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Voluntary Correction Program

How to correct 401(k) plan loan "failures"

"To err is human; to forgive is divine," as the familiar saying goes. But the IRS will forgive errors involving 401(k) plan loans only when you use the Voluntary Correction Program (VCP). Correcting your plan mistakes through the VCP preserves the plan's tax-favored status. One of the biggest areas that trip up plan sponsors is plan loans. There are three primary "failures" involving plan loans that require an IRS remedy: loan defaults, loans exceeding prescribed limits, and loan terms that exceed repayment limits.

1. Loan defaults

When a participant defaults on a plan loan, one of two things happens. The first (and least desirable for the participant) possible outcome is that the IRS treats the loan as a "deemed distribution." The participant must report the amount on IRS Form 1099-R. In addition, the IRS taxes the participant accordingly — including a 10% penalty if the participant is younger than 59½.

When a participant exceeds plan loan limits, the IRS permits correction if there's a payment to the plan based on the excess amount.

The preferable scenario is that the participant makes amends by repaying the owed interest and principal, or the plan reamortizes the loan within prescribed term limits. In either case, the plan will need to use the VCP process to notify the IRS.

2. Loans exceeding prescribed limits

When a participant exceeds plan loan limits, the IRS permits correction if there's a payment to the plan based on the excess amount. You can apply the payment one of three ways:

1. To interest on the excess so the participant repays only 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 equals the outstanding balance remaining on the original loan excess on the date that corrective repayment is made.

Avoiding the excess loan amount "failure" requires careful monitoring of loan activity, especially when participants take multiple loans. Plan participants can take a plan loan for the lesser of $50,000 or 50% of the participant's nonforfeitable account balance.

Accounting implications of a loan default

When a 401(k) participant defaults on a plan loan and is treated as having a deemed distribution, the plan must maintain two sets of records for a period of time under certain circumstances.

When a plan loan is secured by the participant's account balance, and/or the participant is not entitled to an in-service distribution, the recordkeeper cannot officially offset the loan before there's a distributable event. The loan continues to be considered a plan asset, and interest must continue to accrue, even though it will never be distributed.

Why? Because the participant's account balance, including any defaulted loans and accrued interest, is included with all other participants' accounts for purposes of top-heavy tests. The bottom line: Be sure to consult with an ERISA accounting expert in the event of a loan default.

However, when multiple loans are involved, the IRS reduces the $50,000 by the difference between the highest outstanding balance of all of the participant's loans during the 12-month period ending on the day before the new loan, and the outstanding balance of the participant's loans from the plan on the date of the new loan.

Let's look at an illustration furnished by the IRS: Joan has a vested account balance of $100,000 and took a plan loan of $40,000 on January 1, 2016, to be paid in 20 quarterly installments of $2,491. On January 1, 2017, when the outstanding balance is $33,322, Joan wants to take another plan loan. The 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. Because the new loan plus the outstanding loan cannot be more than $43,322 ($50,000 - $6,678), the maximum amount that the new loan can be is $10,000 ($43,322 - $33,322).

3. Loan terms that exceed repayment limits

The third common failure category is loans that fail to satisfy payment schedule requirements. Participants must pay off loans within five years, and make payments no less frequently than quarterly. The consequence of violating these limits is severe: The IRS treats the entire loan amount as a deemed distribution, including accrued interest.

The good news is that, if you use the VCP program, the participant might escape the penalty, if the error is recognized within five years after the loan's issuance. However, 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."

Making the correction

No matter which type of plan loan failure, you'll need to file the VCP's Form 8950 ("Application for Voluntary Correction Program (VCP)") and Form 8951 ("User Fee for Application for Voluntary Correction Program (VCP)") to make a correction. There's a user fee that is paid along with the submission that generally is determined based on the number of plan participants. Of course, it's better to not have the problem in the first place. Review your plan document's loan language and transactions with your employee benefits advisor. Better safe than sorry. □

Making age a factor in choosing QDIA options

Target date funds (TDFs), the most popular 401(k) qualified default investment alternative (QDIA), were designed to meet the investment needs of typical plan participants, no matter what their age. The theory is that employees can essentially "set it and forget it," as TDF portfolios are automatically adjusted from aggressive to more conservative as employees approach and proceed through retirement. That theory, however, has been challenged by research pointing to participants' failure to use TDFs as intended.

Out of balance

Because TDFs are designed to give retirement investors an appropriate asset allocation, in principle, plan participants may want to consider investing their entire portfolio in the age-appropriate TDFs. But research has demonstrated that participants often consider TDFs as a more singular investment that needs to be supplemented by other funds, to avoid "putting all their eggs in one basket."

That becomes a problem if, for example, 35-year-old participants whose optimum retirement portfolio allocation should be 80% stocks and 20% bonds have half of their retirement portfolio in a TDF with that allocation, and the remaining 50% in bond funds. The resulting aggregate picture would be a 40/60 stock/bond allocation.

How big a problem is this suboptimal use of TDFs? As long ago as 2009, the Employee Benefit Research Institute (EBRI) was raising concerns about the matter. The *EBRI Notes* publication it issued in December of that year called attention to an emerging "new class of 401(k) investor" that it dubbed the "mixed TDF investor." Its study concluded that "some mixed TDF investors apparently fail to understand either the purpose or the benefit of a TDF," which could result in "ending up with a potentially inferior portfolio."

The phenomenon can be blamed, to some extent, on inertia — when a TDF became available, participants who started contributing to it simply may have left their prior investments in place. Other research by Financial Engines (an investment management firm) has raised another concern: The same inertia that's fueling the "mixed TDF investor" phenomenon is keeping younger participants who began investing exclusively in a TDF from the start from ever considering other investment options several years down the road.

Age-based patterns

The study by Financial Engines found significant correlations between participant age and TDF investment patterns. Younger participants with smaller accounts are much more apt to have all their 401(k) assets in TDFs. This equals 10% of total plan assets. This means that 90% of defined contribution plan assets aren't

benefiting from use of TDFs, even with widespread default usage as a QDIA.

So why are participants moving out of TDFs or never investing fully in them to begin with? According to the research, participants are looking to diversify more than just their investments and seem to be seeking diversification among investment managers and among funds.

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This indicates something different from a lack of plan participant understanding of the principles of TDF investing that plan sponsors can remedy through a more robust education program. It points to the possibility of a design flaw that may limit TDFs' long-term ability to meet the needs of midcareer participants with average-size accounts.

While younger participants with small account balances may be well served by TDFs, older participants with more substantial account balances and complex financial situations might not be, due to the "one-size-fits-all" age-based structure of the typical TDF.

Managed accounts as QDIA

So how to use a QDIA for older participants? Managed accounts featuring participant access to professional investment advice and customized investment solutions could be more suitable for this group. Financial Engines, which is a provider of managed account funds, researched this question. Specifically, it compared investment results of TDFs with those of managed accounts, by five-year participant age brackets.

The study concluded that median returns from managed accounts and TDFs were the closest for the youngest and oldest participants, and the most divergent (with superior results for managed accounts) for participants in five-year age brackets between 35 and 55.

What's noteworthy about this finding is that employees in that 20-year middle age bracket generally have more dollars to contribute to a 401(k) plan than younger employees, and a greater time horizon before retirement than older employees. That means that achieving the best possible investment returns for that group will have the greatest impact on the ultimate size of their 401(k) portfolios at retirement.

What to do next

So what's the meaning of all this? This doesn't suggest that plan sponsors should rush out and reinvent their QDIA strategy. However, it does raise questions about whether the category of QDIAs should be uniform across all participant age brackets. Talk with your employee benefits specialist and financial advisor to learn more. ☐

Compliance Alert

Upcoming compliance deadlines:

9/15 Extended deadline for corporate tax returns

9/15 Extended deadline for partnership tax returns

9/30* Summary Annual Report (SAR) due for Form 5500 that was due July 31, unless extension was granted (for returns extended to October 15, SAR deadline is December 15)

** This date falls on a Saturday. Historically, the IRS has not extended this deadline.*

Active vs. passive investment funds: Should you let participants decide?

According to a report from Casey Quirk by Deloitte and McLagan, 72% of money invested into funds went into passive funds in 2015. While some may see this as a strong case for passive investing, the issue for plan sponsors isn't clear-cut.

Trending passive

Active investing attempts to outperform the stock market, while passive investing involves investing in the same securities in the same proportions as an index like the S&P 500 or Dow Jones Industrial Average. Passive investment portfolio managers don't make decisions about which securities to buy and sell.

Over the past 20-plus years, the trend has shown an increase toward passive investment strategies. In every year since 1993, there has been a net inflow of dollars to passive mutual funds and exchange-traded funds. In contrast, every year since 2006, there has been a net outflow of dollars from actively managed funds.

What's the explanation for this trend? The biggest driver seems to be the growing recognition that market averages — particularly for large cap, heavily traded and researched stocks — are tough to beat.

Outperforming the indexes

A *Wall Street Journal* article last year brought this point home in a chart highlighting the percentage of actively managed U.S. large company mutual funds that beat the S&P 500 Index over various time spans. The chart summarized 1, 3, 5, 10, 15, 20 and 25 years, ending on June 30, 2016. In only the 10-year time segment did the percentage of actively managed funds outperform the S&P 500 by more than 30%. Over the other time periods, the proportion of actively managed funds that outperformed the stock market ranged from around 11% to 25%.

In another telling data set, of the 20 best-performing (relative to their peers) actively managed U.S. stock funds over the 10-year period ending on December 31, 2005, only seven beat the average performer in the subsequent decade.

Fighting the odds

In the face of this data, why include actively managed stock funds (in addition to passive funds) in your retirement plan's investment lineup? For starters, you're providing choice based on participants' risk tolerance, investment objectives and investment strategies to meet the perceived needs of plan participants. As the *Journal* stated in its compilation of performance data, "The prospect of beating the market — and maximizing your investment potential — is a tantalizing one."

If some participants are willing to fight the odds against superior returns with an active manager, is it a fiduciary's place to deny them that opportunity? Not necessarily, assuming you've carefully researched the actively managed fund or funds you select, and you provide participants with sufficient information to make an informed choice. Participants who consider themselves astute investors might put more in their 401(k) account than they otherwise would have if given the choice of some active funds.

Another reason for possibly including actively managed funds is that, in a down market, passive funds will suffer the same fate as the market, while active funds can cushion the blow by moving to cash. In addition,

in niche stock sectors where stocks are more illiquid and fewer analysts are paying attention, managers of actively managed funds may find good investments.

Getting it right

In addition to monitoring the performance of your plan's funds, keep an eye on how your participants allocate their retirement dollars. If you do offer volatile actively managed funds and a significant proportion of participants appear to be taking on greater risk than might be appropriate, step up investment education programs to equip risk-takers to consider their investment strategy. ◻

Consider your options with nonvested participant forfeitures

Employee benefit plans provide a combination of vested and nonvested assets. When employees leave a company before their matching 401(k) contributions have vested, they forfeit those amounts.

As a plan sponsor, you have four choices regarding what to do with forfeited dollars:

1. Use them to offset plan expenses.
2. Tap them to offset amounts needed for matching contributions for active participants.
3. Reallocate them evenly among active participants.
4. Return forfeited funds to former plan participants who rejoin the plan.

Many plan documents provide that forfeitures are first used to offset employer contributions, with any remainder used to pay expenses. The document will also state when these forfeitures are allocated, so it's important that you follow the plan document. You can't let these amounts accumulate indefinitely. The IRS has shown in recent audits that it doesn't tolerate that practice.

What does your plan document say?

Your plan document should describe your forfeiture policy. However, sometimes plan administrators don't review their plan documents and thus handle forfeitures inconsistently. Be sure that your administrative practice is in keeping with your plan document.

It's possible that, when you started the plan, you didn't give much consideration to the forfeiture options. You may have used some boilerplate language. So when you check your document, think about whether it's consistent with your current philosophy and practical needs.

For example, if you currently distribute forfeitures among active participants but are looking for ways to lower plan expenses, you might amend your plan document to use forfeitures to offset plan fees.

How do you define forfeiture?

Another important policy decision is defining the timing of forfeiture. Generally, it occurs immediately following a participant's separation of service. Again, the plan document will state when the forfeiture will occur. The key is to administer the plan according to its terms. A violation of the terms may jeopardize the plan's qualified status. However, the IRS's correction program is available when errors occur. ◻

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The solution for skyrocketing audit fees

Finding ways to cut costs while maintaining quality seems to be at the top of every executives to do list. As the person responsible for your organization's employee benefit plan audit, we can help you not only reduce your audit costs but also provide a higher level of service.

Pension auditors must sift through enormous amounts of financial data in accordance with the requirements of numerous laws, regulations and professional standards. If they don't know what they're doing, they can easily get lost in the numbers, run up large fees and fail to provide an accurate assessment of a plan's financial status.

Pension audit specialists

Insero & Co. specializes in pension plan audits. Our professionals have extensive experience in this area and to ensure that our audits meet the highest standards of quality, our firm is a member of the American Institute of Certified Public Accountants (AICPA) Employee Benefit Plan Audit Quality Center and is registered with the Public Company Accounting Oversight Board (PCAOB).

Insero & Co. is the independent registered public accounting firm for many companies that file a form 11-K with the Securities and Exchange Commission. We currently perform audits for more than 150 plans ranging in size from 100 to 60,000 participants, and from $1 million to more than $10 billion in assets.

Big firm capabilities, small firm attentiveness

As our many satisfied clients will testify, we offer the comprehensive benefit services of a large national firm, but at less cost and with a higher level of service. With more than 125 accountants, professional consultants and support staff, our firm is large enough to bring robust resources to bear on almost every client need, yet small enough to provide the personal attention and relationship-based service that is important to our clients.

The culture of Insero & Co. is hands-on and proactive, shaped by the old-fashioned notion of doing what is in the best interest of the client. In addition to pension and corporate audits, we provide a full range of tax, accounting and consulting services, including internal audit/Sarbanes-Oxley services, outsourced accounting and wealth management.

Go with the experts

We would welcome the opportunity to discuss your audit or other needs and put our expertise to work for you. Please contact Vince Leo at 585-697-9683 or Mike Giess at 585-697-9639 and let us know how we can be of service.

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