PENSERV PLAN SERVICES

Qualified Plan Loan Offsets (QPLOs)

Tax Cuts and Jobs Act, Public Law 115-97 (TCJA) passed in December 2017 made significant changes to the plan loan offset rollover eligibility and tax reporting rules. The changes add a significant amount of complexity to tax reporting for these loans, and as a result, the industry has been slow to implement the changes. In August 2020, the IRS published proposed regulations that provided more detail on the requirements of the new provisions. Section 13613 of TCJA provides an extended rollover period for a qualified plan loan offset, which is a new type of plan loan offset. These regulations affect participants, beneficiaries, sponsors, and administrators of employer plans, including 403(b), QP, and governmental 457(b) plans.

The effective date is with respect to any loans treated as distributed on or after January 1, 2021, which means that the reporting will first take effect on the 2021 forms 1099-R, which are filed in 2022. Although payers of Form 1099R may apply these rules for any offset loans treated as distributed after August 20, 2020.

In general, loans are "offset" at the point when a participant reaches a distributable event and takes a lump sum distribution from the plan. This means the loan balance is reported as a distribution that is taxable to the participant. The only opportunity to avoid the taxation on this offset prior to August 20, 2020 (the date of the proposed regulations) was for a participant to complete an indirect rollover, depositing the amount of the offset loan balance into an IRA or another eligible retirement account within 60 days of the distribution.

Under the new regulations, there are now three different terms for a loan that is distributed, and each has rollover rules specific to it.

<u>Qualified Plan Loan Offset (**QPLO**):</u> the amount of the loan balance that is offset if it meets all of the following conditions:

1. The distribution is required due to either plan termination, or the employee having separated from service and not permitted to continue to repay the loan (this may also be within a specified period after termination).
2. The loan is in good standing at the time of the offset distribution.
3. Occurs within the period beginning on the date of the employee's severance from employment and ending on the first anniversary of that date.*

> * *This is the latest date that the QPLO will be deemed distributed. This helps with determining when the rollover period ends or the tax filing due date plus extensions. See example below.*

For tax reporting purposes, the loan is reported with a code M on the 1099-R, with either a 1 or 7 based on the age of the participant. If the QPLO is coming from a Designated Roth Account, the loan is reported with a codes M and B. If a numeric code is needed, for example a code 1, then the "M" is dropped from the reporting leaving only B1.

Qualified Plan Loan Offset amounts have a rollover deadline of the participant's tax filing deadline for the year of the distribution, plus extensions. This means the participant has an extended amount of time to accumulate funds to reduce the taxation of the offset distribution.

<u>Plan Loan Offset (**PLO**):</u> Loans that are offset, but do not meet the requirements of a QPLO, continue to be eligible for a 60-day rollover. These loans continue to be reported as a distribution with a code 1 or 7 on the 1099-R. The 60-day period in this case will begin after the one-year period that ends on the one-year anniversary of the severance from employment. Rollovers are still available but must be made within 60 days from such date.

<u>Deemed Distributions:</u> Loans go into default when they fail one of the loan requirements under section 72(p) (such as borrowing too much, or not using a "reasonable interest rate") or reach end of the cure period outlined in the plan loan policy. The loans are reported as a distribution on the 1099-R with a Code L and either a 1 or 7 depending on the age of the participant. These loans remain an asset of the plan and continue to accrue interest until the participant reaches a distributable event.

<u>Examples</u>

Example 1: Susan separates from service in March of 2020. She has an account balance of $10,000 of which $3,000 is invested in a loan, which she cannot afford to pay off immediately. She rolls over the remaining balance in her account and the loan is offset. Susan's loan was in good standing at the time of distribution, and will be reported with the code M1 on her 2020 1099-R. Susan has until October 15th of <u>2021</u>, to accumulate as much possible to rollover the QPLO.

> **Scenario A:** Susan is able to save $2000 before 10/15/21 and deposits that amount as a rollover of her QPLO. The taxable portion of Susan's initial $3000 has now been reduced to $1000.
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> **Scenario B:** Susan is able to save the full $3000 of her loan offset and deposit it as a rollover of her QPLO before 10/15/21. Susan now has zero tax liability caused by the QPLO.

Example 2: Assume the same facts as Example 1, except Susan takes a partial distribution when she separates from service, as well as rolling over her remaining account balance. Susan takes a distribution of $7000. The 20% mandatory withholding on that distribution must also include the loan balance. This means $2,000 is withheld for federal income taxes and the net payment to Susan is $5,000. Her overall tax liability from the distribution is $13,000.

Susan is eligible to do a 60-day rollover of the amount she received in her distribution, plus the total amount that was withheld in federal income taxes to avoid taxation on that distribution.

Susan's QPLO amount is still $3000 and she has until her tax filing deadline, plus extensions to complete that rollover on or before 10/15/21.

Example 3: Carolyn separates from service in July 2019. She has a $10,000 loan at the time of her separation.

> **Scenario A**: Carolyn's plan permits her to continue repaying her loan balance. Carolyn leaves the money in the plan and continues to repay the loan until September 2020, when she rolls over the balance in her account. The remaining balance on Carolyn's loan is offset as part of the rollover distributions, but is not a QPLO because more than one year has passed from Carolyn's separation from service. Carolyn's only rollover option related to the loan balance is a 60-day rollover. *(Comment – the 60 days would be measured from September 2020 since this is not a QPLO.)*

Scenario B: Carolyn's plan permits her to continue repaying her loan balance. Carolyn leaves the money in the plan and continues to repay the loan until April 2020, when she rolls over her account balance. The loan is offset when the rollover distribution occurs. Carolyn's loan is not treated as a QPLO because Carolyn was eligible to continue repaying the loan and elected to take a distribution and offset the loan.

<u>Questions</u>

Q: What is "good standing" for the purposes of a loan being eligible to be treated as a QPLO?

A: The loan must meet the requirements of 72(p)(2) immediately prior to the distributable event causing the offset. This includes:

- The loan is evidenced by an enforceable agreement;
- The loan term cannot exceed 5 years, unless the loan a primary residence loan and eligible for a longer term; and
- The loan must be repaid in substantially level installments.

  Additionally at the time the loan was granted, the amount of the loan may not exceed the limits of 72(p)(2)(A).

  - In general, this means the loan balance must be less than 50% of the vested balance in the participants account. If the loan exceeded these amounts then the excess would have been a "deemed" distribution at the point that the loan was made unless corrected under EPCRS.

While the proposed and final regulations provide for much needed tax relief for participants with loan offsets, administrative requirements tied to this relief are quite complex.