# 401(k) Plan Fix-It Guide - Participant loans don't conform to the requirements of the plan document and IRC Section 72(p).

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<td>9) Participant loans don't conform to the requirements of IRC Section 72(p) or are prohibited transactions under IRC Section 4975.</td>
<td>If the plan document permits participant loans, review all outstanding loans to ensure that the loans comply with IRC Section 72(p) and that employees are repaying their loans timely. For loans made to owners or officers of the employer, verify that such loans qualify for the exemption from prohibited transactions.</td>
<td>You may correct some mistakes by corrective repayment and/or modification of loan terms.</td>
<td>Review each participant loan, including the loan amount, term of the loan and repayment terms. Ensure that there are procedures in place to prevent loans that are prohibited transactions under IRC Section 4975 or that don’t comply with IRC Section 72(p).</td>
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Many 401(k) plans permit loans to participants. Plan sponsors should ensure that their plan document allows loans before allowing participants to borrow money from the plan. Some plan documents include a complete description of loan rules. Others make only a statement that the plan allows participant loans, subject to a separate written loan program.

A participant loan must meet several rules under IRC Section 72(p) to prevent the law from treating it as a taxable distribution. The rules are:

1. The loan must be a **legally enforceable agreement**.
   - It can be a paper or electronic document stating the date and amount of the loan and binding the participant to a repayment schedule.
   - It must be a secured loan and the interest rate and repayment schedule should be similar to what a participant might expect to receive from a financial institution.
2. The **amount of the loan** can’t be more than 50% of the participant’s vested account balance up to a maximum of $50,000.

   - An exception allows a participant to borrow a minimum of $10,000.
   - If the participant previously took out another loan, then the $50,000 limit is reduced by the highest outstanding loan balance during the one-year period ending on the day before the new loan.

3. The **loan terms** should require the participant to make level amortized payments at least quarterly.

   - Each payment should include an allocation of principal and interest.
   - The loan must be repaid within five years unless the participant uses the loan to purchase his or her main home. The five year repayment period is determined from date the loan was made.

4. **Exception for leave of absence:**

   - May suspend repayments for up to one year while the participant is on a leave of absence.
   - May not extend the loan’s maximum repayment period.
   - On return from leave of absence, must make additional payments to ensure repayment within the five-year-period by either:
     - increasing the payments over the rest of the loan, or
     - keeping the payments the same, but making a catch up payment for the missed payments during the leave of absence.

   Note: A plan may suspend loan payments for more than one year for an employee performing military service. In this case, the employee must repay the loan within five years from the date of the loan, plus the period of military service.

**How to find the mistake:**

Review the loan agreements and loan repayments to verify they’ve met the IRC Section 72(p) rules to prevent the loans from being treated as taxable distributions. This review should include:

- Determining whether there are written loan agreements for outstanding loans. If not, the loan is a taxable distribution to the participant.
- Reviewing the terms of each loan agreement to ensure that it meets the rules required to prevent the loan from being treated as a taxable distribution, including:
  - Are loans due within 5 years?
    - For a loan over 5 years, is there documentation in the file showing the employee used the loan to purchase a main home?
  - Is the interest rate reasonable? The interest rate charged for a loan can’t be more favorable than what the participant can get from a financial institution for a similarly secured loan.
  - Was the loan amount less than the dollar limit? You’ll need to know the participant’s vested account balance as of the loan date, and whether the participant had any loans prior to the date of the loan under review.
  - Does the repayment schedule require the participant to make level repayments of interest and principle at least quarterly? Are the payment amounts properly calculated?
- Ensuring that loan payments are timely made per the loan terms.
  - Many participants repay their loans through payroll withholding. Evaluate the payroll system to ensure that the withheld amounts are properly determined and deposited to the plan timely. Pay particular attention to this issue if there has been a change in payroll systems or providers.

**How to fix the mistake:**
Corrective action:
It's important that plans have a system in place to ensure that the terms of a participant loan and its repayments follow the federal tax law so the loan isn't treated as a taxable distribution. Generally, once a loan violates a rule, the participant can't correct it to save that exemption. The plan administrator can make correction and preserve the exemption in a few circumstances:

- If permitted by the loan terms or written loan policy, the plan administrator may allow for a “cure period” that would allow a participant to make up for a missed payment. The cure period can't go beyond the end of the quarter following the quarter in which the missed payment was due.

- If the participant loan violated the plan document terms or IRC Section 72(p), the plan sponsor has two choices. It may be able to:
  - use the Voluntary Correction Program to permit employees to include the amount of the loan amount in income in the year of correction (as opposed to the year in which the problem occurred), or
  - request relief from reporting the loans as taxable distributions to participants from the IRS under the VCP.

- Generally, for a plan loan to be eligible for relief from income tax reporting under VCP:
  - employer action caused the participant's failure to repay the loan, and
  - correction should be done within the maximum time for the loan, usually 5 years from the date the original loan was made.

- The general requirements for correction are:
  - **Loan that exceeds the dollar limit**: The participant must repay the excess loan amount and, if needed, amortize the remaining principal balance as of the repayment date over the original loan's remaining period. The corrective payment for the excess loan amount depends on the:
    - excess amount as of the date of the loan,
    - payments previously made on the loan, and
    - portion of the previously made payments that were allocated to the excess loan amount.

    Three alternative methods that you may use to determine the allocation of prior repayments toward the excess loan amount and the corrective payment required to repay the excess loan amount are:

    1. Prior repayments are applied to reduce the portion of the loan that didn't exceed the limit. None of the prior payments are allocated to the excess loan amount. The corrective payment for the excess loan amount is equal to the original loan excess, plus interest.
    2. Prior repayments are used to pay the interest on the excess portion of the loan, with the remainder of the repayments used to reduce the portion of the loan that didn't exceed the limit. The corrective payment for the excess loan amount is equal to the original excess loan amount.
    3. Prior repayments are applied against the loan excess and the maximum loan amount permitted on a pro-rata basis. The corrective payment for the excess loan amount is equal to the outstanding loan balance attributable to the excess loan amount, after the allocation of prior repayments.

- **Loan that exceeds the maximum loan period**: The outstanding amount of the loan is reamortized over the maximum remaining period allowed under IRC Section 72(p). The maximum duration is determined from date the original loan was made.

- **Loan that's in default (after the passage of the “cure period”) because of the failure to make timely payments**: The participant must either:
- make a lump sum payment for the missed installments (adjusted for interest);
- reamortize the outstanding loan balance, resulting in higher payments going forward; or
- a combination of a make-up payment and reamortization of the loan.

**Example:**
AZ Corp 401(k) Plan maintains a participant loan program. The plan has 50 participants with plan assets that exceed $500,000, but are less than ten million dollars. AZ Corp conducted a year-end review of its loan program and found these issues:

- Bob received a plan loan on May 1, 2016. The loan was for $60,000 over a five-year term, amortized monthly using a reasonable interest rate. Bob timely made the required payments. The loan amount is less than 50% of Bob's vested account balance. However, the loan amount exceeds the maximum limit of $50,000.
- Terri received a loan of $10,000, dated April 1, 2016, over a six-year period. Payments are timely and the interest rate is reasonable. The loan term exceeds the maximum 5-year repayment period.
- Dean borrowed $10,000, dated March 1, 2016, over a five-year period. Because of a payroll error, AZ Corp failed to withhold the required loan repayments from Dean's pay since August 1, 2014. The loan amount is less than 50% of Dean's vested account balance and the interest rate is reasonable.

- AZ Corp corrected the loan errors on February 1, 2017.

**Corrective action:**

**Bob – Loan amount in excess of the $50,000 limit** - AZ Corp corrected this mistake by requiring a corrective repayment to the plan because of the $10,000 loan excess, according to Method 3, above. Since Bob has already repaid some of the loan, these repaid amounts may be considered in determining the amount of the required corrective repayment. AZ Corp applied Bob's prior repayments on a pro-rata basis between the $10,000 loan excess and the $50,000 maximum loan amount. Therefore, Bob's corrective repayment equaled the balance remaining on the $10,000 loan excess as of February 1, 2017, the date of correction.

**Terri – Loan term in excess of the 5-year limit** - AZ Corp is correcting this mistake by reamortizing the loan balance over the maximum remaining period (5 years) from the original loan date. On February 1, 2017, AZ Corp reamortized the loan balance for Terri so that it will be fully repaid by April 1, 2021 (5 years from the date of the original loan).

**Dean – Loan payments not made** - The loan went into default as of November 2, 2016, on the expiration of the plan’s stated three-month cure period. AZ Corp determined it was partially at fault because it failed to collect loan repayments. AZ Corp corrected the mistake by requiring Dean to make a lump sum repayment equal to the additional interest accrued on the loan and reamortize the outstanding balance over the remaining loan period.

**Correction programs available:**

**Self-Correction Program:**
This type of mistake can't be corrected under SCP. AZ Corp must correct under VCP.

**Voluntary Correction Program:**
If the plan is not under audit, AZ Corp makes a VCP submission per Revenue Procedure 2018-52. The user fee for the VCP submission is generally based on the amount of plan assets. In this case, the VCP user fee is $3,000 for a submission made in 2019. VCP user fees may change in subsequent years. When AZ Corp makes its VCP submission, it should consider using the model documents in the Form 14568 series.

**Audit Closing Agreement Program:**
Under Audit CAP, correction is the same as “Corrective Action”. AZ Corp. and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction. The sanction under Audit CAP is based on
facts and circumstances, as discussed in Section 14 of Revenue Procedure 2018-52.

**How to avoid the mistake:**

Develop loan procedures, including:

- A system for determining the participant’s maximum loan amount during the loan approval process. The participant’s account balance and prior loan history should be available to ensure that the loan is within the limits.
- A written policy used to determine the loan terms (for example, the criteria used for determining the loan’s interest rate).
- Written, enforceable loan agreements. The plan shouldn’t permit loans on an oral or informal basis.
- Loan procedures should provide for a cure period (see “How to fix the mistake”) which allows the plan administrator a window of time to get a payment from the participant without it being considered a missed payment.
- Documentation for exceptions to general rules. For example, if the plan approves loans for over 5 years, the loan request should include evidence that the participant is using the loan to purchase his or her primary residence. These requirements should be part of the plan’s loan policy included in the form that a participant completes to request a loan.
- Procedures for monitoring timely repayment. Many plans require loan repayment by payroll deduction. For the process to work, the payroll service provider must know to withhold the loan repayments and needs enough information to determine the correct withholding amount. In addition, the payroll system needs to be able to timely deposit the amounts withheld to the plan.
- Procedures for analyzing deposits. Procedures for the plan’s record keeper to allocate the appropriate amounts to the participants’ loan balances.
- Accurate software (or other tools) used to determine loan limits and repayment amounts.

**Plan loans were made to individuals who are disqualified persons and the loans are prohibited transactions under IRC Section 4975.**

Prohibited transactions under IRC Section 4975 are generally any transfer to, or use by, or for the benefit of, a disqualified person of a plan’s income or assets. A loan from the plan to a disqualified person may be a prohibited transaction unless it meets specific requirements.

Disqualified persons include, among others, a 50% owner (and family members), fiduciaries and persons who provide service to the plan. For a complete list of disqualified persons, see Publication 560, Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans). Prohibited transactions are subject to an excise tax under IRC Section 4975.

Loans to disqualified persons must meet certain requirements to avoid being a prohibited transaction. The loan must:

- be made available to all participants or beneficiaries,
- be made available to highly compensated employees in an amount equal to the amount made available to other employees,
- be made per specific provisions stated in the plan,
- bear a reasonable rate of interest, and
- be adequately secured.
Loans that are prohibited transactions are generally subject to a 15% excise tax on the amount involved. The “amount involved” generally refers to fair market interest for the disqualified person’s use of the plan’s money. The disqualified person pays the tax.

**How to find the mistake:**

To determine if participant loans are prohibited transactions, review the loan agreements and repayments:

1. Determine whether the plan document allows for participant loans and whether the plan and any accompanying loan policy require that loans be made to all participants. (Note: if the plan doesn’t allow for participant loans, then any loan made to a disqualified person is a prohibited transaction.)
2. Identify participants who are disqualified persons and determine whether they received plan loans. (Loans made to individuals who aren’t disqualified persons aren’t prohibited transactions.)
3. Verify that the plan used the same criteria for approving loans to disqualified persons and to other participants.
4. Evaluate the loan terms made to a disqualified person to determine whether the loan was:
   - based on a reasonable interest rate (for example, a rate similar to what the participant would expect to obtain had a similar loan been taken from a financial institution); and
   - adequately secured. (If the participant used his or her account balance to secure the loan, the account balance should be greater than the loan amount.)

Loans made to disqualified persons at below-market interest rates or that aren't adequately secured are prohibited transactions.

- Review the disqualified person's actual loan payments to determine whether he or she is following the loan document terms. The law treats amounts not timely paid per the loan terms as unsecured loans and prohibited transactions.

**How to fix the mistake:**

**Corrective action:**

If a loan is a prohibited transaction, then the disqualified person must repay all outstanding loan amounts (principal and interest) to the plan. Excise taxes under IRC Section 4975 apply until the loan is fully repaid. The disqualified person pays the excise taxes on Form 5330, Return of Excise Taxes Related to Employee Benefit Plans. The plan sponsor or disqualified person may consider submitting a special voluntary closing agreement request to the IRS office in El Monte, CA., if they wish to seek an efficient way to pay the excise taxes that they owe.

**Correction programs available:**

The IRS doesn’t have a correction program that provides relief from the excise taxes owed under IRC Section 4975. The disqualified person must pay all excise taxes owed on the prohibited transaction.

**How to avoid the mistake:**

- Before making a loan to a participant (including a disqualified person), ensure that the plan document provides for loans and that the loan complies with the plan terms.
- The plan should establish a loan policy consistent with the plan terms that ensures that the terms of any loan issued to a disqualified person satisfies the conditions for it not to be a prohibited transaction.
- The plan administrator should monitor payments made by the disqualified person to ensure that he or she makes the payments per the loan terms.
Some loan transactions may also result in fiduciary violations under Title I of the Employee Retirement Income Security Act. The Department of Labor (DOL) has established the Voluntary Fiduciary Correction Program to enable correction of some fiduciary violations.