offsets against Account

Authorized by Plan

- Loans must be authorized by terms of plan
 - Plan document can include specifics, or
 - Refer to separate written loan policy
- Consider specifying that administrator can amend policy so not having to go to board to revise

Code § 72(p) Rules

Code § 72(p) Rules:

- Enforceable agreement
- Loan not more than specified maximum
- Repayment requirements
- Offsets of unpaid loan and tax reporting requirements
- Loan must be bona fide

Enforceable Agreement

- Agreement must set forth:
 1. the amount of the loan,
 2. the date of the loan, and
 3. the repayment schedule
- May be in the form of a written paper document or in an electronic medium
- Principles in Treas. Reg. §1.401(a)-21 apply to electronic

Treas. Reg. §1.72(p)-1, Q&A-3(b)

Maximum Amount of Loans

- Maximum loan amount is lesser of:
 1. the greater of \$10,000 or 50% of vested account, or
 2. \$50,000 (subject to adjustment)Code § 72(p)(2)(A)
- Maximum determined on controlled group basis (Code § 72(p)(4))

Example – Reducing \$50,000

- Vested account balance: \$100,000
- 1/1/2017: Took a plan loan of \$40,000 (paid in 20 quarterly installments of \$2,491).
- 1/1/2018: Outstanding balance of 1st loan is \$33,322. Requests 2nd loan.
- 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**.
- New loan plus outstanding loan cannot be more than \$43,322 (\$50,000 - \$6,678).
- Maximum amount of 2nd loan is **\$10,000** (\$43,322 - \$33,322).

Limits on Loan Term

- Must be repaid within 5 years
 - Policy to specify when starts running
 - No later than when loan proceeds paid to ppt
- Unless, it is principal residence loan, repay over any reasonable term

Repayment Requirements

- Level Amortization
 - Principal and interest must be amortized in substantially level payments
 - Payments must be made at least quarterly
- Refinancing – existing loan replaced by a new loan (Treas. Reg. §1.72(p)-1, Q&A-20)
- Modification of payment frequency – IRS permitted where repayment of loan was done through payroll deductions and the payroll periods changed (PLR 9729042)

Repayment Requirements

Cure Period

- Avoid taxation on defaulted loan if missed payments made up within the plan's cure period
- Optional to have cure period
- Cure period may not extend beyond the last day of the calendar quarter following the calendar quarter in which the missed installment payment was due (Treas. Reg. §1.72(p)-1, Q&A-10)

Repayment Requirements

Example Cure Period

- Loan is repayable installments of \$100 month
- Ppt misses May 1 payment
- Calendar quarter following May 1 is July 1 through September 30
- May provide a cure period lasting no longer than September 30 before the outstanding loan balance must be treated as a deemed distribution

Repayment Requirements

Suspension of payments for non-military LOA

- Payments can be suspended for up to one year because of leave of absence
- When the suspension ends
 - Balance (including interest for the suspension period) must be fully repaid by the latest date permissible when the loan originated
 - Resumed payments can be increased to reflect remaining term or can be the original amount with a balloon payment at the end

Treas. Reg. §1.72(p)-1, Q&A-9(a)

Repayment Requirements

Suspension of payments for military LOA

- Plan *permitted* to suspend loan repayment during military service (even non-USERRA military service) (Code § 414(u)(4))
- Suspension may exceed one year. Resume upon completion of military service
- When suspension ends:
 - Balance (including interest for the suspension period) must be fully repaid by the latest date permissible when the loan originated plus the period of military service (Q&A-9(c) of §1.72(p)-1)
 - Resumed payments can be increased to reflect remaining term or can be the original amount with a balloon payment at the end

Repayment Requirements

- Loan payments are made with after-tax dollars
- No basis is credited for the loan payments, unless the loan payments are made to repay a previously-taxed loan
- The part of the loan payment attributable to interest is double-taxed

Repayment Requirements

- The repayment requirements must be satisfied separately with respect to a designated Roth account (Treas. Reg. § 1.402A-1, Q&A-12)

Deemed Distribution

- If loan violates Code § 72(p)(2), it is a “deemed distribution” for tax purposes.
- Amount due under the loan is deemed to be distributed, is includible in gross income under Code § 72, and is subject to the premature distribution penalty under Code §72(t), if applicable. Treas. Reg. § 1.72(p)-1, Q&A-11.
- Taxed as if received a distribution, but still owes the plan the borrowed proceeds because it was a loan and not an actual distribution

Deemed Distribution

- If loan is too large, only excess amount of the loan is deemed distributed (Treas. Reg. § 1.72(p)-1, Q&A-4(a))
- If loan initially complies, but there is a failure to make payments (taking into account any cure period), deemed distribution equals the outstanding loan balance (including accrued interest at the time of the deemed distribution) (Treas. Reg. § 1.72(p)-1, Q&A-10(b))

Deemed Distribution

- Rollover – Not eligible for rollover
- Withholding –
 - If deemed distribution occurs **after** loan is made,
 - + it is the only distribution made at the time, no withholding is required, or
 - + other cash/property distributed, then withholding
 - If deemed distribution occurs **when** the loan is made, withholding is taken from the excess loan amount being disbursed.

Treas. Reg. §1.72(p)-1, Q&A-15

Deemed Distribution

- Roth – A deemed distribution with respect to a designated Roth account may not be treated as a “qualified Roth distribution” (Treas. Reg. § 1.402A-1, Q&A-11)
- Report – Form 1099-R (Treas. Reg. §1.72(p)-1, Q&A-14)
- Other Purposes – Deemed distribution is a distribution only for purposes of Code §72 (and not for other purposes, for example, such as Code § 401(a)(9)). Treas. Reg. §1.72(p)-1, Q&A-12.

Deemed Distribution

- Account reflects the loan until offset or repaid in full
- Technically, the participant is still obligated to repay the loan
- Treated as outstanding loan for purposes of determining the maximum amount of any future loan (Treas. Reg. §1.72(p)-1, Q&A-19(b))

Deemed Distribution

- If a loan is deemed distributed and has not been repaid, a participant cannot take a future loan unless either (a) repayments are required to be made by payroll withholding, or (b) the participant pledges collateral in addition to his account. Treas. Reg. §1.72(p)-1, Q&A-19(b)(2).
- If the participant repays the defaulted loan, the participant has “basis” for the amount that was previously taxed. Treas. Reg. §1.72(p)-1, Q&A-21.

Bona Fide

- Code §72(p) rules only apply if bona fide loan
- If not bona fide, then actual distribution (Treas. Reg. §1.72(p)-1, Q&A-17)
- *Patrick v. Commissioner*, 75 T.C.M. 1629 (1998) – factors

Loan Offset Against Account

- What is a loan offset?
 - Repayment of loan by offsetting the plan account
 - No offset unless funds are otherwise distributable
 - Treated as an actual distribution
- What triggers a loan offset?
 - Repayment required upon termination or distribution of benefit
 - Loan default

Loan Offset Against Account

- Tax treatment
 - Not previously treated as deemed distribution – Offset is includible in income in the year in which the offset occurs
 - Previously treated as deemed distribution – not included as part of the gross distribution when it is later offset
- Interest on defaulted loan + delayed offset
 - Plan must continue to charge interest under PTE rules
 - Accrued interest is not taxed when it accrues or at time of offset (Treas. Reg. §1.72(p)-1, Q&A-19, Q&A-21, and Q&A-22)

Loan Offset Against Account

Rollover Rules

- If eligible rollover under Code §402(c), participant can defer taxation by making timely rollover
- Rollover of cash equivalent or rollover note itself
- Loan offset of deemed distribution (previously taxed) IS eligible for rollover, but only to IRA
- Automatic rollover rule does not apply to the loan offset (Notice 2005-5, Q&A-1)

Loan Offset Against Account

Changes to Loan Rollover Distribution Rules

- Effective 1/1/2018, if the plan loan offset is due to plan termination or severance from employment, instead of the usual 60-day rollover period, have until due date (including extensions) for filing Federal income tax return for year in which offset occurs
- Relief may not be available in all circumstances
- Update model tax notices
- Review loan procedures

Code §402(c)(3)(C)

Administration

1. Accounting for the Loan
2. Crediting Loan Payments
3. Plan Asset Rules
4. Merges and Acquisitions

Accounting for the Loan

- Usually, the loan is treated as an earmarked investment that is part of the participant's account balance. Loan payments are credited directly to the participant's account.
- The value of a participant's account includes any outstanding loan balance.

Crediting Loan Payments

- Loan payments credited directly to a participant's account are generally allocated to the subaccounts from which they were originally taken and to available investment funds in accordance with plan terms.
- However, if any portion of the loan principal was taken from a designated Roth account, a pro rata share of each loan payment must be credited to the Roth account.

Timing of Remittances

- Loan payments are plan assets as of the earliest reasonable date they can be segregated from the employer's general assets. (DOL Reg. §2510.3-102)
- Loan payments must be transmitted to the plan by the date described above, but no later than the 15th business day of the month following the month in which the loan payment was withheld or received.
- Delinquencies in transmitting loan payments must be reflected as a prohibited transaction on the plan's Form 5500 filing.

Common Errors and Corrections

IRS Top 3 Errors

- IRS Top 3 Most Common Loan Failures
 - Loans that exceed the maximum dollar amount
 - Loans with payment schedules that don't meet the time or payment limits
 - Loans that go into default when there is failure to make required payments

<https://www.irs.gov/retirement-plans/fixing-common-plan-mistakes-plan-loan-failures-and-deemed-distributions>
(visited 7/19/2018)

Other Errors

- Repayments not timely transferred to trust
- Payroll withholding errors, e.g., starts late or stops too early; wrong amount; continues after repaid
- Principal is taken from the wrong investment funds or subaccounts
- Interest on late loan improperly calculated
- Loans are issued to ineligible individuals
- Failure to follow loan procedures
- Mergers and acquisitions

Corrections: EPCRS

3 VCP Correction Methods (only if maximum period for loan has not expired)

- Loan exceeds dollar limit
- Loan that exceeds maximum loan period (e.g., repayment period of 6 years)
- Deemed default

See IRS Fix-It Guide - <https://www.irs.gov/retirement-plans/401k-plan-fix-it-guide-participant-loans-do-not-conform-to-the-requirements-of-the-plan-document-and-irc-section-72p>

Corrections: DOL VFC Program

The following errors can be corrected under the DOL VFC Program:

- Delinquent deposit of plan loan payments to plan trust
- Loans failing to comply with plan provisions for the amount, duration, or level amortization, but only if the participant is party-in-interest solely because he is an employee
- Loan defaults caused by failure to properly withhold loan payments due to administrative or system error, but only if the participant is party-in-interest solely because he is an employee

Corrections: Prohibited Transaction

- No IRS correction program that provides relief from excises taxes under Code
- Pay on Form 5330

Best Practices

1. Administration
2. Avoiding Participant Default
3. Mergers & Acquisitions

Administration

- IRS Advice re: Loan Procedures
 - System for determining max loan during approval process
 - Written policy to determine loan terms (e.g., interest rate)
 - Written, enforceable loan agreements (no oral or informal loans)
 - Provide for cure period
 - Documentation for exceptions to general rules
 - Procedures for monitoring timely repayment
 - Procedures for analyzing deposits
 - Accurate software (or other tools)

Administration

- Review loan procedures periodically to make sure they reflect administration (fiduciary duty)
- Make sure good process to prevent or quickly identify common failures
- Consider loan treatment when making changes
 - Blackout period required to change investment line-up or plan merger
 - Change payroll frequency

Administration

IRS Advice re: Record Retention

- Evidence of the loan application, review and approval process
- An executed plan loan note
- If applicable, documentation verifying that the loan proceeds were used to purchase or construct a primary residence
- Evidence of loan repayments
- Evidence of collection activities for defaulted loans and related Forms 1099-R, if applicable

<https://www.irs.gov/retirement-plans/its-up-to-plan-sponsors-to-track-loans-hardship-distributions> (visited 7/19/2018)

Mergers and Acquisitions

- Freeze 401(k) plan and/or merge 401(k) plan
 - Effect of freeze/blackout period on repayments
 - To what plan will loan repayments be made?
 - How will repayments be invested?
 - Is repayment frequency changing?
 - Differences in loan terms
 - Number of outstanding loans permitted
 - Loans for primary residence
- Change payroll / re-amortize

Avoiding Participant Default

- Educate Participants
 - Consequences of default
 - Consequences of terminating with outstanding loan

Avoiding Participant Default

- Limit Loans
 - Number of loans
 - Types of contributions (i.e., elective deferrals only)
 - Dollar amount
 - Reasons can take loans

Avoiding Participant Default

- Impose Service Fees
 - Aon Hewitt report “minimizing Defined Contribution Plan Loan Leakage” reported that plans with higher loan origination fees have smaller outstanding balances

Avoiding Participant Default

- Make Repayment Easy
 - Payroll deductions
 - Bank account deductions
 - Allow repayment following termination
- Utilize grace period

Questions ?

Christen Sewell

424-332-4772 | csewell@cov.com

Will Woolston

202-662-5844 | wwoolston@cov.com