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IRS Releases Final QPLO Regulations

Plan participants have more time to roll over certain plan loan offsets under the Tax Cuts & Jobs Act of 2017 (TCJA). These are known as qualified plan loan offsets (QPLOs). In response to this legislative change, the IRS released proposed regulations in August 2020. The IRS finalized the regulations in December 2020, with only one modification: the applicability date.

The IRS had previously stated that the regulations, once finalized, would apply to plan loan offset amounts treated as distributed on or after the date the final regulations were published in the Federal Register. Plan administrators and service providers were concerned that, if the final regulations were published in 2020, then they would not have enough time to implement the required changes for reporting distributions on the 2020 IRS Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*

To help alleviate this concern, the IRS revised the applicability date. The final regulations apply to plan loan offsets treated as distributed on or after January 1, 2021. The new applicability date will affect how QPLOs are reported on 2021 Forms 1099-R, which won't be sent to taxpayers until January 2022. Taxpayers—including Form 1099-R filers—may, however, choose to rely on these final regulations for plan loan offset amounts that were treated as distributed on or after August 20, 2020—the date the IRS released the proposed regulations.

Overview

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, is that the participant will request a total distribution, 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 participant 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, participants had to complete the rollover within 60 days of the loan offset. While this may be enough time for some participants, others might not understand that the offset amount is taxable until they receive a Form 1099-R, 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 Still Apply

Many of the familiar rollover rules pertaining to offset amounts remain intact. For instance, the final 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, participants can indirectly roll over offset amounts.

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, then the plan administrator must calculate the 20 percent withholding based on the sum of the cash distribution plus the offset amount.

> **Example**: A participant quits his job and requests a lump-sum distribution of his entire account balance. This balance includes $7,000 in cash and a $3,000 unpaid loan amount, which is offset in accordance with the plan's loan policy. The total distribution eligible for rollover is $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 and sends the participant a $5,000 check. If the participant had requested a direct rollover of the $7,000, no withholding would apply, and the $3,000 QPLO could be rolled over from the participant's other assets.

QPLO Requirements

While "regular" plan loan offset amounts still exist, a QPLO describes offsets that occur only upon plan termination or severance from employment. Plan 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 the loan offset amount to another eligible retirement plan or IRA. This rule applies to QPLOs from 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 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 either because the eligible employer plan was *terminated* or because 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 Internal Revenue Code Section (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 normally 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 is terminated on August 1, 2021. Any offset amount may be considered a QPLO because all loan requirements were satisfied immediately before plan termination.
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> 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.

Automatic Six-Month Rollover Extension

In the final 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.

If these requirements are met, taxpayers will normally have until October 15 of the year following the QPLO distribution to roll over that amount.

> **Example**: On June 1, 2020, Participant D has a $10,000 QPLO amount that is distributed from her plan. The automatic six-month extension applies if Participant D timely files her tax return (generally by April 15, 2021), rolls over the QPLO amount, and if necessary, amends her tax return by October 15, 2021, to reflect the rollover.

12-Month "Bright-Line" Test

Both the proposed and the final regulations contain a test 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 the plan loan offset 1) relates to a failure to meet the loan's repayment terms solely because of the severance, and 2) 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 Requirements

Plan administrators must report whether a distribution is a regular offset amount or a QPLO on Form 1099-R. The 2021 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 plan administrator should enter code M in Box 7, along with any other applicable code.

Next Steps

Because the delayed applicability date is the only change contained in the final regulations, plan administrators, recordkeepers, and service providers have received additional time to comply with the new regulations. Plan administrators should start working with their service providers, if applicable, to create procedures for tracking severance of employment dates and to ensure that their systems can report QPLOs properly on Form 1099-R.

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