LEGAL UPDATE

Recent Cases and IRS Guidance with Respect to Loan Administration under 401(k) Plans

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One of the more complex aspects of tax-qualified plan administration involve loan administration. Two recent Tax Court cases, an IRS Chief Counsel's Advice, and an IRS memorandum for Employee Plans Examinations Employees address various aspects of loan administration.

I. *Gowen v. Commissioner*, 2017 Summary Opinion 2017-51. Petitioner in this case was a CPA, a fact generally of no relevance, except that it is evidence of the general creativity of accountants who, as a class, are generally regarded as the most creative people in Hollywood. In this case, participant ceased making loan repayments in August of 2012. The plan had a typical cure period, under which if the missed payments were made up by the end of the calendar quarter following the calendar quarter of the missed payment, the loan would not be treated as in default. Since Gowen ceased making loan payments in August 2012, it would seem clear that if he did not make his missed payments by December 31, 2012, he would be treated as in default and receive a 1099-R for that year. In his view, calendar quarters meant quarters of a year, because otherwise a participant's period of cure would be approximately six months, if the first missed payment were July 1, and 3 months if the first missed payment was at the end of August. Therefore, in his situation, the claimed first quarter was August, September, October, and the second quarter was November, December, and January. Therefore, Gowen's position was that the deemed distribution occurred in January 2013, rather than 2012. Unfortunately for Gowen, the Code Section 72 regulations contained an example directly on point contrary to his position, resulting in a 2012 distribution, a 10 percent penalty for early withdrawal, and a 20 percent penalty for an underpayment attributable to a disregard of IRS Regulations. II. *Frias v. Commissioner*, T.C. Memo 2017-139. This case illustrates the type of garden-variety error that can result in a tax deficiency for a participant. Frias received a $40,000 loan from the plan on July 27, 2012, and went on a maternity leave from July 30, 2012 to October 12, 2012. Frias had entered into a payroll deduction agreement with her employer requiring the employer to deduct from her after-tax salary in each payroll period the amount necessary to make the loan repayments. The first payment was due on August 24, and the plan's cure period with respect to missed payments ended on September 30, 2012. However, the employer failed to deduct the amounts from her salary and remit the loan payments. When Frias returned to work and was advised of the failure to make loan repayments, she immediately made a $1,000 loan repayment; instructed her employer to withhold and remit loan payments increased by $5,000 each month through mid-July 2013, and thereafter continued to make loan repayments until the loan was repaid in full in July 2014. Because Frias received compensation for her accrued sick, personal, and vacation time while she was on leave in an amount greater than the installments due on her loan, she could not qualify for the relief from the substantially level amortization requirement for certain participants on leave of absence. Petitioner argued that the failure to make a corrective payment by the end of the cure period should not result in a deemed distribution because: (i) the parties to the loan acted as though they had agreed to suspend payments; (ii) the substance of the repayments should be honored over the form of the repayments; and (iii) the default was cured in accordance with EPCRS. With respect to this latter point, the Court indicated that EPCRS allows a plan sponsor to correct loans that do not comply with Code Section 72(p). Thus, Frias was subject to tax on the deemed distribution and the 10 percent excise tax for an early withdrawal, but, under these facts and circumstances, was not subject to the 20 percent accuracy-related penalty for an understatement of taxes attributable to negligence or disregard of an IRS regulation. Also, Frias has a tax basis in the amounts that she paid on the defaulted loan.

The news was not entirely bleak, however. In Chief Counsel's Advice 201736002, the IRS indicated in two situations how missed installment payments could be cured either by making missed installments during a cure period, even where the missed payments occurred in multiple calendar quarters, or by refinancing of the loan. In a July 2017 Memorandum for Employee Plans Examining Employees, the IRS indicated that where a plan permits multiple loans, there are two alternative permissible ways of determining the "highest outstanding balance of loans" ending on the one year period before the loan is made.

The Code's loan regulations can be complex, as can their interaction with DOL fiduciary rules. If a plan administrator has any questions about how to deal with a possible loan default, a call to counsel is a prudent step.

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