[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-209476-82]

RIN 1545-AE41

Loans to Plan Participants

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document amends proposed Income Tax Regulations under section 72(p) of the Internal Revenue Code relating to loans made from a qualified employer plan to plan participants or beneficiaries. Section 72(p) was added by section 236 of the Tax Equity and Fiscal Responsibility Act of 1982, and amended by the Technical Corrections Act of 1982, the Deficit Reduction Act of 1984, the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. These regulations provide guidance to the public with respect to section 72(p), and affect administrators of, participants in, and beneficiaries of qualified employer plans that permit participants or beneficiaries to receive loans from the plan (including loans from section 403(b) contracts and other contracts issued under qualified employer plans).

DATES: Written comments and requests for a public hearing must be received by April 2, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-209476-82), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-209476-82), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Vernon S. Carter, (202) 622-6070; concerning submissions or requests to speak at the hearing, La Nita VanDyke, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Proposed Income Tax Regulations (26 CFR Part 1) under section 72 of the Internal Revenue Code of 1986 (Code). These amendments provide additional guidance concerning the tax treatment of loans that are deemed to be distributed under section 72(p).

Explanation of Provisions

Section 72(p)(1)(A) provides that a loan from a qualified employer plan (including a contract purchased under a qualified employer plan) to a participant or beneficiary is treated as received as a distribution from the plan for purposes of section

72 (a deemed distribution). Section 72(p)(1)(B) provides that an assignment or pledge of (or an agreement to assign or pledge) any portion of a participant's or beneficiary's interest in a qualified employer plan is treated as a loan from the plan.

Section 72(p)(2) provides that section 72(p)(1) does not apply to the extent certain conditions are satisfied. Specifically, under section 72(p)(2), a loan from a qualified employer plan to a participant or beneficiary is not treated as a distribution from the plan if the loan satisfies requirements relating to the term of the loan and the repayment schedule, and to the extent the loan satisfies certain limitations on the amount loaned.

Regulations were proposed in 1995[1] with respect to many of the issues arising under section 72(p)(2). The preamble to the 1995 proposed regulations requested comments on whether further guidance should be provided on certain issues that were not addressed. Following publication of the 1995 proposed regulations, comments were received and a public hearing was held on June 28, 1996. One of the issues on which comments were requested and received was the effect of a deemed distribution on the tax treatment of subsequent distributions from a plan (such as whether a participant has tax basis as a result of a deemed distribution). After reviewing the written comments and comments made at the public hearing, these new proposed regulations

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[1]Proposed § 1.72(p)-1 (EE-106-82) was published in the Federal Register (60 FR 66233) on December 21, 1995.

address this issue.

These new proposed regulations provide that once a loan is deemed distributed under section 72(p), the interest that accrues thereafter on that loan is not included in income.[2] Further, because the loan amount is treated as distributed for purposes of section 72, neither the income that resulted from the deemed distribution nor the interest that accrues thereafter increases the participant's investment in the contract (tax basis) for purposes of section 72.

For example, assume that, after a loan has been made from a defined contribution plan to a participant, a deemed distribution occurs as a result of failure to make timely loan repayments (e.g., the repayments were not to be made by payroll withholding[3]). The participant's total account then consists of non-loan assets and a receivable for the loan balance. At

[2]This treatment applies for purposes of determining the amount taxable under section 72 (including application of return of tax basis). However, as discussed below, the loan is still considered outstanding for purposes of determining the maximum amount of any subsequent loan to the participant under section 72(p)(2)(A). Even though interest continues to accrue on the outstanding loan and is taken into account for purposes of determining the maximum amount of any subsequent loan, this additional interest is not treated as an additional loan that results in a further deemed distribution for purposes of section 72(p).

[3]With respect to coverage under Title I of the Employee Retirement Income Security Act of 1974, the Department of Labor has advised the Service that an employer's tax-sheltered annuity program would not necessarily fail to satisfy the Department's regulation at 29 CFR 2510.3-2(f) merely because the employer permits employees to make repayments of loans made in connection with the tax-sheltered annuity program through payroll deductions as part of the employer's payroll deduction system, if the program operates within the limitations set by that regulation.

separation from employment, the participant’s vested account balance is reduced (offset) by the loan amount and the remaining account balance is distributed in a lump sum to the participant. In this case, in addition to the income that previously arose as a result of the deemed distribution due to the failure to make timely payments on the loan, the participant would have a taxable distribution at separation from employment for the remaining account balance reflecting the non-loan assets that are distributed in a lump sum (with no tax basis as a result of the prior deemed distribution of the loan amount). The offset of the loan balance (i.e., the offset of the loan receivable by the loan amount) would be disregarded for purposes of section 72 because the loan had previously been deemed distributed as a result of the failure to make timely payments on the loan.

A loan that is deemed distributed under section 72 is nevertheless outstanding for other purposes until the loan obligation is satisfied (e.g., by cash repayment or by offset against the participant’s accrued benefit). Q&A-13 of the 1995 proposed regulations lists other differences between a deemed distribution and a loan offset. In addition, for purposes of calculating the maximum permitted amount of any subsequent loan, a loan that has been deemed distributed is considered outstanding until the loan obligation has been satisfied.

The proposed regulations also provide that if a participant makes any cash repayments on a loan after the loan is deemed distributed, the repayments increase the participant’s tax basis in the plan in the same manner as if the repayments were after-tax contributions. However, such repayments are not treated as after-tax contributions for purposes of section 401(m) or 415(c)(2)(B).

These regulations are proposed to become effective for loans made on or after the first January 1 that is at least 6 months after the date the regulations are published as final regulations in the Federal Register (the regulatory effective date). These regulations also revise the proposed effective date for the 1995 proposed regulations, so that the same proposed effective date would apply to the 1995 proposed regulations and these proposed regulations.

Generally, a plan is permitted to apply the new proposed regulations to loans made before the regulatory effective date. However, the regulations include a special consistency rule applicable if there has been any deemed distribution of the loan before the date the plan switches to the new proposed regulations for the loan. In this event, a plan is not permitted to apply the new proposed regulations to the loan unless the plan reported, in Box 1 of Form 1099-R, a gross distribution with respect to the loan that is at least equal to the amount required by the 1995 proposed regulations (referred to as the initial default amount in the new proposed regulations) for a taxable year that is not later than the latest year that would be permitted under the 1995 proposed regulations. In such a case, the plan may apply the new proposed regulations to the loan even though, in the past, the plan reported deemed distributions with respect to the loan in a manner that is not consistent with the new proposed regulations.

If a plan does apply the new proposed regulations to a pre-regulatory effective date loan that has been deemed distributed, then the plan, in its subsequent reporting and withholding, must not attribute investment in the contract (tax basis) to the participant based upon the initial default amount. For example, a plan that reported income for the initial default amount plus all interest accruing thereafter as a result of the default and made corresponding increases in the participant’s tax basis would comply with this consistency rule by reducing the participant’s tax basis by an amount equal to the initial default amount. In addition, a special rule applies if a plan had increased a participant’s tax basis by the initial default amount and, just before the first actual distribution made after the plan switches to applying the new proposed regulations to the loan, the sum of the participant’s tax basis immediately before the switch plus any increase in basis thereafter (e.g., from after-tax contributions) is less than the initial default amount (as a result of intervening distributions). In this case, a loan transition amount equal to the amount by which the initial default amount exceeds the participant’s tax basis is treated as remaining outstanding and that amount is includible in the participant’s income at the time of the next actual distribution from the plan to the participant. The proposed regulations include examples illustrating the application of the consistency rule.

Comments are requested on whether the final regulations should include further guidance relating to plan loans made to participants before the regulatory effective date.

Taxpayers may rely on these proposed regulations for guidance pending the issuance of final regulations. If, and to the extent, future guidance is more restrictive than the guidance in these proposed regulations, the future guidance will be applied without retroactive effect.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely (preferable a signed original and eight copies) to the IRS. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time and place for the hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Vernon S. Carter, Office of Associate Chief Counsel (Employee Benefits and Exempt Organizations). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Previously Proposed Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805. * * *

Par. 2. Section 1.72(p)-1 of the proposed regulations published December 21, 1995, (60 FR 66233) is amended as follows:

1. Q&A-19 is redesignated as Q&A-21.

2. New Q&A-19 and Q&A-20 are added.

3. Q&A-21, as redesignated, is revised.

The additions and revision read as follows:

§ 1.72(p)-1 Loans treated as distributions.

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Q-19: If there is a deemed distribution under section 72(p), is the interest that accrues thereafter on the amount of the deemed distribution an indirect loan for income tax purposes?

A-19: (a) General rule. Except as provided in paragraph (b) of this Q&A-19, a deemed distribution of a loan is treated as a distribution for purposes of section 72. Therefore, a loan that is deemed to be distributed under section 72(p) ceases to be an outstanding loan for purposes of section 72, and the interest that accrues thereafter under the plan on the amount deemed distributed is disregarded in applying section 72 to the participant or beneficiary. Even though interest continues to accrue on the outstanding loan (and is taken into account for purposes of determining the tax treatment of any subsequent loan in accordance with paragraph (b) of this Q&A-19), this additional interest is not treated as an additional loan (and, thus, does not result in an additional deemed distribution) for purposes of section 72(p). However, a loan that is deemed distributed under section 72(p) is not considered distributed for all purposes of the Internal Revenue Code. See Q&A-11 through Q&A-16 of this section.

(b) Exception for purposes of applying section 72(p)(2)(A) to a subsequent loan. A loan that is deemed distributed under section 72(p) (including interest accruing thereafter) and that has not been repaid (such as by a plan loan offset) is considered outstanding for purposes of applying section 72(p)(2)(A) to determine the maximum amount of any subsequent loan to the participant or beneficiary.

Q-20: Is a participant's tax basis in the plan increased if the participant repays the loan after a deemed distribution?

A-20: (a) Repayments after deemed distribution. Yes, if the participant or beneficiary repays the loan after a deemed distribution of the loan under section 72(p), then, for purposes of section 72(e), the participant's or beneficiary's investment in the contract (tax basis) under the plan increases by the amount of the cash repayments that the participant or beneficiary makes on the loan after the deemed distribution. However, loan repayments are not treated as after-tax contributions for other purposes, including sections 401(m) and 415(c)(2)(B).

(b) Example. The following example illustrates the rules in paragraph (a) of this Q&A-20 and is based on the assumptions described in ASSUMPTIONS FOR EXAMPLES:

Example. (a) A participant receives a $20,000 loan on January 1, 1999, to be repaid in 20 quarterly installments of $1,245 each. On December 31, 1999, the outstanding loan balance ($19,179) is deemed distributed as a result of a failure to make quarterly installment payments that were due on September 30, 1999 and December 31, 1999. On June 30, 2000, the participant repays $5,147 (which is the sum of the three installment payments that were due on September 30, 1999, December 31, 1999, and March 31, 2000, with interest thereon to June 30, 2000, plus the installment payment that was due on June 30, 2000). Thereafter, the participant resumes making the installment payments of $1,245 from September 30, 2000 through December 31, 2003. The loan repayments made after December 31, 1999 through December 31, 2003 total $22,577.

(b) Because the participant repaid $22,577 after the deemed distribution that occurred on December 31, 1999, the participant has investment in the contract (tax basis) equal to $22,577 as of December 31, 2003.

Q-21: When is the effective date of section 72(p) and these regulations?

A-21: (a) Statutory effective date. Section 72(p) generally applies to assignments, pledges, and loans made after August 13, 1982.

(b) Regulatory effective date. This section applies to assignments, pledges, and loans made on or after the first January 1 that is at least 6 months after the date of publication of the final regulations in the Federal Register (the regulatory effective date).

(c) Loans made before the regulatory effective date -- (1) General rule. A plan is permitted to apply Q&A-19 and Q&A-20 of this section to a loan made before the regulatory effective date (and after the statutory effective date in paragraph (a) of this Q&A-21) if there has not been any deemed distribution of the loan before the transition date or if the conditions of paragraph (c)(2) of this Q&A-21 are satisfied with respect to the loan.

(2) Consistency transition rule for certain loans deemed distributed before the regulatory effective date. (i) The rules in this paragraph (c)(2) apply to a loan made before the regulatory effective date (and after the statutory effective date in paragraph (a) of this Q&A-21) if there has been any deemed

distribution of the loan before the transition date.

(ii) The plan is permitted to apply Q&A-19 and Q&A-20 of this section to the loan beginning on any January 1, but only if the plan reported, in Box 1 of Form 1099-R, for a taxable year no later than the latest taxable year that would be permitted under this section, a gross distribution of an amount at least equal to the initial default amount. For purposes of this section, the initial default amount is the amount that would be reported as a gross distribution under Q&A-4 and Q&A-10 of this section and the transition date is the January 1 on which a plan begins applying Q&A-19 and Q&A-20 of this section to a loan.

(iii) If a plan applies Q&A-19 and Q&A-20 of this section to such a loan, then the plan, in its reporting and withholding on or after the transition date, must not attribute investment in the contract (tax basis) to the participant or beneficiary based upon the initial default amount.

(iv) This paragraph (c)(2)(iv) applies if--

(A) The plan attributed investment in the contract (tax basis) to the participant or beneficiary based on the deemed distribution of the loan;

(B) The plan subsequently made an actual distribution to the participant or beneficiary before the transition date; and

(C) Immediately before the first actual distribution made on or after the transition date, the initial default amount (or, if less, the amount of the investment in the contract so attributed) exceeds the sum of the participant’s or beneficiary’s investment in the contract (tax basis) immediately before the transition date plus any increase in the participant's or beneficiary's investment in the contract (tax basis) on or after the transition date. If this paragraph (c)(2)(iv) applies, the plan must treat the excess (the loan transition amount) as a loan amount that remains outstanding and must include the excess in the participant's or beneficiary's income at the time of the actual distribution.

(3) Examples. The rules in paragraph (c)(2) of this Q&A-21 are illustrated by the following examples, which are based on the assumptions described in ASSUMPTIONS FOR EXAMPLES (and, except as specifically provided in the examples, also assume that no distributions are made to the participant and that the participant has no investment in the contract with respect to the plan). Example 1, Example 2, and Example 4 illustrate the application of these rules to a plan that, before the transition date, did not treat interest accruing after the initial deemed distribution as resulting in additional deemed distributions under section 72(p). Example 3 illustrates the application of these rules to a plan that, before the transition date, treated interest accruing after the initial deemed distribution as resulting in additional deemed distributions under section 72(p).

Example 1. (a) In 1995, when a participant's account balance under a plan is $50,000, the participant receives a loan from the plan. The participant makes the required repayments until 1996 when there is a deemed distribution of $20,000 as a result of a failure to repay the loan. For 1996, as a result of the deemed distribution, the plan reports, in Box 1 of Form 1099-R, a gross distribution of $20,000 (which is the initial default amount in accordance with paragraph (c)(2)(ii) of Q&A-21 of this section) and, in Box 2 of Form 1099-R, a taxable amount of $20,000. The plan then records an increase in the participant’s tax basis for the same amount ($20,000). Thereafter, the plan disregards, for purposes of section 72, the interest that accrues on the loan after the 1996 deemed distribution. Thus, as of December 31, 1998, the total taxable amount reported by the plan as a result of the deemed distribution is $20,000 and the plan’s records show that the participant's tax basis is the same amount ($20,000). As of January 1, 1999, the plan decides to apply Q&A-19 of this section to the loan. Accordingly, it reduces the participant's tax basis by the initial default amount of $20,000, so that the participant’s remaining tax basis in the plan is zero. Thereafter, the amount of the outstanding loan is not treated as part of the account balance for purposes of section 72. The participant attains age 59-1/2 in the year 2000 and receives a distribution of the full account balance under the plan consisting of $60,000 in cash and the loan receivable. At that time, the plan’s records reflect an offset of the loan amount against the loan receivable in the participant’s account and a distribution of $60,000 in cash.

(b) For the year 2000, the plan must report a gross distribution of $60,000 on Box 1 of Form 1099-R and a taxable amount of $60,000 in Box 2 of Form 1099-R.

Example 2. The facts are the same as in Example 1, except that in 1996, immediately prior to the deemed distribution, the participant’s account balance under the plan totals $50,000 and the participant’s tax basis is $10,000. For 1996, the plan reports, in Box 1 of Form 1099-R, a gross distribution of $20,000 (which is the initial default amount in accordance with paragraph (c)(2)(ii) of Q&A-21 of this section) and reports, in Box 2 of Form 1099-R, a taxable amount of $16,000 (the $20,000 deemed distribution minus $4,000 of tax basis ($10,000 times ($20,000/$50,000)) allocated to the deemed distribution). The plan then records an increase in tax basis equal to the $20,000 deemed distribution, so that the participant’s remaining tax basis as of December 31, 1996 totals $26,000 ($10,000 minus $4,000 plus $20,000). Thereafter, the plan disregards, for purposes of section 72, the interest that accrues on the loan after the 1996 deemed distribution. Thus, as of December 31, 1998, the total taxable amount reported by the plan as a result of the deemed distribution is $16,000 and the plan’s records show that the participant's tax basis is $26,000. As of January 1, 1999, the plan decides to apply Q&A-19 of this section to the loan. Accordingly, it reduces the participant's tax basis by the initial default amount of $20,000, so that the participant’s remaining tax basis in the plan is $6,000. Thereafter, the amount of the outstanding loan is not treated as part of the account balance for purposes of section 72. The participant attains age 59-1/2 in the year 2000 and receives a distribution of the full account balance under the plan consisting of $60,000 in cash and the loan receivable. At that time, the plan's records reflect an offset of the loan amount against the loan receivable in the participant's account and a distribution of $60,000 in cash.

(b) For the year 2000, the plan must report a gross distribution of $60,000 on Box 1 of Form 1099-R and a taxable amount of $54,000 in Box 2 of Form 1099-R.

Example 3. (a) In 1990, when a participant's account balance in a plan is $100,000, the participant receives a loan of $50,000 from the plan. The participant makes the required loan repayments until 1992 when there is a deemed distribution of $28,919 as a result of a failure to repay the loan. For 1992, as a result of the deemed distribution, the plan reports, in Box 1 of Form 1099-R, a gross distribution of $28,919 (which is the initial default amount in accordance with paragraph (c)(2)(ii) of Q&A-21 of this section) and, in Box 2 of Form 1099-R, a taxable amount of $28,919. For 1992, the plan also records an increase in the participant's tax basis for the same amount ($28,919). Each year thereafter through 1998, the plan reports a gross distribution equal to the interest accruing that year on the loan balance, reports a taxable amount equal to the interest accruing that year on the loan balance reduced by the participant's tax basis allocated to the gross distribution, and records a net increase in the participant's tax basis equal to that taxable amount. As of December 31, 1998, the taxable amount reported by the plan as a result of the loan totals $44,329 and the plan's records for purposes of section 72 show that the participant's tax basis totals the same amount ($44,329). As of January 1, 1999, the plan decides to apply Q&A-19 of this section. Accordingly, it reduces the participant's tax basis by the initial default amount of $28,919, so that the participant's remaining tax basis in the plan is $15,410 ($44,329 minus $28,919) as of December 31, 1999. Thereafter, the amount of the outstanding loan is not treated as part of the account balance for purposes of section 72. The participant attains age 59-1/2 in the year 2000 and receives a distribution of the full account balance under the plan consisting of $180,000 in cash and the loan receivable equal to the $28,919 outstanding loan amount in 1992 plus interest accrued thereafter to the payment date in 2000. At that time, the plan's records reflect an offset of the loan amount against the loan receivable in the participant's account and a distribution of $180,000 in cash.

(b) For the year 2000, the plan must report a gross distribution of $180,000 in Box 1 of Form 1099-R and a taxable amount of $164,590 in Box 2 of Form 1099-R ($180,000 minus the remaining tax basis of $15,410).

Example 4. (a) The facts are the same as in Example 1, except that in 1997, after the deemed distribution, the participant receives a $10,000 hardship distribution. At the time of the hardship distribution, the participant’s account balance under the plan totals $50,000. For 1997, the plan reports, in Box 1 of Form 1099-R, a gross distribution of $10,000 and, in Box 2 of Form 1099-R, a taxable amount of $6,000 (the $10,000 actual distribution minus $4,000 of tax basis ($10,000 times ($20,000/$50,000)) allocated to this actual distribution). The plan then records a decrease in tax basis equal to $4,000, so that the participant’s remaining tax basis as of December 31, 1997 totals $16,000 ($20,000 minus $4,000). After 1996, the plan disregards, for purposes of section 72, the interest that accrues on the loan after the 1996 deemed distribution. Thus, as of December 31, 1998, the total taxable amount reported by the plan as a result of the deemed distribution plus the 1997 actual distribution is $26,000 and the plan’s records show that the participant's tax basis is $16,000. As of January 1, 1999, the plan decides to apply Q&A-19 of this section to the loan. Accordingly, it reduces the participant's tax basis by the initial default amount of $20,000, so that the participant’s remaining tax basis in the plan is reduced from $16,000 to zero. However, because the $20,000 initial default amount exceeds $16,000, the plan records a loan transition amount of $4,000 ($20,000 minus $16,000). Thereafter, the amount of the outstanding loan, other than the $4,000 loan transition amount, is not treated as part of the account balance for purposes of section 72. The participant attains age 59-1/2 in the year 2000 and receives a distribution of the full account balance under the plan consisting of $60,000 in cash and the loan receivable. At that time, the plan’s records reflect an offset of the loan amount against the loan receivable in the participant’s account and a distribution of $60,000 in cash.

(b) In accordance with paragraph (c)(2)(iv) of Q&A-21 of this section, the plan must report in Box 1 of Form 1099-R a gross distribution of $64,000 and in Box 2 of Form 1099-R a taxable amount for the participant for the year 2000 equal to $64,000 (the sum of the $60,000 paid in the year 2000 plus $4,000 as the loan transition amount).

/s/ Michael Dolan
Deputy Commissioner Internal Revenue