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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 released proposed regulations—which can be relied on as of August 20, 2020—to align the IRS's guidance with the statutory rules, while providing additional clarification and examples on 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. Often, plan loan policies require loan repayments to be made through payroll withholding, so former employees cannot continue previously scheduled loan payments. In this case, a loan default 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 participant will request a distribution of the account, and the plan administrator will offset the loan amount, removing it as a plan asset. This cancelled loan amount—the offset amount—is not simply "forgiven." It is considered an actual distribution and is taxable to the former employee for the year in which it is offset, unless it is rolled over. But often participants will not do this. It could be that they don't have the out-of-pocket funds to roll over the offset amount. Or perhaps they don't understand their options.

Before the TCJA was enacted, the 60-day rollover rule would require participants to complete the rollover within 60 days of the loan offset. But participants might not understand that the offset amount is included in income 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. More fundamentally, 60 days doesn't provide much time to come up with the money to roll over the offset amount. If a participant cannot repay the loan to the plan, it's also unlikely that the participant can make up the offset amount by rolling over the loan amount into another eligible plan within 60 days. Under the TCJA, participants have a much longer time period to complete a rollover of certain loan offsets.

Existing Rules Pertaining to Offsets Still Apply

Many of the familiar rollover rules pertaining to offset amounts remain intact. For instance, the revised regulations still contain a definition of "plan loan offset amount," which is eligible to roll over within 60 days. And Treasury Regulation (Treas. Reg.) 1.401(a)(31)-1 Q&A-16 still applies. This provision exempts offsets from the requirement that a plan administrator must offer a direct rollover option on all eligible rollover distributions. Although offset amounts are eligible for rollover treatment, they cannot be rolled over directly because the outstanding loan assets are no longer in an account that can be paid to another eligible plan. Instead, offset amounts can be indirectly rolled over.

Another rule, under Treas. Reg. 31.3405(c)-1, Q&A-11, provides that offset amounts alone are not subject to 20 percent mandatory federal withholding. But if the offset is processed along with a cash distribution that is also an eligible rollover distribution, the 20 percent that must be withheld is calculated on the sum of the cash distribution plus the offset amount.

> **Example**: Participant A severs from employment and requests a lump-sum distribution of his entire individual account under the plan. This balance includes $7,000 in mutual funds and a $3,000 loan amount, which is offset immediately upon termination in accordance with the plan's loan policy. The total distribution eligible for rollover is considered to be $10,000. Therefore, the plan administrator must withhold $2,000 on the lump-sum distribution, which is equal to 20 percent of the total $10,000 eligible rollover distribution. The plan administrator withholds $2,000 from the $7,000 cash portion of the distribution, leaving the participant with a $5,000 net cash amount.

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 plans, 401(k) plans, and defined benefit plans), 403(a) plans, 403(b) plans, and governmental 457(b) plans.

Two "Qualifying" Conditions

The proposed regulations define a *qualified* plan loan offset—a QPLO—as a plan loan offset amount that meets the following two conditions.

- The loan amount is treated as distributed from an eligible employer plan to a participant or spousal beneficiary because
    - o the eligible employer plan was *terminated*, or
    - o the participant incurred a *severance from employment* that caused a failure to meet the loan repayment terms.
- 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 term maximum, 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 of the conditions of IRC. Sec. 72(p)(2), and she has 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.

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: 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.

12-Month "Bright-Line" Test

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

- 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. Fortunately, the new rules are fairly straightforward. Nonetheless, the IRS is taking comments and requests for public hearing on the proposed regulations until October 5, 2020. The proposed rules are slated to apply to distributions on or after the date that the final regulations are published in the *Federal* Register. But taxpayers and plan administrators may rely on this guidance immediately.

Ascensus will continue to follow new developments as they arise. Visit ascensus.com for the latest information.