

Qualified Retirement Plans Practice Alert

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How Can You Correct a Defective Plan Loan?

A qualified retirement plan, whether defined contribution or defined benefit, may allow for participant loans in the plan document. The maximum loan cannot be more than the lesser of 50% of the participant's vested benefit or \$50,000 and must be repaid at least quarterly, with interest, over no more than five years. The interest rate must be what a financial institution would charge for a similarly situated loan. For a variety of reasons, e.g. financial setback or administrative oversight, the required payments may be overlooked or missed. To avoid plan disqualification the plan must correct the defect through the Employee Plans Compliance Resolution System (EPCRS).

Example 1: On January 1, 2009 a participant receives a loan for \$25,000. The plan loan is for a period of five years at an interest rate of 6.0% payable monthly in the amount of \$1,459.33. According to statutory loan limits the maximum loan available to this participant was \$15,000. On January 1, 2010 the defect is discovered when the outstanding balance of the loan is \$20,493.23. To correct this defect the participant must pay \$10,000, the amount of the excess loan. The loan is then recast so the corrected balance of \$10,493.23 is paid over the remaining term of the loan, four years. The payments are now \$251.07 monthly.

Example 2: Using the same fact pattern as in Example 1 the employer fails to withhold three loan payments from the participant's salary. To correct the defect the loan payments are recast to amortize the loan balance over the remaining period of the loan or the employer may allow the participant to make a lump sum payment to bring the payments to a current status. Assuming the missed payments are months 13 through 15, the payments necessary to fully amortize the loan over the remaining 45 months would be \$528.64 or, as an alternative, the participant can make a lump sum payment of \$1,478.41.

Example 3: Again using the same fact pattern as in Example 1 the employer fails to remit loan payments that were withheld in a timely fashion. In accordance with Department of Labor rules the amount withheld is subject to the same remittance rules as 401(k) salary deferrals, i.e. as soon as reasonable based on the facts and circumstances. In this case the employer is capable of remitting funds withheld from a participant in six business days. To correct this defect the employer must pay the lost earnings to the plan. This amount can be determined using the Department of Labor (DOL) online calculator or manually in accordance with examples illustrated on the DOL website.

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