Federal Legislative Update

Indiana Benefits Conference

Ian (Ilya) Minkin, Ice Miller LLP

September 11, 2018

The Tax Cuts and Jobs Act of 2017 (TCJA) Plan Participant Loan - Summary of Certain Considerations

IceMiller®
LEGAL COUNSEL

SUMMARY of IRC §402(c)(3)(C), as Added by TCJA §13613

The new rule of IRC §402(c)(3)(C), as added by TCJA §13613 applies to unpaid accrued loan amounts that are <u>offset from the participant's account solely for reasons of plan termination or severance from employment</u>. Before this change, the deadline was the 60th day after the date the loan offset arose. This has been extended up to the due date (including extensions) for filing of the participant's federal income tax return for the year of the offset.

Summary of Certain Plan Loan Rules

- A compliant Plan loan is not a taxable distribution to the participant
- An enforceable loan agreement is required
- Level amortization payments (no less frequently than quarterly) are required
- Adequate security is required
- Loan is typically secured by the participant's account balance

Deemed Distribution
Participant Plan Loan Default

A "deemed" distribution occurs when there have been insufficient loan repayments made in the quarter, or through the "cure period" (the following quarter) to satisfy the level amortization requirements. When this loan default happens, the loan is a "deemed distribution," and will be reported as taxable <u>even if the participant's account balance is not offset by that amount</u>. The regulations specifically state that a "deemed" distribution will NOT be treated as an "actual" distribution.

Deemed Distribution- Taxation

- A deemed distribution is subject to the same tax rules under IRC §72 as an actual distribution from the plan
- Deemed distribution is subject to the premature distribution penalty under §72(t)
- Deemed distribution is **not** an eligible rollover distribution
- A deemed distribution is reported on Form 1099-R, as if the plan actually made a distribution. The distribution is coded in Box 7 as either a regular distribution, or a distribution that is a premature distribution, depending on whether the participant is under age 59½

Loan Offset

An "actual" distribution of a loan default occurs when, under the terms governing a plan loan, the accrued benefit of the participant is reduced (offset) in order to repay the loan (including the enforcement of the plan's security interest in the accrued benefit). A distribution of a plan loan offset amount could occur in a variety of circumstances, such as where the terms governing the plan loan require that, in the event of the participant's request for a distribution, the offset occurs.

Loan Offset Mechanics

- An offset generally can’t occur unless there has been a distributable event under a plan
- Plan provisions control the offset mechanics. Often, loans are not offset until the participant comes in for a distribution after terminating employment
- There is not typically an independent notice to the participant of the date of the offset

IRC §402(c)(3)(C)

- IRC §402(c)(3)(C), as added by TCJA §13613, provides additional time to roll over a qualified loan offset
- Loan offset is qualified when it occurs solely by reason of the *termination of the plan* or the failure to meet the repayment terms *by reason of the participant's severance from employment*

Additional Time to Rollover Eligible Participant Loan Offsets under IRC §402(c)(3)(C)

- Effective January 1, 2018, the rollover may occur up to the due date (including extensions) for filing the participant's federal income tax return for the year in which the loan offset is treated as distributed from the plan
- For example, an offset occurring in January of 2019 is eligible for rollover for about 21 months, a rather long time as compared to the prior period of 60 days
- Applies only to loans from a qualified employer plan, defined in IRC §402(c)(3)(C)(v) to mean a qualified plan under IRC §401(a), a section 403(b) plan, or a governmental 457(b) plan

Mechanics of the Offset Rollover

- The rollover is completed by contributing to the recipient plan or IRA an amount of the loan offset amount, which is the amount by which the participant's accrued benefit is reduced to repay the loan.
- Plans are not required to offer a direct rollover option for participant plan loan offsets
- In the event that a direct rollover option is not available, the participant will need to come up with the cash to be contributed in the rollover
- The rollover relief will provide additional time for an individual who incurs the offset to accumulate the funds needed to avoid taxation on the loan offset

CASH OFFSET ROLLOVER EXAMPLE

Joe has requested a lump sum distribution from his employer's profit sharing plan. His vested account balance is $100,000, which includes a loan receivable of $10,000. The entire $100,000 is taxable unless rolled over. Joe elects a direct rollover to defer taxation . The plan offsets the loan receivable (note: this offset is an actual distribution, not a deemed distribution) from the $100,000, and directly rolls over $90,000 to his IRA. To complete the rollover of the $10,000 representing the offset, Joe may transfer $10,000 in cash to the IRA. The $10,000 rollover must occur within the 60-day rollover period. However, if the loan offset is triggered by his termination of employment with the employer, he would have until the due date of his income tax return (including extensions) for the year in which the offset occurs.

OFFSET ROLLED OVER DIRECTLY

Suppose in the prior example that Joe is working for a new employer and participates in the qualified plan. The plan accepts rollovers and also provides for a participant loan program. Joe elects a direct rollover of $100,000 to the new plan. Since the recipient plan is a qualified plan, the direct rollover may include the outstanding loan of $10,000. This eliminates the need for Joe to come up with $10,000 in cash to complete a rollover of $10,000. He will continue to repay the $10,000 note under the recipient plan.

How helpful are the extended rollover rules?

A substantial number of loan defaults results in taxation under the “deemed” distribution rules, rather than the “actual/offset” distribution rules, because the offset occurs after the return including deemed distribution has been filed, the amount having already been taxed under the deemed distribution rules

Example

- A participant leaves employment on June 1, 2018; the loan defaults because the termination resulted in no payroll deductions being made; and the account balance is not immediately offset
- The taxable deemed distribution occurs at the end of the cure period, September 30. This deemed distribution is not eligible for a rollover
- the defaulted loan amount with penalties (if applicable) will be reported on the Form 1040

Example Continued

- The participant takes a distribution on January 1, 2021, at which point the account balance is offset
- The tax liability has fixed in the prior tax year when the deemed distribution occurs
- The participant has the right now to roll over that amount by April 15, 2022 (or the extended due date), how meaningful is this extended rollover period when the tax liability relating to a deemed distribution has already attached?

Fiduciary Obligations and the Extended Rollover Period

- It appears that for the new extended rollover rule to work best, it may be beneficial for the offsets to occur early
- Is accelerating offsets consistent with plan sponsors' fiduciary obligations?

Loans as Plan Investment – Fiduciary Obligation

- According to the Department of Labor: ***"there is no basis in the statute for departing from the position that <u>participant loans should function as plan investments</u>."*** (See 54 FR 30520)
- As a plan investment, the loan fund is subject to the ERISA's prudence standard. According to the DOL, "***section*** 408(b)(1) recognizes that a program of participant loans, like other plan investments, must be prudently established and administered…." (See 29 CFR § 2550.408b-1)

CONCLUSION

- TCJA brings new opportunities for advantageous treatment of plan loan defaults
- Loans are investments subject to the same ERISA prudence rules as any other plan investment, and changes to loan offset procedures impacts the investment as the loan is no longer collectable following the offset
- The nature of the analysis of the loan procedure would benefit from including the fiduciary component