OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL,
CC:MSR:KSM:KCY
Attn:

FROM: Associate Chief Counsel (Income Tax & Accounting)
CC:ITA

SUBJECT: Deduction of Interest on Loan from Disqualified Pension Plan

This Field Service Advice responds to your request of May 3, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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LEGEND:

Mr. X =

Year A =
$b =
Year C =
$d =
$e =
Date f =
Date g =
Period h =
Entity I =
$j =
Tax Year k =
$m =
$n =

ISSUE:

Whether Mr. X may deduct interest paid on a mortgage obtained from his pension and profit sharing trust, when the amount of the mortgage over $50,000 was deemed to be a taxable distribution to him.

CONCLUSION:

Assuming the loan is otherwise a bona fide debt, Mr. X may deduct interest paid on a mortgage obtained from his pension and profit sharing trust, even though the amount of the mortgage over $50,000 was deemed to be a taxable distribution to him.

FACTS:

In Year A, Mr. X obtained a mortgage in the amount of $b from his pension and profit sharing trust. Subsequently, in Year C, his pension and profit sharing plans were audited and disqualified because the plans failed to comply with the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the Deficit Reduction Act of 1984 (DEFRA) and the Retirement Equity Act of 1984 (REA). The Service then issued statutory notices of deficiency to Mr. X, his corporation, and the profit sharing plans. Mr. X petitioned the Tax Court on behalf of himself, his corporation and his pension and the profit sharing plans. The parties settled the matter prior to trial.

The stipulated decision document provided that the portion of the mortgage in excess of $50,000 was a taxable distribution under I.R.C. § 72(p). As a result, $d out of the total mortgage principal constituted a taxable distribution to Mr. X and he agreed to the resulting deficiency of $e. Mr. X and the Service also entered a closing agreement on Date f, which provided that the Service will treat the plans as having been timely amended to conform with the requirements of TEFRA, DEFRA, and REA for the years of the plans beginning on and after Date g. In Period h, the pension and profit sharing

plans sold the mortgage to Entity I, an unrelated party, for $j. Mr. X has consistently made payments on the mortgage, both before and after its sale.

In Tax Year K, Mr. X claimed an interest deduction of $m; he now concedes the most he could have claimed was $n. This interest deduction is the issue in the case.

LAW AND ANALYSIS:

Section 163(a) allows as a deduction all interest paid or accrued in the taxable year on indebtedness. Indebtedness has been defined to be "an existing, unconditional, and legally enforceable obligation for the payment of money." Halle v. Commissioner, 83 F.3d 649, 652 (4th Cir. 1996), quoting Howlett v. Commissioner, 56 T.C. 952, 960 (1971).

Although section 163(h)(1) disallows the deduction of personal interest, qualified residential interest is allowable under section 163(h)(2)(D). “Qualified residential interest” is defined under section 163(h)(3) generally to include home mortgages (with certain limitations not apparently applicable here.)

The issue in the present case is whether there can still be indebtedness for purposes of section 163(a) after a loan is deemed to be distributed under section 72(p).

Although the Code allows a plan participant to borrow money from a qualified pension plan, there are restrictions that apply. If these restrictions are not satisfied, the loan may disqualify the plan under section 401(a)(13) or 401(a)(2) or may be a prohibited transaction under section 4975. In addition, the loan may be considered a “deemed” distribution, which will be included in a participant’s income under section 72(p). If the participant has not reached retirement age, the “deemed” distribution may also be characterized as an early distribution, resulting in a 10 percent additional tax under section 72(t).

Section 72(p)(1)(A) provides that a loan from a qualified plan to a plan participant shall be treated as having been received by such individual as a distribution under such plan. Section 72(p)(2) provides an exception, however, where the following requirements are met: (1) the loan does not exceed the lesser of the amount set forth in section 72(p)(2)(A)(i) or (ii);[1] (2) the loan, by its terms, must be repaid within 5 years from the date of its inception or is made to finance the acquisition of a home which is the principal residence of the participant; and (3) the loan must have substantially level amortization with quarterly or more frequent payments required over the term of the

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[1] Section 72(p)(2)(A)(i) apparently supplies the $50,000 limitation found in the present case.

loan[2]. (For example, except in the case of certain home loans, the exception in section 72(p)(2) only applies to a loan that by its terms is to be repaid over not more than five years in substantially level installments.)

A loan failing to qualify for the exception under section 72(p)(2) is treated as a distribution from the plan. However, distribution treatment does not necessarily apply for other tax purposes. For example, under Q&A-12 of Treas. Reg. § 1.72(p)-1, distribution treatment does not apply for purposes of the qualification requirements. In fact, the introductory language of Treas. Reg. § 1.72(p)-1 specifies that the examples in the regulations are based on the assumption that a bona fide loan is made to a participant.

The case law also supports a determination that the deemed distribution of a purported loan under section 72(p) does not undue a loan that is in fact bona fide. In Medina v. Commissioner, 112 T.C. 51 (1999), the taxpayers argued they were not subject to excise tax under section 4975 on a loan from the husband's pension plan because, under section 72(p), the loan was a taxable distribution in an earlier year. The court rejected this argument holding the characterization of the loan for section 72 purposes does not change its inherent character for section 4975. 112 T.C. at 54-55.

In Hickman v. Commissioner, T.C. Memo. 1997-545, the court held that the taxpayer could deduct the interest paid on a loan from a pension plan as investment interest under section 163(d), even though the loan was a prohibited transaction. Significantly, that the loan did not satisfy the requirements under section 72(p)(2) did not preclude it from being treated as a loan for purposes of section 163.

The characterization of the loan as a distribution under section 72(p) does not necessarily change its character as a loan for other tax purposes. Accordingly, there may be requisite indebtedness for purposes of section 163(a) even though the loan, pursuant to section 72(p), was treated as a distribution. Section 163(h) may therefore allow a deduction of qualified residential interest paid on the loan, if the loan is otherwise bona fide.

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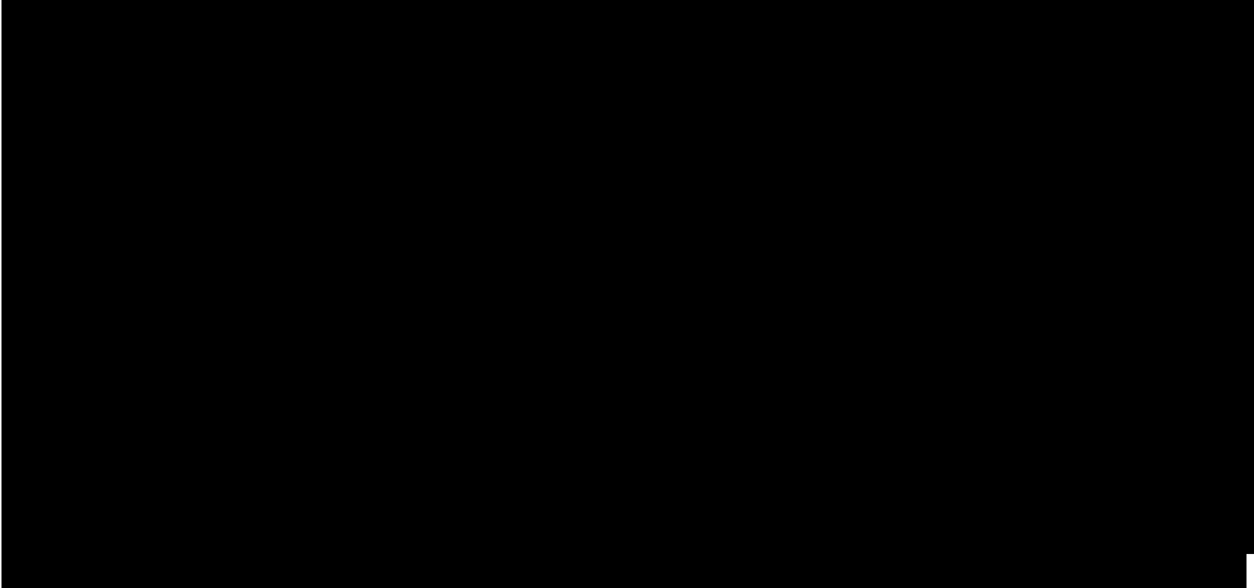
[2] The substantial level amortization requirement was added by the Tax Reform Act of 1986 and is effective for loans made, renewed, renegotiated, modified, or extended after December 31, 1986. This requirement would not seem to apply in this case because the loan was made before that date. Similarly, we assume that section 72(p)(3), which disallows certain interest deductions and has the same effective date, would not be applicable to this transaction.

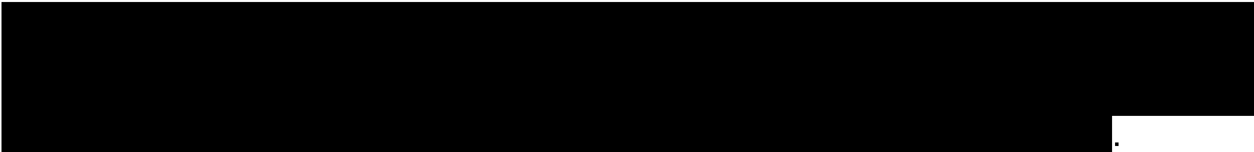
[3]

[4]

[3]

[4]





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