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Participant Loans: A Road Map for Practitioners

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The ability of participants in qualified plans, especially Section 401(k) plans, to obtain loans from such plans is responsible in no small way for the popularity of the plans and the increased participation of employees in such plans. Plan loans, however, are subject to a very specific set of rules, which, if not followed, may subject such loans to income and penalty taxes. Specifically, such loans must comply with the conditions set forth in Section 408(b)(1) of the Employee Retirement Income Security Act of 1974, as amended (ERISA), and Section 72(p) of the Internal Revenue Code of 1986, as amended (Code). If these conditions are not met, loans to plan participants may be prohibited transactions under ERISA, may violate the "anti-alienation" rules of ERISA and the Code and may be deemed to be taxable distributions to the participants who received the loans. This article attempts to chart the course that must be followed so that unintended consequences are avoided.

Part I examines the prohibited transaction rules of ERISA § 408. Part II examines the taxable distribution rules of Code § 72(p), as well as issues relating to deemed distributions and foreclosures. Other miscellaneous issues are examined in Part III.

PART I—PROHIBITED TRANSACTION STATUTORY EXEMPTION

Generally

Loans from a plan to a participant are prohibited extensions of credit from the plan to a party in interest unless the requirements of the statutory exemption of ERISA § 408(b)(1) and Code § 4975(d)(1) are met.[1] The requirements of Code § 4975(d)(1) also must be met in order that the loan not violate the anti-assignment rule of Code § 401(a)(13) and ERISA § 206(d).

The conditions of this statutory prohibited transaction exemption of ERISA § 408(b)(1) and Code § 4975(d)(1) are that the loans must:

1. Be available to all participants and beneficiaries on a reasonably equivalent basis;
2. Not be available to highly compensated employees in an amount greater than to other employees;
3. Be made in accordance with the loan provisions set forth in the plan;
4. Bear a reasonable rate of interest; and
5. Be adequately secured.[2]

In addition, Department of Labor (DOL) regulations require that the loan program be legitimate.[3]

Requirement of Plan-Wide Availability on a Reasonably Equivalent Basis

General. The loans must be available to all participants and beneficiaries on a reasonably equivalent basis.[4] To meet this requirement: (1) the loans must be available without regard to race, religion, gender, etc.; (2) consideration must be given only to factors that would be considered in normal commercial circumstances by an entity in the business of making similar types of loans, including, for example, the creditworthiness and financial need of the applicant; and (3) the loans in actual practice must not be unreasonably withheld from any applicant.[5]

Availability May Be Limited to Parties in Interest. The DOL takes the position that the plan-wide availability requirement is required only with respect to parties in interest, and that a plan may limit loans to parties in interest.[6] Active employees of the sponsoring employer are all parties in interest. Former employees typically are not parties in interest, but certain former employees by reason of some other relationship to the company or plan may be parties in interest.[7] A plan could therefore not exclude all former participants where some are parties in interest.

A plan provision permitting loans is a benefit, right, or feature subject to the nondiscriminatory availability test of Treas. Reg. § 1.401(a)(4)-4. Most loan programs easily meet this rule for active employees. However, because plan loans are only required to be made available to those former employees who also are parties in interest, the potential for discrimination with respect to former employees in favor of highly compensated former employees is greater. In recognition of this problem, the Section 401(a)(4) regulations provide that former employees who are parties in interest may be treated as active employees.[8]

Minimum Loan Amounts. Minimum loan amounts of up to $1,000 may be established without violating the reasonably equivalent basis requirement.[9]

Other Restrictions Allowed. A plan is allowed to limit the availability of loans to specific purposes such as hardship, college tuition, home purchases, etc., provided that loans continue to be made available to participants and beneficiaries on a reasonably equivalent basis.[10]

Loans to Particular Bargaining Unit Employees. A plan whose participants are members in several unions and makes a loan feature available only as their collective bargaining agreements are renegotiated would not violate the reasonably equivalent requirement, if within a reasonable time period all bargaining units approve the loan feature.[11]

Prohibited Loans to Executive Officers Under Sarbanes Oxley Act. The Sarbanes Oxley Act of 2002 prohibits loans to directors or executive officers. There is no clear authority as to whether the Sarbanes Oxley Act of 2002 prohibition on loans to executive officers would apply to 401(k) plan loans, as extensions or arrangements of credit by the issuer. A joint memo by 25 law firms "Interpretive Issues Under § 402—Prohibition on Certain Insider Loans," (Oct. 15, 2002) argued that 401(k) loans should be permitted, since the officer is effectively borrowing from himself and the loan is from the plan rather than the issuer, but there has been no SEC guidance on the matter. The DOL in a field assistant bulletin has held that possible restrictions on loans to officers and directors under the Sarbanes Oxley Act would not cause a plan to violate the reasonably equivalent basis rule for participant loans under ERISA § 408(b)(1)(A).[12]

Loan Fees. The preamble to the DOL regulations makes it clear that fees may be charged to cover the administrative cost of making loans.[13]

Requirement That Loans Not Be More Available to Highly Compensated Employees than to Other Employees

The loans may not be available to highly compensated employees[14] in an amount greater than to other employees.[15] To meet this requirement, it must be determined upon consideration of the facts and circumstances that the program does not operate to exclude large numbers of participants from receiving loans. A loan program will not fail because it limits loans to a maximum dollar amount or to a maximum percentage of a participant's vested accrued benefit, despite the fact that under a percentage limit the maximum loan amount will vary with the size of the participant's accrued benefit.[16]

Requirement That the Plan Document Specifically Permit Loans

General. The loans must be made in accordance with loan provisions set forth in the plan.[17] Regulations provide that plan provisions must contain explicit authorization for the establishment of a loan program.[18] In addition, the plan document or a written document forming part of the plan must include: (1) the identity of the person or position authorized to administer the loan program; (2) a procedure for applying for loans; (3) the basis on which loans will be approved or denied; (4) limitations (if any) on the type of loans offered; (5) the procedure for determining a reasonable rate of interest; (6) the types of collateral that may secure the loan; and (7) the events constituting default and the steps that will be taken to preserve plan assets in the event of such default.[19]

Summary Plan Description (SPD). The enumerated items described in the preceding paragraph affect the rights and obligations of participants and therefore must be set forth in a plan's SPD.[20] The preamble to the final regulations notes that the SPD alone can satisfy the plan provision requirement if it contains the required loan provisions and is a document forming part of the plan.[21]

Loan Documentation. Typically, loan documents will include the plan loan provisions (contained in the plan or SPD), loan application guidelines, a loan application, a loan disclosure statement, and a promissory note and security agreement.

Requirement of a Reasonable Interest Rate

General. The loans must bear a reasonable rate of interest.[22] To meet this requirement, the loan must provide the plan with a return commensurate with the interest rates charged by persons in the business of lending money for loans that would be made under similar circumstances.[23] A strict reading of the regulations may require different interest rates depending on each participant's creditworthiness.[24] Thus, if local banks would lend the participant, taking into account his or her creditworthiness and the collateral offered, at a fixed rate of 12 percent, a plan that loaned at 8 percent would not be charging a reasonable rate of interest and would not be entitled to the relief provided by ERISA § 408(b)(1).[25]

State Usury Laws Not Relevant. State usury laws may not be used to justify a low rate of interest.[26]

Rates of Interest Commonly Used. Some courts have analyzed reasonable interest taking into account that the loan is a compensating balance loan with the loan secured by a sum of money deposited by the borrower with the lender, and therefore, according to expert testimony cited in one case, a rate of one or two percent above the certificate of deposit rate would be reasonable. [27] Many plans have been charging the prime interest rate plus 1 or 2 percentage points. However, because the prime rate in recent years has been low, IRS officials have indicated at a 2011 phone forum that prime plus 2 percent is currently what the IRS deems to be a reasonable rate of interest.[28] Other plans charge the prevailing rate for home equity loans.

Rates for Loan Renewals. When a loan is subject to renewal, the prevailing market rate at the time of renewal must be charged.[29]

Fixed Versus Adjustable Rates. Most plans charge a fixed interest rate for the loan for administrative convenience, although adjustable rates also are permitted.

Requirement of Adequate Security

Security That Can Be Foreclosed with "No Loss." The loans must be adequately secured.[30] To meet this requirement, the security posted must be: (1) something more than a mere promise to pay; (2) capable of being foreclosed on or otherwise disposed of in the event of default in an amount equal to the amount due; and (3) of such value and liquidity that it is reasonably anticipated that there will be no loss of principal or interest.[31]

Use of 50 Percent of Participant's Vested Accrued Benefit as Security. A participant's vested accrued benefit may be adequate security, but only up to 50 percent of such benefit may be so utilized.[32]

Spousal Consent. Because foreclosure of a plan loan is treated as a distribution, spousal consent to waive the qualified joint and survivor annuity requirement, where applicable, must be obtained. Spousal consent rules apply mainly to defined benefit plans (and money purchase pension plans).[33] The spousal consent rules can be met by obtaining spousal consent to the loan and foreclosure not more than 90 days before the date the loan is made.[34] The adequate security requirement of ERISA § 408(b)(1) may require that spousal consent be obtained at the time a loan is made from a plan subject to the spousal consent rules.[35]

Mortgage Loans. Code § 72(p)(3) provides that an interest deduction may not be taken with respect to a plan loan if it is: (i) made to a key employee (as defined in Code § 416(i)), or (ii) secured by the participant's Section 401(k) elective deferrals. If a loan to a non-key employee is secured by the participant's principal residence (*i.e.*, a mortgage) rather than by his or her Section 401(k) account, the mortgage interest deduction would be allowed.[36]

In certain limited circumstances, plans that have investment programs making mortgages available to individuals including plan participants will not be subject to the limits of Code § 72(p) with respect to the participant loans.[37]

Source of Loan Proceeds. Typically, participant loans from defined contribution plans are taken directly from the participant's account. Often a special loan subaccount is created.[38] The loan then becomes an investment of the individual account but not of the entire plan. Under another method most commonly used by plans that do not have individual accounts, the participant borrows from the plan as a whole and, as the loan principal and interest are repaid, they accrue to the entire plan rather than to the participant's account. The loan is then considered a general investment of the entire plan.

Impact of Source of Collateral on "No Loss" Rule. Where a loan is treated as an investment attributable solely to the participant's account, the adequate security requirement will be met and the "no loss" rule satisfied even if the security interest cannot be immediately foreclosed on (*e.g.*, because of "in-service distribution" restrictions).[39] However, if the loan investment is allocated to the plan as a whole, the preamble to the 1989 DOL regulations states that the security of the accrued benefit may not be sufficient without some additional security, such as mandatory payroll deduction or discounting the value of the vested accrued benefit to take into account the time delay between any possible default and the first distributable event with respect to the borrowing participant's account.[40]

Legitimacy Requirement.

DOL regulations provide that to meet the requirements of ERISA § 408(b), there must be a legitimate loan program that is administered by the fiduciary primarily in the interest of participants.[41] The legitimacy of a loan program will be determined by consideration of all facts and circumstances.[42] Where there is, for example, no intention that the loan be repaid by the participant, the loan is not exempt. Likewise, a loan program designed to benefit a party in interest other than a participant is not exempt.[43]

PART II—CODE RULES TO PREVENT TAXABLE DISTRIBUTIONS; DISTRIBUTION VERSUS FORECLOSURE CODE § 72(P) GENERALLY

Code § 72(p) provides that loans to participants or beneficiaries from a qualified plan (*i.e.*, under Code §§ 401(a), 403(a), or 403(b)) will be treated as taxable distributions from the plan,[44] unless:

1. The loan does not exceed statutory dollar limit or percentage limit;
2. The loan requires repayment within 5 years (or a longer period if the loan is used to acquire a principal residence);
3. The loan requires substantially level amortization over its term; and
4. The loan is evidenced by a legally enforceable agreement in writing or acceptable electronic medium.[45]

Plans that May Offer Loans

Plans that may offer loans include: (i) qualified plans under Code § 401(a); (ii) Code § 403(a) and Code § 403(b) annuity plans; and (iii) governmental 457 plans.[46] However, loans cannot be taken from Individual Retirement Accounts (IRAs) or Simple Employee Pensions (SEPs).

Requirement That the Loan Be Limited in Amount

General. The statutory requirement is that the total of all outstanding loans of the participant from the plan[47] may not exceed the lesser of:

1. $50,000 reduced by the excess, if any, of (A) the highest outstanding balance of loans during the one-year period ending on the day before the date of the loan, over (B) the outstanding balance of loans from the plan on the date the loan is made;[48] or
2. the greater of (A) one-half the present value of the participant's nonforfeitable accrued benefit, or (B) $10,000.[49]

$10,000 Minimum Not Typically Relevant. Despite the statutory authority to do so, plans do not typically provide that a participant may borrow $10,000 regardless of the size of his or her nonforfeitable accrued benefit, because the ERISA adequate security requirement,[50] discussed in Part I above, precludes plans from considering more than 50 percent of the participant's vested accrued benefit as collateral, and would require additional collateral. For example, a vested accrued benefit of $18,000 would not be adequate security for a $10,000 loan.

$50,000 Limit May Be Restated in Simpler Way. The complex statutory formulation of the $50,000 prong of the loan limit may be more simply stated: the maximum amount of any individual new loan is limited to $50,000 reduced by the highest outstanding balance of loan(s) during the one-year period before the new loan is made.[51]

For example, if the highest outstanding balance on prior plan loans of a participant during the preceding year is $25,000, and the outstanding balance of prior loans immediately before taking the new loan is $15,000, the maximum aggregate loan balance the participant may have (under the statutory formulation) cannot exceed $50,000 reduced by $10,000 (the excess of $25,000 over $15,000), or $40,000. Since the $15,000 prior loan is still outstanding, the maximum new loan cannot exceed $25,000. The same result is reached by simply limiting the new loan itself to $50,000 minus the highest outstanding loan balance during the preceding year ($50,000 minus $25,000).

The 50 percent of vested accrued benefit limit of Code § 72(p)(2)(A) must still be met on an aggregate basis for all loans from controlled group plans, and cannot be simplified in the above manner.

Loan Considered Outstanding for Maximum Permitted Amount After Deemed Distribution and Additional Security for Subsequent Loans. For purposes of calculating the maximum permitted amount of a subsequent loan under Code § 72(p)(2)(A), a loan that has been deemed distributed under Section 72(p) and has not been repaid (such as by plan loan offset) is still considered outstanding until the loan obligation has been satisfied for purposes of determining the maximum amount of any subsequent loan to the participant.[52]

As amended in December 2002, regulations provide that if a loan is deemed distributed to a participant and has not been repaid (such as by plan loan offset), then no payment made thereafter to the participant will be treated as a loan for purposes of Section 72(p)(2), unless there is an enforceable arrangement among the plan, participant, and employer, under which repayments will be made by payroll withholding or the plan receives adequate security in addition to the participant's accrued benefit for the additional loan. [53]

Frequency of Loans. Some plans provide that no more than one loan may be outstanding at any time. Others provide for waiting periods between loans.[54]

Requirement That the Loan Be Repaid within Five Years

General. A loan by its terms must require repayment within five years.[55] If the loan is not required to be repaid within five years, it is an immediate taxable distribution. In addition, if a loan providing for repayment over five years is not repaid during such period, the amount remaining payable at the end of the five years is a taxable distribution.[56] If there are required periodic payments, the first of which is due to be made within two months of the date the loan was made, legislative history indicates that the five-year repayment period will be measured from the due date of that first payment, but some practitioners recommend amortization over 59 months in such cases.[57]

Principal Residence Loans. Loans used to acquire a principal residence are an exception to the five-year repayment requirement.[58] Nonetheless, plans typically do impose some limit on principal residence loans, such as 10, 15, or 20 years. A principal residence loan that is for a significantly longer period than the period under commercially available loans (*e.g.*, longer than 30 years) may not be permissible.[59]

A principal residence has the same meaning as under Code § 121 (relating to exclusion of gain from sale of principal residence).[60] There is no requirement that it be a principal residence for any specific period of time.[61] Tracing rules similar to those applicable under Code § 163(h)(3)(B) (relating to the deduction for home acquisition indebtedness) apply.[62] Refinancings do not qualify as principal residence loans, although a plan loan that would otherwise qualify may be used to repay a bank loan.[63]

Requirement of Level Amortization

General. Substantially level amortization over the term of the loan is required, and participants must make payments no less frequently than quarterly.[64]

Payroll Deductions and Written or Electronic Authorizations. Most plans provide for loan repayment by payroll deduction. Some state wage-and-hour laws require that payroll deductions be in writing. These laws, however, may be preempted by ERISA. For example, a 1994 DOL Advisory Opinion held that a New York Law requiring written authorization for payroll deductions, is preempted by ERISA to the extent it prevents a plan from implementing a salary reduction arrangement by a telephone voice response system.[65] Similarly, a 1996 DOL Advisory Opinion held that ERISA preempts a Puerto Rico law that allows authorized payroll deductions only for contributions to pension plans and not for loans.[66]

Cessation of Payments during Leave of Absence. The level amortization requirement will not be violated if repayments cease while an employee is on a leave of absence for a period of up to one year.[67] However, the loan (plus interest accruing during the leave of absence) must still be paid within the original five-year period, and therefore when the employee returns to work an accelerated payment schedule or a lump sum repayment at the end of the five year period would be necessary.[68] If repayments cease while an employee is on a military leave of absence even for a period beyond one year as permitted under Code § 414(u)(4), the suspension will not cause the loan to be deemed distributed, as long as loan repayments resume upon the completion of the military service, the amount then remaining due on the loan is repaid in substantially level installments thereafter, and the loan is fully repaid by the latest permissible term of a loan (five years for a non-principal residence loan) plus the period of the military service.[69]

Level Amortization in Loan Refinancings. Regulations as added in 2002 provide that while a loan can be refinanced and additional amounts may be borrowed, the prior loan and additional loan must each satisfy the requirements in Section 72(p)(2)(B) and Section 72(p)(2)(C) that each loan be repaid in level installments, not less often than quarterly, over five years.[70] The loans collectively must satisfy the amount limitations of Section 72(p)(2)(A). A refinancing is, in effect, treated as a new loan that is then applied to repay a prior loan if the new loan both replaces a prior loan and has a later repayment date. This rule does not apply to a refinancing loan under which the amount of the prior loan is to be repaid by the original repayment date of the prior loan.[71]

Regulatory Requirement of an Enforceable Agreement in Writing or Electronically

The Treasury regulations impose an additional requirement in order to avoid a deemed distribution under Code § 72(p): the loan must be evidenced by a legally enforceable agreement (which may include more than one document), and the terms of the agreement must demonstrate compliance with the requirements of Code § 72(p) (specifying the amount of the loan, the date of the loan and the repayment schedule in accordance with the rules of Section 72(p)).[72]

Regulations issued in 2000 provide that the loan agreement must be in a written enforceable agreement or in an electronic medium reasonably accessible to the participant under a system (i) reasonably designed to preclude anyone other than the participant from requesting a loan, (ii) that provides a reasonable opportunity to review the terms of the loan and to confirm, modify or rescind the terms of the loan, and (iii) that provides a confirmation of the loan terms through a written document or an electronic medium.[73] If an electronic medium is used to provide confirmation of the loan terms, it must be reasonably accessible and must be provided in a manner no less understandable than a written paper document. Also, the participant must be advised of the right to receive a copy of the confirmation on a written document without charge.[74] The regulations provide that the loan agreement does not have to be signed if the agreement is enforceable under applicable law without signature.[75]

The IRS has indicated that a Plan sponsor should maintain the loan application, executed promissory note, proof that loan proceeds were used to purchase or construct a primary residence (if applicable), proof of loan repayments, in the event of default, proof of collection activities, and if there is a deemed distribution on Form 1099-R.[76]

Consequences of Violating Code § 72(p)

Violation in Form or in Operation. A deemed distribution will occur when the requirements of Code § 72(p) are not satisfied in form or in operation.[77]

Deemed Distribution at Time Loan Is Made.[78] If the terms of the loan do not require repayment within five years and level amortization or are not evidenced by an enforceable agreement in accordance with Section 72(p) and the regulations, the entire amount of the loan is deemed distributed at the time the loan is made. If the terms of the loan merely fail to satisfy the amount requirement of Section 72(p)(2)(A), only the amount in excess of the permissible loan amount is a deemed distribution at the time the loan is made.

Later Deemed Distribution for Not Making Level Installment Payments. If the loan initially satisfies the requirements of Code § 72(p), but repayments are not being made in accordance with the level amortization requirement of Code § 72(p)(2)(C), a deemed distribution occurs at the time of such failure.[79] However, the plan administrator may allow a cure period extending up to the end of the calendar quarter following the calendar quarter in which the required installment payment was due and not made. Such cure period given by the plan administrator will avoid a deemed taxable distribution until the end of the grace period.[80] If the installment payment is not made before the expiration of the cure period, the entire outstanding balance of the loan (including accrued interest) will be a deemed distribution.[81] Chief Counsel Advice 201736022 provides two examples of failures to make loan payments under a qualified plan that were timely corrected, so that a loan default was avoided, and the loan was deemed to be satisfactorily reinstated.[82]

Case-Law Regarding Deemed Distributions for Not Making Timely Payments. There are various cases regarding deemed distribution under Code § 72(p) with income tax and Code § 72(t) early distribution tax for failure to make timely payments on participant loans. [83] Several cases have held that failure to provide documentary evidence of the loan would result in a deemed distribution with ordinary income (and a 10 percent early distribution tax). [84]

Interest on Loan Not Included in Income. Interest that accrues after a deemed distribution under Code § 72(p) is not included for purposes of Code § 72, and therefore the additional interest is not treated as an additional loan and does not result in an additional deemed distribution under Code § 72(p).[85]

Section 72(t) Tax. When there is a deemed distribution of a plan loan, in addition to the income tax under Section 72(p) there will also be a 10 percent Code § 72(t) early distribution tax if the deemed distribution occurs prior to age 59-1/2.[86]

Tax Reporting. Any deemed distribution under Code § 72(p) must be reported on IRS Form 1099-R.[87]

Distinction between Taxable Deemed Distribution and Foreclosure

A Taxable Deemed Distribution Is Not Necessarily an Actual Distribution. Even if Code § 72(p) is violated and there is a deemed taxable distribution under Code § 72(p), such distribution is not treated as an actual distribution for purposes of the in-service distribution restrictions under Section 401 regulations for money purchase plans, the eligible rollover distribution rules of Code § 402, the in-service distribution restrictions of Code § 401(k)(2)(B), or the vesting requirements of Treas. Reg. § 1.411(a)-7(d)(5) (regarding graded vesting schedule where prior distribution occurred).[88] Thus, it is possible to be taxed on the deemed distribution at an earlier time than the actual distribution. A deemed distribution will therefore not be considered an in-service distribution or an eligible rollover distribution. After a taxable deemed distribution occurs, the participant may still want to repay the loan, in order, for example, to be able to take a new plan loan.

A Plan Loan Offset (But Not a Default Alone) Is Treated as an Actual Distribution. The regulations provide that an actual distribution occurs when, under the terms governing the plan loan, the accrued benefit of the participant is reduced (offset) in order to repay the loan.[89] This might occur, for example, where the terms governing the plan loan require that if a participant requests a distribution, a loan must be repaid immediately or treated as in default. A distributable event under the plan, e.g., age 59-1/2 or severance from employment, may be required to offset the loan. The amount of the account balance that is used to offset the loan is treated as an actual distribution. On the other hand, an event of default under the loan documents without an actual offset does not automatically cause there to be a Code § 72(p) taxable event.

Plan loan procedures may provide for offset for failure to make payments when due if a distribution is permitted. Other common offset triggers are termination of employment or termination of the plan.[90]

Foreclosure Should Be Avoided if Restrictions on In-Service Distributions Apply. Restrictions on in-service distributions (*e.g.*, under Code § 401(k)(2)(B)) are violated if foreclosure occurs and the participant's accrued benefit is offset by the loan amount.[91] (The same should apply with respect to the Code § 72(t) 10 percent penalty tax on early distributions.) A taxable distribution under Section 72(p) by itself, however, is not considered an in-service distribution, as stated above.

Coordination of Foreclosure with Requirement of Participant Consent to Actual Distributions. Plan distributions in excess of $5,000 require a participant's consent under Code § 411(a)(11). Thus, plan loan documents should provide that the participant consents both to the taking of the loan and to a foreclosure in the event of a default.

Coordination with Spousal Consent Requirements. To foreclose on a plan loan, spousal consent, if applicable, is required. Code § 417(a)(4) requires that no part of a participant's accrued benefit may be used as security for a loan from a plan subject to the qualified joint and survivor annuity rules and the qualified pre-retirement survivor annuity rules of Code § 401(a)(11) unless there is spousal consent. Accordingly, spousal consent should be obtained at the time the loan is made, discussed in Part I above.

Foreclosure as Eligible Rollover Distribution; 20 Percent Withholding Obligation. A distribution from a qualified plan is subject to 20 percent mandatory withholding if the distribution is an "eligible rollover distribution" and the participant fails to elect a direct rollover. As stated above, if a loan becomes a deemed taxable distribution because it does not comply with Code § 72(p), it is not an eligible rollover distribution and cannot be rolled over.[92] The pre-1993 10 percent voluntary withholding rules apply in such case.[93]

If a loan is foreclosed by offsetting the accrued benefit, however, there is an actual distribution, and if this offset occurs prior to a deemed distribution this offset is considered an eligible rollover distribution that may be rolled over and is subject to 20 percent withholding.[94] Although the foreclosed amount constitutes an eligible rollover distribution and is included in the amount subject to withholding, withholding need only be made from cash or other property distributed, and if there is no other cash or property distributed, there is nothing to withhold from.[95]

If a deemed distribution of a loan or a loan offset results in income at a date after the loan is made, withholding is required only if a transfer of cash or property is made to the participant or beneficiary from the plan at the same time.[96]

Direct Rollovers and Trust-to-Trust Transfers of Notes. A trust-to-trust transfer of assets (under Code § 414(*l*)) from one plan to another can include the transfer of a participant note.[97] Ordinary rollovers, where amounts are first distributed to participants and then rolled over, should intuitively not be able to be made with a note because the interest of the lender and the borrower will merge once the note is distributed to the participant. Nevertheless, recent regulations and rulings provide that a direct rollover under Code § 401(a)(31) may be made with a note even though a direct rollover is considered a distribution.[98]

Extension of Rollover Period for Offset Loans under Tax Cuts and Jobs Act of 2017. If an offset of a loan occurs before the amount has been taxed as a deemed distribution (*e.g.*, due to termination of employment or termination of the plan), the offset loan is eligible for a tax-free rollover to an eligible retirement plan (including a qualified plan or an IRA) under Code § 402(c)(3)(A).[99] Prior to the Tax Cuts and Jobs Act of 2017, the offset loan rollover would have to be made within 60 days from the date of offset. The Tax Cuts and Jobs Act added Code § 402(c)(3)(C) to provide that, for plan loan offsets in tax years beginning after December

31, 2017, the period during which a "qualified plan loan offset amount" (*i.e.*, an offset due to termination of employment that results in failure to meet repayment terms of loan, or an offset due to termination of the plan) may be rolled over to an eligible retirement plan is extended from the 60 day period after the offset to the due date (including extensions) for filing an income tax return for the tax year in which the plan loan offset occurs.[100] Note that a rollover of an offset loan cannot be made where there was already a deemed distribution, since the tax already was paid.

PART III—MISCELLANEOUS ISSUES

Exemption from Truth-in-Lending Requirements

Plan loans used to be subject to federal truth-in-lending disclosure statement requirements under Regulation Z of the Truth-in-Lending Act. However, effective July 1, 2010, Regulation Z was amended to specifically exempt 401(a), 403(b) and 457(b) participant loans from the truth-in-lending disclosure requirement, provided that the loan is composed of fully vested funds from the participant's account and the loan is in compliance with the requirements of the Internal Revenue Code.[101]

Applicability of Loan Provisions to Individual Retirement Accounts

Loans from IRAs are not permitted. Although IRAs are not subject to ERISA, they are subject to the Code § 4975 excise tax on prohibited transactions.[102] Furthermore, pursuant to Code § 408(e)(2), if in any year an individual for whose benefit an IRA is established engages in any transaction prohibited by Code § 4975 with respect to the IRA, the IRA ceases to be an IRA as of the first day of such year (and all of the assets of the IRA on the first day of such year are treated as having been distributed on such day).[103]

Loans in Bankruptcy

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) provides that all retirement funds exempt from taxation under Code §§ 401, 403, 408, 408A, 457 or 501(a) are protected from bankruptcy creditors. Bankruptcy Code §§ 522(b)(3)(C) and 522(d)(12). IRAs are limited to $1 million as adjusted under Bankruptcy Code § 522(n). With regard to participant loans, BAPCPA provides in Bankruptcy Code § 362(b)(19) that the bankruptcy petition does not operate as a stay for the withholding of wages to pay for participant loans under ERISA § 408(b)(1) or Code § 72(p). Thus, withholding from wages for participant loans could remain in effect even though the participant is in bankruptcy.

With regard to Chapter 7 liquidations, BAPCPA introduced a means test (measuring monthly disposable income), and there are some cases regarding whether amounts withheld to repay participant loans are counted as part of the means test.[104] This issue would not be applicable to a Chapter 13 individual bankruptcy filing, as the means test does not apply to Chapter 13 filings (and in fact was instituted to limit Chapter 7 filings to encourage Chapter 13 filings instead).

Impact of Loan Repayments on Code § 415 Annual Additions

Loan repayments are not treated as annual additions for purposes of Code § 415.[105]

Code § 411(d)(6)-Anti-Cutback Protection Not Applicable

Plan loans are not Code § 411(d)(6) protected optional forms of benefit and may be cut back or taken away without violating the anti-cutback rules.[106]

EPCRS Correction for Plan Loan Defaults

The Employee Plans Compliance Resolution System (EPCRS) program in Revenue Procedure 2016-51 provides that where there is a failure to repay a plan loan by the end of the calendar quarter following the quarter in which the payments are due, which generally would be a taxable deemed distribution under Section 72(p), the voluntary correction program (VCP) of EPCRS can be used by re-amortizing the loan balance over the remainder of the loan period or by repaying the arrears in lump sum, or a combination of the two.[107] This may cure not just the operational failure but also can avoid the deemed distribution under Section 72(p) (and a Form 1099-R reporting the deemed distribution will not be required), provided relief is specifically requested from the IRS that the loan failure will not result in Section 72(p) deemed distribution tax.[108] Alternatively, the VCP relief can be limited to reporting the deemed distribution in the year of correction instead of the year of failure.[109] Examples when the IRS may limit the VCP relief to reporting the deemed distribution in the year of correction instead of the year of failure (and not avoiding the deemed distribution tax entirely) could be, for example, where the affected employee is a key employee or an owner-employee[110] or where the loan cannot be re-amortized within the five year term and will need to be defaulted in the correction year. [111]

Prior to 2018, there were reduced VCP correction fees for loan failures based on the number of participants: (i) $300 for 13 or fewer affected participants; (ii) $600 for 50 or fewer affected participants; (iii) $1,000 for 100 or fewer affected participants; (iv) $2,000 for 150 or fewer affected participants; and (v) $3,000 for greater than 150 affected participants.[112] However, Rev. Proc. 2018-4 eliminates the reduced VCP fees for loan errors and provides for uniform VCP user fees (for all failures) based on the entire plan's assets as follows: (i) $1,500 if the plan's assets are of $500,000 or less; (ii) $3,000 if the plan's assets are $500,001 to $10,000,000; and (iii) $3,500 if the plan's assets are of over $10,000,000.[113]

NOTES

1. In general, ERISA § 408(b)(1) and Code § 4975(d)(1) mirror each other. There are some differences, however. For example, ERISA applies even to nonqualified plans. In addition, any employee of a plan sponsor is a party in interest under ERISA § 3(14); only a highly compensated employee is a disqualified person under Code § 4975(e)(2). Therefore, prohibited transaction excise taxes under Section 4975 would only apply to prohibited loans to employees who are highly compensated or are otherwise disqualified persons.

   The Department of Labor (DOL) regulations cited below apply equally to the ERISA requirements and the Code requirements pursuant to Section 102 of Reorganization Plan No. 4 of 1978, which transferred the authority relating to these provisions from the Treasury Department to the Labor Department. *See,* DOL Reg. § 2550.408b-1(a)(1).
2. ERISA § 408(b)(1) and Code § 4975(d)(1); DOL Reg. § 2550.408b-1. DOL regulations provide that loans that meet the conditions of ERISA § 408(b)(1) are exempt not only from the prohibited transaction rules of ERISA § 406(a) (for extensions of credit to a party in interest) but also from the self-dealing prohibitions of ERISA § 406(b)(1) and §406(b)(2). DOL Reg. § 2550.408b-1(a)(1). Such loans, however, are not exempt from the anti-kickback rule of ERISA § 406(b)(3) or the fiduciary duties of ERISA § 404. DOL Reg. § 2550.408b-1(a)(2). As stated above, the conditions of the above exemption also must be met so that the loan does not violate the anti-alienation rules of ERISA § 206(d)(2) and Code § 401(a)(13)(A).
3. DOL Reg. § 2550.408b-1(a)(3).
4. ERISA § 408(b)(1)(A).
5. DOL Reg. § 2550.408b-1(b)(1).
6. ERISA Advisory Opinion 89-30A; Preamble to DOL Regulations, 54 Fed. Reg. 30522 (July 20, 1989).
7. Note that a loan cannot be made available to certain owner-employees or certain shareholder-employees because the exemptions of ERISA § 408(b) do not apply to these individuals. ERISA § 408(d). *See,* DOL Info. Ltr. to Thomas M. Curtin (Oct. 7, 1999) regarding a loan to a participant who later becomes an owner employee, quoted in 26 *BNA Pen. & Ben. Rptr*. 2437 (October 18, 1999).
8. Treas. Reg. § 1.401(a)(4)-10(c).
9. DOL Reg. § 2550.408b-1(b)(2).
10. DOL Reg. § 2550.408b-1(a)(4), Ex. 8.
11. DOL Adv. Op. 95-19A.

12. DOL Field Assistance Bulletin 2003-1 (April 15, 2003).
13. 54 Fed. Reg. 30520, 30522 (July 20, 1989). *See* DOL Field Assistance Bulletin 2003-3 that based on DOL Reg. § 2550-404c-1(b)(2)(ii)(A), reasonable expenses associated with taking a plan loan may be charged to the participant's account.
14. For 2018, highly compensated employees are those earning over $120,000 in 2017 who, if the top-paid group election is made, are also in the top 20 percent group, or 5 percent owners. Code § 414(q).
15. ERISA § 408(b)(1)(B).
16. DOL Reg. § 2550.408b-1(c).
17. ERISA § 408(b)(1)(C).
18. DOL Reg. § 2550.408b-1(d)(1).
19. DOL Reg. § 2550.408b-1(d)(2).
20. DOL Reg. § 2550.408b-1(d), Ex. (1).
21. 54 Fed. Reg. 30520, 30523 (July 20, 1989).
22. ERISA § 408(b)(1)(D).
23. DOL Reg. § 2550.408b-1(e).
24. In practice, plan-wide rates typically are used, possibly in recognition of the fact that the 50 percent account balance collateral makes participants' other creditworthiness less meaningful.
25. DOL Reg. § 2550.408b-1(e), Ex. (1).
26. DOL Reg. § 2550.408b-1(e), Ex. (3). *See,* preamble to final DOL regulations. 54 Fed. Reg. 30520, 30525 (July 20, 1989). *See, also,* McLaughlin v. Rowley, 698 F. Supp. 1333 (N.D. Tex. 1988), which held that state usury laws with respect to plan loans are preempted by ERISA.
27. *See McLaughlin*, 698 F. Supp. 1333 (where trustees of a defined contribution plan were held liable, among other things, for charging less than a prudent interest rate on plan loans to participants; the plan was an individual account defined contribution plan, although assets were pooled for investment purposes; the plan charged only 7 percent during the period 1977 to 1982; the DOL's expert witness testified that loans in such case are comparable to "compensating balance loans," which are loans that are secured by a sum of money deposited with the lender; the expert further testified that prudent lenders would charge fair market rates of interest at one or two percentage points above the rate paid on the borrower's certificate of deposit; the rate also would vary in accordance with the size and the term of the deposit; the fact that the security for the loan is substantially the same as the amount of the loan does not matter; the court rejected the claim that the participants were merely borrowing their own money).
28. Participant Loans IRS Phone Forum, Sept. 12, 2011*, https://www.irs.gov/pub/irs-tege/loans_phoneforum_transcript.pdf*; 38 BNA Pension & Benefits Reporter 1694 (Sept. 20, 2011).
29. DOL Reg. § 2550.408b-1(e), Ex. (2).
30. ERISA § 408(b)(1)(E).
31. DOL Reg. § 2550.408b-1(f)(1).
32. DOL Reg. § 2550.408b-1(f)(2). *See* Part II below regarding 50 percent loan limit under Code § 72(p)(2)(A). Note that while the 50 percent Section 72(p) limit is a requirement at the time the loan is taken, it is not clear if the 50 percent adequate security requirement of DOL Reg. § 2550.408b-1(f)(2) must be met over the term of the loan.

33. Code § 401(a)(11). Profit-sharing plans are not subject to spousal consent rules if the participant's entire accrued benefit is payable on death to his or her surviving spouse (or another designated beneficiary with the spouse's consent) and a life annuity payment form is not elected. Code § 401(a)(11)(B)(iii).
34. Treas. Reg. § 1.401(a)-20, Q&A 24.
35. The preamble to Treas. Reg. § 1.401(a)-20, 53 Fed. Reg. 31837, 31840 (August 22, 1988), states that the DOL has indicated that a loan may not be adequately secured if consent to a reduction in the accrued benefit is not obtained before the loan is secured. Mardy, Loesel & Hamburger, *Guide to Assigning & Loaning Plan Money* ¶ 416 (Thompson Publishing Group), provides that the DOL concern is lessened by the "no loss" rule of the 1989 DOL regulations under which a delayed foreclosure is permissible as long as there are precautions taken to avoid loss of principal or interest on the loan. It would seem, however, that since the inability to foreclose without spousal consent could result in loss of principal or interest on the loan, plans subject to the spousal consent requirement should require such consent at the time of the loan.
36. *See,* PLR 8933018 (interest on loans made to non-key employees that are secured by recorded deed on residence and not by amount attributable to § 401(k) deferrals is deductible).
37. *See,* Conference Report to TEFRA, H.R. Conf. Rep. No. 97-760 (1982), which states that residential mortgage investments made in the ordinary course of an investment program are not considered plan loans under § 72(p) if the loans do not exceed the fair market value of the property, are not self-directed investments of an individual account and are not made to officers, directors, or owners. The fiduciary duty and prohibited transaction rules must still be complied with. *Id. See, also,* Treas. Reg. § 1.72(p)-1, Q&A 18 which states that a mortgage investment program exists only if the plan has established, in advance of a specific investment, that a certain percentage or amount of the assets will be invested in residential mortgages. The above regulations also impose certain additional requirements. *See, also,* PLR 8824045 (mortgage loans made available only to plan participants are subject to § 72(p)); PLR 9110039 (mortgage loan program primarily for plan participants is subject to § 72(p)); DOL Adv. Op. 81-12A (mortgage loan program as a plan investment must be prudent).
38. When plans take the loan proceeds directly from a participant's accounts, this often is done in a certain order; for example, the following order: 401(k) contributions, catch-up contributions, rollover contributions, matching contributions, employer contributions, Roth contributions, Roth catch-up contributions, Roth rollovers, after-tax contributions.
39. *See,* DOL Reg. § 2550.408b-1(f)(1) and Preamble to final DOL regulations, 54 Fed. Reg. 30520, 30526 (July 20, 1989).
40. *Id*.
41. DOL Reg. § 2550.408b-1(a)(3).
42. *Id. See also,* Treas. Reg. § 1.72(p)-1, Q&A 17 that if the loan is not bona fide (*e.g*., an understanding that the loan will not be repaid) the amount transferred is treated as an actual distribution and not as a loan or deemed distribution under Code § 72(p). In determining whether there is a bona fide loan, courts will focus on: existence of a debt instrument, security, interest and fixed repayment date, record of loan, ability to repay, relationship of parties, and other factors. *See, e.g.*, Patrick v. C.I.R., T.C. Memo 1998-30 (transfers from profit sharing plan to two participants who were shareholders of the employer were taxable income to the

participants and not plan loans). *See also*, Fuller v. C.I.R., T.C. Memo. 1980-370, 1980 WL 4206 (1980) (as long as the proper formalities are observed, the burden is on the IRS to prove that the transaction was not a loan; the court held that even though the employer, sole shareholder and loan recipient was also one of the plan's trustees, and even though loan repayments had been sporadic, a loan transaction in which the proper formalities had been observed was a loan, rather than a taxable distribution, from the plan).

43. *Id*.
44. A taxable distribution, in turn, also may trigger a 10 percent early distribution penalty tax under Code § 72(t), if applicable. Treas. Reg. § 1.72(p)-1, Q&A 11, 65 Fed. Reg. 46591 (July 31, 2000).
45. Code § 72(p)(2); Treas. Reg. § 1.72(p)-1, Q&A 3.
46. Code § 72(p)(4); Treas. Reg. § 1.72(p)-1, Q&A 2.
47. All plans of an employer (determined under the rules of subsections (b), (c) and (m) of Code § 414) are treated as a single plan for purposes of the loan rules. Code § 72(p)(2)(D)(i) and § 72(p)(2)(D)(ii).
48. The reason for adjusting the maximum by the repayment amount is to prevent an employee from effectively maintaining a permanent outstanding $50,000 loan balance. 21 H.R. Rep. 99-426 at 735 (1985).

    With respect to the maximum participant loan amount when the participant has prior loans, the IRS in Memorandum for Employee Plans (EP) Examinations Employees, revised at TE/GE-04-0417-0020 (July 26, 2017) (to be incorporated into IRM 4.71.1.14), provides that the IRS will permit two alternative methods for computing the highest outstanding balance within one year of the request for a new loan. As stated in the Memorandum for EP Employees, if a participant borrowed $30,000 in February which was fully repaid in April, and $20,000 in May which was fully repaid in July, before applying for a third loan in December, the plan may determine that no further loan would be available, since $30,000 + $20,000 = $50,000. Alternatively, the plan may identify "the highest outstanding balance" as $30,000, and permit the third loan in the amount of $20,000. Both methods will be acceptable on audit.
49. Code § 72(p)(2)(A). Note that the 50 percent limit appears to be a requirement at the time the loan is made but not an ongoing obligation. See Treas. Reg. § 1.72(p)-1, Q&A 4.
50. DOL Reg. § 2550.408b-1(f)(2).
51. This could be the sum of the highest outstanding balances for each loan during the one year period or alternatively the highest outstanding balance of all loans combined at any point during the one year period. *See* discussion above regarding Memorandum for EP Employees (July 26, 2017).
52. Treas. Reg. § 1.72(p)-1, Q&A 19(b)(1). *See*, Raymond H. v. C.I.R., T.C. Memo. 2011-139, aff'd, 2012-1 U.S. Tax Cas. (CCH) P 50391, 2012 WL 2036776 (5th Cir. 2012) (an individual who was a long time US Air Force employee had borrowed money from his thrift savings plan; repayments were to be made by payroll withholding; the individual lost his job and the plan notified the individual that the remaining portion of the loan was due; he did not timely repay the loan and received a Form 1099R for a deemed distribution; the individual filed with the Tax Court, which held that he received a constructive distribution and was subject to the additional 10 percent tax under IRC § 72(t) for a premature distribution); Marquez v. C.I.R., T.C. Summ. Op. 2009-80, 2009 WL 1405883 (T.C. 2009) (the refinancing of a plan loan under which both

the original and new loan were treated as being outstanding for purposes of IRC § 72(p)(2), resulted in a constructive distribution and the imposition of a 10 percent premature distribution tax; when the refinancing was authorized, the participant was advised that an additional loan could be made on the same terms as the original loan, or a new loan for a smaller amount could be made, either of which alternatives would have avoided exceeding the permissible loan limitation); Billups v. I.R.S., T.C. Summ. Op. 2009-86, 2009 WL 1519901 (T.C. 2009) (a participant refinanced a loan from a qualified plan, which resulted in exceeding the permissible loan limitation under IRC § 72(p); the individual had an outstanding loan balance of $27,013, and the participant refinanced it to borrow an additional $12,630, thus increasing his loan balance to $39,748; Tax Court determined that his loan would violate IRC § 72(p) limitations if it exceeded one-half of his $52,863 loan balance; court concluded that the sum of the new loan and the loan it replaced was $66,655 ($39,642 + $27,017), and that amount exceeded the applicable 50 percent of his account balance (the highest amount of permissible loan value without exceeding IRC § 72(p) limitation) by $39,748).

53. Treas. Reg. § 1.72(p)-1, Q&A 19(b)(2). 67 Fed. Reg. 71821 (December 3, 2002).
54. See discussion below in section entitled "Proposed Amendments Regarding Refinancing and Multiple Loans" regarding a controversial proposed regulatory limit of two loans per year.
55. Code § 72(p)(2)(B).
56. Conference Report to TEFRA 1982; Treas. Reg. § 1.72(p)-1, Q&A 4.
57. Joint Committee of Taxation General Explanation to TEFRA 1982 (Blue Book) § IV.D.2.
58. Code § 72(p)(2)(B)(ii).
59. *See,* Mardy, Loesel & Hamburger, "Guide to Assigning & Loaning Plan Money," ¶ 465.
60. Treas. Reg. § 1.72(p)-1, Q&A 5.
61. Treas. Reg. § 1.72(p)-1, Q&A 6.
62. Treas. Reg. § 1.72(p)-1, Q&A 7.
63. Treas. Reg. § 1.72(p)-1, Q&A 8. *See* Part I above regarding mortgage loans and mortgage investment programs.
64. Code § 72(p)(2)(C).
65. DOL Adv. Op. 94-27A. It held that Dreyfus Service Corporation's telephone voice response system could be used to make salary deferrals into pension plans because New York Labor Law § 193, which requires written authorization for payroll deductions (implying that telephone requests are not sufficient), is preempted by ERISA with respect to employee benefit plans.

    The New York State Department of Labor has issued at least one opinion that written authorization for payroll deductions may be satisfied when a blanket authorization has been made in writing for any future loan requests by electronic communications. Butterworth, "Paperless Plan Administration: Electronic Communications from Employees," *22 Tax Mgmt. Comp. Plan. J. 8* (August 5, 1994).
66. DOL Adv. Op. 96-01A. It involved § 5(g) of Puerto Rico Act No. 17, which allows payroll deductions in writing for purposes of mandatory contributions to pension and savings plan, implying their payroll deductions for purposes of repaying plan loans would not be permitted. The DOL held that § 5(g) is preempted by ERISA and ERISA § 514, since particularly, § 5(g) attempts to specifically regulate ERISA-covered plans.

67. Treas. Reg. § 1.72(p)-1, Q&A 9(a).
68. Treas. Reg. § 1.72(p)-1, Q&A 9(a) & Q&A 9(d) Ex. (1). *See*, however, Frias v. C.I.R., T.C. Memo 2017-139 (a plan loan taken before a leave of absence was considered a plan distribution since the participant failed to begin making payments even though she was receiving paychecks from her employer while on leave).
69. Treas. Reg. § 1.72(p)-1, Q&A 9(b) & (c); Conf. Rep. to TRA 1986. The participant loan interest rate may be restricted during the military service to 6 percent under the Soldiers & Sailors Civil Relief Act Amendments of 1942. *See*, Treas. Reg. § 1.72(p)-1, Q&A 9(d), Ex (2).
70. Treas. Reg. § 1.72(p)-1, Q&A 20(a)(1). 67 Fed. Reg. 71821 (Dec. 3, 2002).
71. Treas. Reg. § 1.72(p)-1, Q&A 20(a)(2).
72. Treas. Reg. § 1.72(p)-1, Q&A 3(b).
73. Treas. Reg. § 1.72(p)-1, Q&A 3(b)(2).
74. *Id*.
75. Treas. Reg. § 1.72(p)-1, Q&A 3(b). In 65 Fed. Reg. 46677 (July 31, 2000) the Treasury asked for comments on the impact of the Electronic Signatures in Global and National Commerce Act, P.L. 106-229, June 30, 2000, 15 U.S.C. §§ 7001-7031, on plan loan transactions.
76. Employee Plans News (April 1, 2015). *See also* Fidelity Points of View (April 2015) criticizing the requirement to have documentation verifying that the loan proceeds were used to purchase or construct the home.
77. Treas. Reg. § 1.72(p)-1, Q&A 4(a).
78. *Id*.
79. Treas. Reg. § 1.72(p)-1, Q&A 4(a) & 10(a). The same is true for the other requirements of § 72(p) such as the five-year repayment requirement. Treas. Reg. § 1.72(p)-1, Q&A 4(a).
80. Treas. Reg. § 1.72(p)-1, Q&A 10(a).
81. Treas. Reg. § 1.72(p)-1, Q&A 10(b).
82. In the first situation, loan payments were missed in two consecutive months, March 31 and April 30, which fell in different calendar quarters. Loan payments were resumed in the following two months and applied to the previously missed payments. In the third calendar quarter, the individual caught up all payments so that the loan was current. In the second situation, the taxpayer missed payments for three consecutive months during the fourth quarter of the year. In the following quarter, the taxpayer refinanced the loan with a new replacement loan equal to the outstanding balance of the original loan including the missed payments. In both cases Chief Counsel Advice 201736022 held that the missed loan payments were timely corrected, so that a loan default was avoided.
83. *See, e.g.*, Leon v. C.I.R., T.C. Summ. Op. 2008-86, 2008 WL 2796058 (T.C. 2008) (distribution following termination of employment includible in income under § 72(p) and subject to § 72(t) 10 percent penalty on early distribution on the expiration of the 90-day grace period to repay the loan); Plotkin v. C.I.R., T.C. Memo. 2001-71, T.C.M. (RIA) P 2001-071 (2001) (money purchase plan loan to sole shareholder violated the five year payment requirement and in addition to being a taxable distribution under § 72(p) also would be subject to the additional 10 percent early distribution tax under § 72(t)); Raymond H. v. C.I.R., T.C. Memo. 2011-139, T.C.M. (RIA) P 2011-139 (2011), *aff'd*, 2012-1 U.S. Tax Cas. (CCH) P 50391, 109 A.F.T.R.2d 2012-2433, 2012 WL 2036776 (5th Cir. 2012) (an individual who was a US Air Force employee

had borrowed money from his thrift savings plan; repayments were to be made by payroll withholding; the individual lost his job and the plan notified the individual that the remaining portion of the loan was due; he did not timely repay the loan and received a Form 1099-R for a deemed distribution; the individual filed with the Tax Court, which held that he received a constructive distribution and was subject to the additional 10 percent tax under IRC § 72(t) for a premature distribution); Matthews v. C.I.R., T.C. Summ. Op. 2014–84, 2014 WL 4251116 (T.C. 2014) (a participant who had a plan loan outstanding requested a distribution of funds from his 401(k) plan; he asked that the funds be used first to pay off the loan, a portion of the funds were withheld for income tax and the remaining were distributed to him and used for a rollover IRA; the Tax Court held that the 10 percent premature distribution penalty under IRC § 72(t) applied to the amount of the distribution used for the loan payoff); El v. C.I.R., Tax Ct. Rep. (CCH) 60251, Tax Ct. Rep. Dec. (RIA) 144.9, 2015 WL 1063061 (T.C. 2015) (Tax Court held that the 10 percent tax imposed under IRC § 72(p) for exceeding the permissible requirements for a loan under IRC § 72(p)(2) is not a penalty for purposes of IRC § 7491(c); therefore, the IRS does not bear the burden of proving that an assessment under § 72(p) is proper); Gowen v. C.I.R., TC Summary Opinion 2017-57 (Tax Court held that a CPA who defaulted on a plan loan during one tax year must include the deemed distribution once the cure period for repayment expires in the next tax year; the CPA who had a master's degree in taxation allowed a loan payment to a qualified plan to go into default in the third quarter of the year and failed to cure the default by the end of the fourth quarter; the CPA argued that the failure should be reported in the following tax year because he did not receive final notice from the plan custodian until after the end of the year; however, the Tax Court held that the failure was reportable for the year in which the failure occurred rather than the following year)..

84. Olagunju v. C.I.R., T.C. Memo. 2012-119, 2012 WL 1392677 (holding that a distribution had to be included in gross income when the record contained no loan documents or other evidence showing that the distribution was evidenced by a legally enforceable agreement); Bormet v. C.I.R., T.C. Memo 2017-201 (an individual who obtained an initial loan, suffered an injury and received short-term and then long-term disability benefits, was reported by the retirement plan's TPA as being in default for nonpayment of a loan for $26,954; the individual claimed that the loan had been renegotiated but was unable or unwilling to offer any evidence that the loan was renegotiated or evidence of his disability; the Tax Court concluded that there was insufficient evidence of a renegotiated loan and determined that the entire unpaid balance of $26,954 should be includable in the individual's income)..
85. Treas. Reg. § 1.72(p)-1, Q&A 19(a).
86. Treas. Reg. § 1.72(p)-1, Q&A 11. *See*, *e.g.*, Leon and Tilley v. C.I.R., 2008 WL 2796058, 44 E.B.C. 2405 (2008) (distribution following termination of employment includible in income under § 72(p) and subject to § 72(t) 10 percent penalty on early distribution on the expiration of the 90 day grace period to repay the loan); Plotkin v. C.I.R., T.C. Memo 2001-71 (2001) (money purchase plan loan to sole shareholder violated the five year payment requirement and in addition to being a taxable distribution under § 72(p) also would be subject to the additional 10 percent early distribution tax under § 72(t)).
87. Treas. Reg. § 1.72(p)-1, Q&A 14.

88. Treas. Reg. § 1.72(p)-1, Q&A 12. *See also,* Treas. Reg. § 1.402(c)-2, Q&A 4(d), Treas. Reg. § 1.401(k)-1(d)(6)(ii), and Notice 93-3, 1993-1 C.B. 293.
89. Treas. Reg. § 1.72(p)-1, Q&A 13; Treas. Reg. § 1.402(c)-2, Q&A 9(a).
90. Plan loan procedures typically provide for various events of default. The most basic one is failure to make payments when due. Some administrators treat loans as being in default if payments are not made for three months, since that is the period after which they will be considered to be taxable distributions. Another common event of default is termination of employment. Termination of the plan often will cause an event of default. Once an event of default has occurred the administrator may foreclose (unless otherwise prohibited from doing so) by offsetting the account balance. A foreclosure generally is treated as a distribution. Foreclosure occurs when the participant's account balance is offset by the loan amount.
91. Treas. Reg. § 1.72(p)-1, Q&A 13(b).
92. Treas. Reg. § 1.402(c)-2 Q&A 4(d); Treas. Reg. § 1.72(p)-1, Q&A 12; Notice 93-3, 1993-1 C.B. 293.
93. Treas. Reg. § 35.3405-1T, Q&A F-4 & F-5.
94. Treas. Reg. § 1.402(c)-2, Q&A 9; Notice 93-3, 1993-1 C.B. 293.
95. IRS Notice 93-3 § III(b)(3), 1993-1 C.B. 293.
96. Treas. Reg. § 1.72(p)-1, Q&A 15. To the extent that a loan constitutes a deemed distribution that results in income at the time the loan is made, withholding is required for such deemed distribution regardless of whether there is other cash or other property to withhold from. *Id.*
97. Priv. L. Rul. 8910034; Priv. L. Rul. 8950008.
98. Treas. Reg. § 1.401(a)(31)-1, Q&A 16 ("A plan administrator is permitted to allow a direct rollover of a participant note of a plan loan to a qualified trust"). *See also,* Priv. L. Rul. 9617046 (Jan. 31, 1996) (newly-transferred employees rolled over loan notes from one plan to another plan, with the transferee plan requiring the participant to acknowledge that transferee plan is new obligee; IRS held that the transfer of a loan note as a direct rollover under § 401(a)(31) could be made and would not be a taxable distribution under Code § 402(a) or 72(p); also since substantive terms of loan have not changed, not considered a revision or renegotiation of the loan and therefore not a new loan under § 72(p); Priv. L. Rul. 9729042 (direct rollover of note is permissible, and will not be a taxable distribution). *See, also,* Treas. Reg. § 1.402(c)-2, Q&A 9; 23 *BNA Tax Mgmt. Compensation Plan. J.* 195 (Aug. 4, 1995); 18 *BNA Pen. Rptr*. 2118 (Nov. 30, 1992); 92 TNT 235-3 (Nov. 24, 1992). It is not clear from the regulations if a direct rollover of a note would be considered like a new loan from the transferee plan.
99. A deemed distribution is not eligible to be rolled over to an eligible retirement plan because it is not considered a distribution. Treas. Reg. § 1.72(p)-1, Q&A 12.
100. Code § 402(c)(3)(C) as added by the Tax Cuts and Jobs Act of 2017 § 13613.
101. 12 CFR § 226.3(g).
102. Although an IRA does not explicitly fit within the definition of disqualified person under Code § 4975(c)(2), the Conf. Rep. to ERISA, Rep. No. 43-1280 at 501, and Priv. L. Rul. 8849001 support the view that transactions between the IRA and the IRA owner are prohibited transactions.
103. Code § 408(e)(2)(A) and (B). *See, also,* Code § 408(e)(4).

104. *See*, *e.g.*, In re Egebjerg, 574 F. 3d 1045 (9th Cir. 2009) (holding that a 401(k) loan is not a debt since the participant is merely paying it to himself, and Egebjerg could not include his payments on the participant loans as deductions for calculating monthly disposable income for the means test). *See also*, Welmerink, "Cleaning the Mess of the Means Test: The Need for a Case-by-Case analysis of 401(k) Loans in Chapter 7 Bankruptcy Petitions," 41 *Golden Gate U.L. Rev.* 121 (Fall 2010).
105. Treas. Reg. § 1.415-6(b)(3)(ii).
106. Treas. Reg. § 1.411(d)-4, Q&A 1(d)(4).
107. Rev. Proc. 2016-51, §§ 6.02(6) & 6.07. This relief was originally provided in Rev. Proc. 2006-27, §§ 6.02(6), 6.07.
108. Rev. Proc. 2016-51, § 6.07(2)(a) & (3). *See* Rev. Proc. 2016-51, § 6.02(6) that for defaulted loans the employer should pay a portion of the correction payment equal to the interest that accumulates as a result of such failure (generally determined at a rate equal to the greater of the plan loan interest rate or the rate of return under the plan).
109. Rev. Proc. 2016-51, § 6.07(1).
110. Form 14568-E (Model VPC Compliance Statement for Plan Loan Failures), § IIA & B, provides that if the affected participant is either a key employee under Code § 416(i)(1) (*e.g.*, an officer earning over $175,000 in 2018) or an owner-employee under Code § 401(c)(3), relief will be limited to reporting the deemed distribution in the year of correction instead of the year of failure.
111. *See also* Rev. Proc. 2016-51, § 6.07(2)(a), that the IRS can deny correction to entirely avoid a deemed distribution if it deems appropriate, for example, where the loan failure is not caused by employer action.
112. Rev. Proc. 2015-27, at § 4.13 and Rev. Proc. 2017-4, App. A .08.
113. Rev. Proc. 2018-4, at § 2.03(4) (eliminating specific reduced VCP fees, beginning in 2018); Rev. Proc. 2018-4, at § 2.03(1) and App. A .09 (beginning in 2018, VCP user fees now based on plan assets).