WRMarketplace
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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: 10% Additional Tax on Early Distributions Applies to Participant Plan Loan Offsets.

MARKET TREND: Use of participant loans from qualified retirement plans has increased, resulting in taxable distributions for participants who cannot repay their loans in full in the event of a termination of employment.

SYNOPSIS: Failure to repay a participant loan from a qualified retirement plan can result in income tax on the amount of the remaining loan and the application of an additional 10% tax for early distributions. A recent Tax Court case, *Matthews et. ux. v. Commissioner*, held that there is no exception from the additional tax for economic hardship.

TAKE AWAYS: Consultants and advisors to qualified retirement plans should ensure that employer-clients maintaining qualified retirement plans are familiar with the plan terms and events that cause treatment of a plan loan as a deemed participant distribution or plan loan offset. Such deemed distributions or plan loan offsets constitute gross income subject to federal income tax and are subject to the 10% additional tax on early plan distributions, with limited exceptions (which regrettably do not include an exception for economic hardship).

MAJOR REFERENCES: Internal Revenue Code §§72(p) and (t); Treas. Regs. §1.72(p)-1 and §1.402(c)-2; *Matthews et. ux v. Commissioner*, T.C. Summary 2014-84 (Aug.28, 2014).

For various economic reasons, including changes in financial circumstances, individuals may seek early access to their retirement funds, including those held in qualified plans, via loans. A recent Tax Court case, *Matthews et ux. v. Commissioner*,[1] serves as an important reminder that participant loans from qualified retirement plans can result in both income tax and a potential 10% additional tax on the loan amount if not properly repaid in accordance with the loan terms.

PARTICIPANT LOANS REQUIREMENTS

Requirements and Limitations. A loan to a participant or beneficiary from a qualified employer plan (e.g., 401(k) plan, profit sharing plan, 403(b) plan) will not be treated as a potentially taxable deemed distribution if the loan, at origination, satisfies the following:[2]

- **Loan Term Requirement.** Generally, a plan loan is required to be repaid within five years, unless used to acquire a principal residence for the participant.

- **Level Amortization Requirement.** With limited exceptions, a plan loan must provide for substantially level amortization over its term, with payments required at least quarterly.[3]

- **Enforceable Agreement Requirement.** A plan loan must be evidenced by a legally enforceable agreement under applicable state law and demonstrate compliance with the plan loan requirements, including specifying the loan amount, date, and repayment schedule.

- **Loan Amount Limitations.** A plan loan is subject to certain limits on the amount a participant can borrow without triggering treatment of part of the loan as a plan distribution:

    - A plan loan cannot exceed $50,000, provided that this $50,000 limit is reduced by the excess, if any, of: (i) the highest outstanding balance of loans from the plan during the one-year period ending the day before the date of the new plan loan, over (ii) the outstanding balance of the plan loans on the date of the new loan;

    - A plan loan cannot exceed the greater of: (i) one-half of the non-forfeitable accrued benefit of the employee under the plan, or (ii) $10,000; and

    - The amount that can be borrowed as a new loan is reduced by any other outstanding plan loan balances.

  Example: A participant has an existing plan loan but wants to take a new participant loan in the maximum amount that will not be treated as a distribution. If the participant's vested account balance is $100,000, the balance of the existing plan loan is $10,000 and the highest outstanding balance during the last year was $20,000, then the maximum new loan that would not be treated as a distribution would be $30,000. This loan limit amount is determined by reducing $40,000 (which equals the lesser of: (1) the $50,000 limit reduced by the $10,000 excess of the $20,000 highest one-year balance over the $10,000 current balance) and (2) $50,000 (the greater of $50,000 (one-half of the vested account balance) or $10,000) by the $10,000 outstanding loan balance.

Compliance with Loan Terms. A plan loan also must be operated in accordance with its terms. If any installment payment is not paid when due under loan terms, a **deemed distribution of the entire outstanding balance** of the loan (including accrued interest) would occur at the time of the failure. To prevent deemed distributions from occurring, a plan may allow for late installment payments made during a "cure period" to be treated as not violating the rules. The maximum cure period permissible is no later than the end of the calendar quarter following the calendar quarter in which the required installment payment was due.

DEEMED DISTRIBUTIONS

Plan loans failing to satisfy the above requirements will be treated as deemed distributions from the plan, which will constitute gross income to the participant, subject to federal income tax, and, as discussed below, potentially subject to the 10% additional tax on early distributions. A deemed distribution also is **not** considered an actual distribution from the plan for most retirement plan purposes; thus, the amount of a deemed distribution **is not eligible to be rolled over to another plan or an IRA** (which otherwise could be a method to avoid the tax).

PLAN LOAN OFFSET

The terms of a plan loan may require immediate repayment of a plan loan or treatment as a default upon the occurrence of certain events (*e.g.*, the employee's termination of employment or upon a request for a distribution). A plan loan offset occurs if the accrued benefit of the participant or beneficiary is reduced (offset) in order to repay the defaulted loan (including enforcement of the plan's security interest in the accrued benefit).

Like deemed distributions, plan loan offsets are included in gross income and subject to income tax, as well as the 10% additional tax on early distributions (see below). Unlike deemed distributions, however, plan loan offsets **are treated as actual distributions from the plan** and can be an eligible rollover distribution; thus, an amount equal to the plan loan offset amount may be eligible to be rolled over by the employee (or spousal distributee) to an eligible retirement plan within the 60-day period.

ADDITIONAL TAX ON EARLY DISTRIBUTIONS

Unless an exception is available, an additional 10% tax may apply to deemed distributions or loan offsets resulting from a plan loan.[4] The available exceptions include those for plan distributions:

- Made on or after the date on which the employee attains age 59½;
- Attributable to the employee being disabled;
- Made to a beneficiary or an estate on or after the employee's death;
- Made as part of a series of substantially equal periodic distributions for the life of the employee or joint lives of the employee and his/her designated beneficiary; or
- Made to an employee after separation from service after attainment of age 55.

The amount of deductible medical expenses (*i.e.*, those exceeding 10% of adjusted gross income ("**AGI**"))[5] reduces the amount of distributions from a plan that is subject to the tax.

PLAN LOANS & THE ADDITIONAL TAX - THE MATTHEWS CASE

In the *Matthews* case, the participant had an outstanding loan at the time of his termination of employment from the corporation sponsoring the 401(k) plan. The participant changed jobs and subsequently became unemployed six months later. The terms of the plan required that the plan loan be repaid in full before distributions could be made from the participant's account. The participant requested a withdrawal of funds from his 401(k) plan account in order to alleviate economic hardship. When a distribution from the 401(k) plan was made, some of the participant's benefits in the plan were applied to offset the outstanding loan. The participant and his wife filed an income tax return but did not include any additional tax for early distributions related to the plan loan offset.

Because the participant's account was reduced to pay the plan loan, the offset amount constituted gross income subject to federal income taxation. The offset was also subject to the additional tax on early distributions unless an exception applied. The participant, however, was age 49 at the time of the distribution; thus, he was not eligible for the age 59 ½ exception or the separation from service after age 55 exception. Neither were the participant and his wife eligible for a reduction of the additional tax due to unreimbursed medical expenses, since those expenses did not exceed the applicable AGI threshold required for deductibility in that year.[6]

The participant and his wife argued they should be excused from the additional tax because the participant was obligated to take the distributions to alleviate economic hardship. The Tax Court found no authority to exist in the Internal Revenue Code, in the legislative history or case law for a general financial hardship exception to the imposition of the additional tax on early distributions. The Tax Court also disagreed with their argument that the offset amount should not be subject to the additional tax because the participant did not actually receive that amount as offsets are required to be treated as actual distributions. Ultimately, the Tax Court held that the participant's distributions from the 401(k) plan were subject to the 10% additional tax despite the participant's economic hardship, as that was not an allowable exception.

TAKE AWAYS

- Consultants and advisors to qualified retirement plans should ensure that employer-clients maintaining qualified retirement plans are familiar with the plan terms and events that cause a plan loan to be treated as distributed to the participant.

- Deemed distributions or plan loan offsets resulting from plan loans constitute gross income subject to federal income tax and are subject to the 10% additional tax on early distributions unless an exception applies.

- Regrettably, there is no exception to the 10% additional tax on early distributions for economic hardship.

NOTES

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[1] *Matthews v. Commissioner of Internal Revenue, T.C. Summary 2014-84 (Aug.28, 2014).*
[2] Note that an outstanding loan will be treated as having been received by the individual not as a loan but as a plan distribution at the first time these requirements are not met.
[3] Exceptions include if a participant is on a bona fide leave of absence for a period not longer than one year if the participant is without pay or the participant's pay after tax withholdings is less than the installment payments of the loan. A plan can also suspend the obligation to repay a plan loan made to an employee for any part of the period of time the employee is performing service in the uniformed services even if the suspension exceeds one year and even if the term of the loan is extended.
[4] The taxpayer's tax for the taxable year in which such amount is received shall be increased by an amount equal to 10% of the portion of such amount which is includible in gross income. This additional tax is designed to discourage taxpayers from taking premature distributions from retirement plans.
[5] Effective for tax years beginning after December 31, 2012, the 10% threshold for medical expense deductions was increased from 7.5%, with a limited exception through 2016 for taxpayers who have attained age 65.
[6] The AGI threshold in the tax year at issue in *Matthews* was 7.5%.

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