IRS Releases Guidance on Loan Offset Rollovers

As part of the Tax Cuts & Jobs Act of 2017 (TCJA), Congress provided more time for plan participants to roll over certain types of plan loan offsets. The IRS has now released proposed regulations—which can be relied on as of August 20, 2020—to align guidance with statutory rules, while providing additional clarification and examples of how these rules work.

Background

A plan loan offset is generally described as the process by which a participant's accrued benefit is reduced (offset) in order to repay an outstanding plan loan. The offset can occur only when the participant has a distributable event, such as a severance from employment. Because many plans require loan repayments to be made through payroll withholding, a loan default often occurs when a participant leaves the employer. At that point, the participant can cure the default by paying off the loan balance. More likely, however, the plan administrator would offset the loan amount, removing it as a plan asset. This cancelled loan amount—the offset amount—is considered an actual distribution and is taxable to the former employee unless it is rolled over.

Before the TCJA was enacted, participants would have to complete the rollover within 60 days of the loan offset. But participants might not understand that the offset amount is included in income—at least not until they receive *IRS Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, which may be well after the 60-day time frame. Under the TCJA, participants now have a much longer time period to complete a rollover of certain loan offsets.

Proposed regulations give more clarity

While "regular" plan loan offset amounts still exist, the TCJA created a new term: qualified plan loan offset (QPLO). Available for 2018 and later tax years, a QPLO describes offsets that occur only upon plan termination or severance from employment. Here is the crux of the new rule under the TCJA and the proposed regulations: participants and spousal beneficiaries have until their tax filing deadline (including extensions) for the taxable year in which a QPLO occurs to indirectly roll over all or part of it to another eligible retirement plan or IRA.

This rule applies to QPLOs from Internal Revenue Code (IRC) Section 401(a) plans (such as profit sharing, 401(k), and defined benefit plans), 403(a) plans, 403(b) plans, and governmental 457(b) plans.

Two "qualifying" conditions

The proposed regulations define a QPLO as a plan loan offset amount that meets two conditions:

1. The loan amount is treated as distributed from an eligible employer plan to a participant or spousal beneficiary because:
    a. The eligible employer plan was terminated, or
    b. The participant incurred a severance from employment that caused a failure to meet the loan repayment terms.
2. The loan offset amount must relate to a plan loan that met the requirements of IRC Sec. 72(p)(2) immediately before the plan termination or the participant's severance from employment.

IRC Sec.72(p)(2) contains the plan loan conditions that must be met to avoid treating a loan as a distribution. Such conditions include the $50,000 limitation, the five-year maximum term, and the level repayment requirement. If these loan requirements are not met immediately before the loan offset occurs, the offset amount cannot be treated as a QPLO.

Example

Participant B and Participant C both take loans in 2019 from Plan X. Participant B's loan meets all the conditions of IRC. Sec. 72(p)(2), and she had not missed any payments on her loan when her plan was terminated on August 1, 2021. Any offset amount may be considered a QPLO because all loan requirements were satisfied immediately before plan termination.

On January 1, 2021, Participant C defaulted on his loan payments. The employer provided a cure period until June 30, 2021, during which Participant C made no repayments. When the plan terminates on August 1, 2021, Participant C's loan offset amount will not be a QPLO because the loan did not satisfy the level repayment requirement immediately before plan termination. It will, however, still be eligible to be rolled over within 60 days of the offset.

Timely tax filing allows automatic six-month extension on rollover

The relief granted under the TCJA allows those who request a tax filing extension to roll over QPLOs by the extended filing deadline of October 15. In the proposed regulations, the IRS has clarified that the automatic six-month extension under Treas. Reg. 301.9100-2(b) also applies to the deadline by which a QPLO must be rolled over, provided that:

- The taxpayer files a timely tax return, and
- The taxpayer takes corrective action within the six-month period.

Example

On June 1, 2020, Participant D has a $10,000 QPLO amount that is distributed from her plan. She may roll over the $10,000 amount as late as October 15, 2021. The automatic six-month extension applies if Participant D timely files her tax return (by April 15, 2021, the due date of her return), rolls over the QPLO amount within the six-month period ending on October 15, 2021, and amends her tax return by October 15, 2021, if necessary, to reflect the rollover.

Twelve-month “bright-line” test

The IRS provides a test in the proposed regulations that is designed to help plan administrators identify QPLOs after a severance from employment. A plan loan offset amount will meet the severance from employment requirement if it:

- Relates to a failure to meet the loan’s repayment terms, and
- Occurs within the period beginning on the date of the participant’s severance from employment and ending on the first anniversary of that date.

As a result, plan administrators must not report an offset as a QPLO if the offset occurs more than 12 months after the participant’s severance from employment. Offsets occurring after the 12-month period will be treated like regular loan offset amounts, which are subject to the 60-day indirect rollover deadline.

Form 1099-R reporting codes

Plan administrators must report whether a distribution is a regular offset amount or a QPLO on *Form 1099-R*. The 2020 *Form 1099-R* instructions provide that if a participant’s accrued benefit is offset to repay a loan (a regular offset amount), the plan administrator should report the distribution as an actual distribution (code 1 for an early distribution or code 7 for a normal distribution) in box 7 and not use code L, which is used only for deemed distributions. But for a QPLO, the administrator should enter the special code M in box 7, along with any other applicable code.

Next Steps

The proposed regulations contain helpful clarifications and numerous examples. And while the proposed rules are slated to apply to distributions on or after the date that the final regulations are published in the Federal Register, taxpayers and plan administrators may rely on this guidance immediately.

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