

MEMO# 12435

August 2, 2000

IRS RELEASES FINAL AND PROPOSED PLAN LOAN REGULATIONS

[12435] August 2, 2000 TO: PENSION MEMBERS No. 41-00 PENSION OPERATIONS ADVISORY COMMITTEE No. 59-00 RE: IRS RELEASES FINAL AND PROPOSED PLAN LOAN REGULATIONS

The Internal Revenue Service has issued final and proposed regulations regarding the tax treatment of loans from qualified employer plans to plan participants. The final regulations adopt, with modifications, proposed regulations published in December, 1995¹ and January, 1998.² The proposed regulations address loan repayment obligations during periods of military service and the tax treatment of refinancing and multiple loans to participants. Final Regulations Section 72(p) of the Internal Revenue Code provides that an amount received as a loan from a qualified employer plan by a participant is treated as a deemed distribution from the plan for purposes of section 72, except where certain conditions, set forth at section 72(p)(2), are satisfied. The final regulations clarify the statutory requirements by specifying certain terms that must be included in a loan agreement, identifying situations in which a loan is deemed distributed, and clarifying the tax treatment of outstanding loan amounts in the event a deemed distribution occurs. Terms and Formation of Loan Agreement, Including Electronically. The final regulations retain the proposed rule requirement that a loan, to avoid being treated as a deemed distribution, be evidenced by a legally enforceable agreement either in writing or in another form approved by the IRS. The final regulations, however, also specifically permit an electronic medium to be used for a loan agreement, as long as standards set forth in the regulation are satisfied. See Q&A-3 of the final regulations. These standards are identical to those set forth in recent IRS guidance for an electronically delivered consent to a distribution under section 1.411(a)-11(f)(2).³ The final regulations also clarify that as long as a signature is not required in order for the loan to be enforceable under applicable law, the agreement need not be signed. 1 See Institute Memorandum to Pension Members No. 2-96, dated January 11, 1996. 2 See Institute Memorandum to Pension Members No. 2-98, dated January 12, 1998. 3 See Institute Memorandum to Pension Members No. 14-00, Pension Operations Advisory Committee No. 13-00, Operations Committee No. 4-00, Tax Committee No. 6-00, and Transfer Agent Advisory Committee No. 10-00, dated February 15, 2000, for a description of this IRS guidance. 2Determination of Deemed Distribution. Under the final regulations, a deemed distribution occurs at the first time that the loan fails to satisfy the requirements for a loan agreement or loan repayment that are set forth at Q&A-3. The regulations set forth numerous examples of when these requirements are not satisfied. See Q&A-4; see also Q&A-10 regarding deemed distributions resulting from failure to make loan payments. "Cure Periods" For Payment Default. The final regulations require that repayment of a plan loan be made in substantially level installments made not less than quarterly over the term of the loan. Under the regulations, a plan administrator may provide a "cure period" for late payment of installments; the loan would not be treated as

in default if payments are made by the end of the cure period. The cure period, however, may not continue beyond the last day of the calendar quarter following the quarter in which the required installment payment is due. See Q&A-10.4 Tax Treatment of Defaulted Loans That Are Deemed Distributions. Under the final regulations, a deemed distribution generally is treated as a distribution for tax purposes (e.g., for purposes of applying section 72(e) rules to determine tax basis and imposing the section 72(t) tax on early distributions). The regulations clarify, however, that a deemed distribution is not treated as an actual distribution for purposes of the section 401 qualification requirements, the section 402 distribution provisions, the sections 401(k)(2)(B) and 403(b)(11) distribution restrictions, or section 1.411(a)-7(d)(5) vesting requirements. See Q&A-11 and 12. The final regulations also adopt the proposed regulations' rules on the noninclusion in income of interest accruing on a loan after it is deemed to be a distribution, see Q&A -19; clarify the tax treatment of "plan loan offset amounts," see Q&A-13; and address the treatment of loan repayments made after the deemed distribution of a loan, see Q&A-21. Effective Date. The final regulations apply to plan loans made on or after January 1, 2002. However, a plan is permitted to apply the rules relating to interest accruing after a deemed distribution, see Q&A-19, and those relating to basis resulting from repayments after a deemed distribution, see Q&A-20, to loans made before January 1, 2000 if specific circumstances, set forth at Q&A-22, are satisfied. Proposed Regulations The proposed regulations address (1) the suspension of loan repayments for periods during which a participant is performing military service and (2) the tax treatment of refinancing and multiple loan arrangements to a participant. With respect to military service, the proposed regulations would clarify that, under section 414(u)(4), if a plan provides for the suspension of a participant's obligation to repay a loan during a period of military service, the suspension will not cause the loan to be deemed distributed, even if the leave exceeds one year, as long as the loan repayments are resumed upon the completion of such service. With respect to situations in which a loan is refinanced or more than one loan is made, the proposed regulations provide the following. First, if a loan is deemed distributed and has not been repaid, then no payment made to the participant will be treated as a loan under section 72(p)(2) unless there is an enforceable arrangement under which repayments will be made by payroll withholding, or the plan 4 Commentators asked the Service to clarify how to implement this cure period and requested that the final regulations enable plan administrators to grant a participant a reasonable period of time to cure a default in loan repayment. Although the Service rejected these requests, it has included in its examples situations which involve cure periods. 3receives adequate security for the additional loan that is in addition to the participant's accrued benefit under the plan. Second, while a loan may be refinanced and additional amounts borrowed, the requirements of section 72(p)(2)(B) and (C), requiring that each loan be repaid in level installments not less often than quarterly over five years, must be satisfied for each loan. Furthermore, the amount limitations of section 72(p)(2)(A) apply to the amount of the outstanding loan plus the new loan; if the limitations are exceeded, a deemed distribution would result. However, the proposed regulations provide that if the new loan is a refinancing in which the prior loan is repaid by the original repayment date of the prior loan, the prior loan amount would not be considered when applying the section 72(p)(2)(A) amount limitations. Finally, to avoid abuses of the proposed multiple loan and refinancing rules, the number of such loans that may be made available to a participant would be limited. Specifically, a loan would be deemed distributed if two or more loans were previously been made from the plan to the participant during the year. Requests For Comment The Service requests comments on the effect of the Electronic Signatures in Global and National Commerce Act⁵ on the final regulations and on any guidance needed to apply the Act to plan loan transactions. The Service also requests comments on the proposed regulations. Comments are due by October 31, 2000. Russell G.

Galer Senior Counsel Attachments Note: Not all recipients receive the attachments. To obtain copies of the attachments to which this memo refers, please call the ICI Library at (202) 326-8304 and request the attachments for memo 12435. ICI Members may retrieve this memo and its attachments from ICINet (<http://members.ici.org>). Attachment no. 1 (in .pdf format) 5 See Institute Memorandum to Pension Members No. 39-00, Pension Operations Advisory Committee No. 56-00, SEC Rules Members No. 54-00, Tax Members No. 22-00 and Electronic Commerce Advisory Committee No. 5-00, dated July 28, 2000, for a discussion of the legislation.

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