# Part IV. Items of General Interest

## Notice of Proposed Rulemaking

## Loans to Plan Participants

## EE–106–82

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed Income Tax Regulations under section 72(p) of the Internal Revenue Code relating to loans made from a qualified employer plan to plan participants or beneficiaries. Section 72(p) was added by section 236 of the Tax Equity and Fiscal Responsibility Act of 1982, and amended by the Technical Corrections Act of 1982, the Deficit Reduction Act of 1984, the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988. These regulations provide guidance to the public with respect to this provision, and affect any plan participant or beneficiary who receives a loan from a qualified employer plan.

DATES: Written comments and requests for a public hearing must be received by March 20, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (EE–106–82), Attention: Plan Loans Guidance, Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (EE–106–82), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Vernon S. Carter, of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations), IRS, at (202) 622-6070 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

*Background*

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 72 of the Internal Revenue Code of 1986 (Code). These amendments are proposed to conform the regulations to section 236 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which added section 72(p) to the Code, and to the amendments to section 72(p) made by the Technical Corrections Act of 1982, the Deficit Reduction Act of 1984, the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988.

*Explanation of provisions*

Section 72(p) of the Code generally provides that an amount received as a loan from a qualified employer plan by a participant or beneficiary is treated as received as a distribution from the plan for purposes of section 72 (a deemed distribution), except to the extent certain conditions are satisfied. For purposes of section 72, a qualified employer plan includes a plan that qualifies under section 401 (relating to qualified trusts), 403(a) (relating to qualified annuities) or 403(b) (relating to tax sheltered annuities), as well as a plan (whether or not qualified) maintained by the United States, a State or a political subdivision thereof, or an agency or instrumentality thereof. A qualified employer plan also includes a plan which was (or was determined to be) a qualified plan or a government plan. A loan from a contract purchased under a qualified employer plan is also treated as a loan from the plan. Section 72(p) also provides that an assignment or pledge of (or an agreement to assign or pledge) any portion of a participant's or beneficiary's interest in a qualified employer plan is to be treated as a loan from the plan.

Under section 72(p), a loan from a qualified employer plan to a participant or beneficiary is not treated as a distribution from the plan if the loan satisfies certain requirements relating to the terms of the loan and the repayment schedule, and to the extent the loan satisfies certain limitations on the amount loaned. The proposed regulations require that the loan be evidenced by an enforceable agreement, set forth in writing or in another form that is approved by the Commissioner of Internal Revenue, that includes terms that satisfy the statutory requirements. Thus, the agreement must specify the amount of the loan, the term of the loan, and the repayment schedule. The agreement may be set forth in more than one document.

If a loan fails to satisfy the repayment requirements or the enforceable agreement requirement, the proposed regulations provide for the balance then due under the loan to be treated as a distribution from the plan. This may occur at the time the loan is made or at a later date if the loan is not repaid in accordance with the repayment schedule. If the loan satisfies the repayment requirements and the enforceable agreement requirement, but at the time the loan is made the amount of the loan exceeds the statutory limitation on the amount that is permitted to be loaned, the proposed regulations provide that only the excess amount is a deemed distribution.

One of the repayment requirements is that the loan be repaid within five years, unless the loan is used to acquire a dwelling unit which within a reasonable time is used as the principal residence of the participant. The proposed regulations provide that a principal residence has the same meaning as under section 1034 (relating to the taxation of a sale of a residence) and that tracing rules established under section 163(h)(3)(B) (relating to interest deductions for indebtedness incurred with respect to the acquisition of a principal residence) will be used to determine whether the section 72(p)(2)-(B)(ii) exception to the five-year repayment requirement applies. (Notice 88–74 (1988–2 C.B. 385), sets forth certain standards applicable under section 163(h)(3).)

The Tax Reform Act of 1986 amended section 72(p) to require that, in order for a loan to not be treated as a distribution, the loan must be repaid in substantially level installments (not less frequently than quarterly) over the term of the loan.

Section 72(p) authorizes regulations to allow exceptions from this requirement. Pursuant to this authorization, the proposed regulations permit loan repayments to be suspended during a leave of absence of up to one year, if the participant's pay from the employer is insufficient to service the debt, but only if the loan is repaid by the latest date permitted under section 72(p)(2)(B).

If the repayment terms of a loan are not satisfied after the loan has been made due to a failure to make a scheduled loan repayment, the proposed regulations provide for the balance then due under the loan to be deemed to be distributed. The proposed regulations permit a grace period, to the extent the grace period does not extend beyond the end of the calendar quarter next following the calendar quarter in which the repayment was scheduled to be made.

If a loan is treated as a distribution under section 72(p), the proposed regulations state that the amount so distributed is to be treated as a taxable distribution, subject to the normal rules of section 72 if the participant's interest in the plan includes after-tax contributions (or other tax basis). A deemed distribution would also be a distribution for purposes of the 10 percent tax in section 72(t) and the excise tax on excess distributions under section 4980A. However, a deemed distribution under section 72(p) is not treated as an actual distribution for purposes of the qualification requirements of section 401, the rollover and income averaging provisions of section 402 and the distribution restrictions of section 403(b).

By contrast, if a participant's accrued benefit is reduced (offset) in order to repay a loan, an actual distribution occurs for purposes of the provisions in sections 401, 402 and 403(b) referred to above. Thus, for example, a plan is prohibited from enforcing its security interest in a participant's account balance attributable to amounts contributed pursuant to an election under section 401(k) until a date on which distribution is permitted under section 401(k).

The proposed regulations do not address all issues arising under section 72(p). Comments are requested on whether further guidance should be provided on issues that are not addressed and how the issues should be resolved, including the effect of a deemed distribution on the tax treatment of subsequent distributions from the plan and the application of the $50,000 limitation and the five year repayment requirement to a refinancing and to multiple loan arrangements.

Taxpayers may rely on these proposed regulations for guidance pending the issuance of final regulations. If, and to the extent, future guidance is more restrictive than the guidance in these proposed regulations, the future guidance will be applied without retroactive effect.

*Special Analysis*

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f), this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

*Comments and Request for Public Hearing*

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the following address:

CC:DOM:CORP:R (EE–106-82)
Attention: Plan Loans Guidance, Room 5228
Internal Revenue Service
POB 7604, Ben Franklin Station
Washington, DC 20044

All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

*Drafting Information*

The principal author of these proposed regulations is Vernon S. Carter, Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). However, other personnel from the IRS and Treasury Department participated in their development.

*List of Subjects in 26 CFR Part 1*

Income taxes, Reporting and recordkeeping requirements.

*Proposed Amendments to the Regulations*

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805. * * *

Par. 2. Section 1.72–17A is amended as follows:

1. Paragraphs (d)(1), (d)(2) and (d)(3) are redesignated as paragraphs (d)(2), (d)(3) and (d)(4), respectively.

2. New paragraph (d)(1) is added to read as follows:

*§1.72–17A Special rules applicable to employee annuities and distributions under deferred compensation plans to self-employed individuals and owner-employees.*

* * * * * *

(d) * * * (1) The references in this paragraph (d) to section 72(m)(4) are to that section as in effect on August 13, 1982. Section 236(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 repealed section 72(m)(4), generally effective for assignments, pledges and loans made after August 13, 1982, and added section 72(p). See section 72(p) and §1.72(p)–1 for rules governing the income tax treatment of certain assignments, pledges and loans from qualified employer plans made after August 13, 1982.

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Par. 3. Section 1.72(p)–1 is added to read as follows:

*§1.72(p)–1 Loans treated as distributions.*

The questions and answers in this section provide guidance under section 72(p) pertaining to loans from qualified employer plans (including government plans and tax-sheltered annuities and employer plans that were formerly qualified).

*ASSUMPTIONS FOR EXAMPLES*

The examples included in the questions and answers in this section are

based on the assumption that a bona fide loan is made to a participant from a qualified defined contribution plan pursuant to an enforceable agreement (in accordance with Q&A–3(b) of this section), with adequate security and with an interest rate and repayment terms that are commercially reasonable. (The particular interest rate used for illustration in this section is 8.75 percent compounded annually.) In addition, unless the contrary is specified, it is assumed in the examples that the amount of the loan does not exceed 50 percent of the participant's nonforfeitable account balance, the participant has no other outstanding loan (and had no prior loan) from the plan or any other plan maintained by the participant's employer or any other person required to be aggregated with the employer under section 414(b), (c) or (m), and the loan is not excluded from section 72(p) as a loan made in the ordinary course of an investment program as described in Q&A–18 of this section. No inference should be drawn from these regulations or the examples therein that a loan would not result in a prohibited transaction under section 4975 or would be consistent with the fiduciary standards of Title I of the Employee Retirement Income Security Act of 1974, as amended. See, for example, 29 CFR §2550.408b–1 (interpreting the statutory prohibited transaction exemption for loans to participants and beneficiaries).

QUESTIONS AND ANSWERS

Q–1: In general, what does section 72(p) provide with respect to loans from a qualified employer plan?

A–1: (a) *Loans*. Under section 72(p), an amount received by a participant or beneficiary as a loan from a qualified employer plan is treated as having been received as a distribution from the plan (a deemed distribution), unless the loan satisfies the requirements of Q&A–3 of this section. For purposes of section 72(p), a loan made from a contract that has been purchased under a qualified employer plan (including a contract that has been distributed to the participant or beneficiary) shall be considered a loan made under a qualified employer plan.

(b) *Pledges and assignments*. Under section 72(p), if a participant or beneficiary assigns or pledges (or agrees to assign or pledge) any portion of his or her interest in a qualified employer plan as security for a loan, the portion of the individual's interest assigned or pledged (or subject to an agreement to assign or pledge) is treated as a loan from the plan to the individual, with the result that such portion is subject to the deemed distribution rule described in paragraph (a) of this Q&A–1. For purposes of section 72(p), any assignment or pledge of (or agreement to assign or to pledge) by a participant or beneficiary of any portion of his or her interest in a contract that has been purchased under a qualified employer plan (including a contract that has been distributed) shall be considered an assignment or pledge of (or agreement to assign or pledge) an interest in a qualified employer plan. However, if all or a portion of a participant's or beneficiary's interest in a qualified employer plan is pledged or assigned as security for a loan from the plan to the participant or the beneficiary, only the amount of the loan received by the participant or the beneficiary, not the amount pledged or assigned, is treated as a loan.

Q–2: What is a qualified employer plan for purposes of section 72(p)?

A–2: For purposes of section 72(p), a qualified employer plan means—

(a) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a);

(b) An annuity plan described in section 403(a);

(c) A plan under which amounts are contributed by an individual's employer for an annuity contract described in section 403(b);

(d) Any plan, whether or not qualified, established and maintained for its employees by the United States, by a State or political subdivision thereof, or by an agency or instrumentality of the United States, a State or a political subdivision of a State; or

(e) Any plan which was (or was determined to be) described in paragraph (a), (b), (c), or (d) of this Q&A–2.

Q–3: What requirements must be satisfied in order for a loan to a participant or beneficiary from a qualified employer plan not to be a deemed distribution?

A–3: (a) *In general*. A loan to a participant or beneficiary from a qualified employer plan will not be a deemed distribution to the participant or beneficiary if the loan satisfies the repayment term requirement of section 72(p)(2)(B), the level amortization requirement of section 72(p)(2)(C), and the enforceable agreement requirement of paragraph (b) of this Q&A–3, but only to the extent the loan satisfies the amount limitations of section 72(p)(2)(A).

(b) *Enforceable agreement requirement*. A loan does not satisfy the requirements of this paragraph unless the loan is evidenced by a legally enforceable agreement (which may include more than one document) set forth in writing or in such other form as may be approved by the Commissioner, and the terms of the agreement demonstrate compliance with the requirements of section 72(p)(2) and this section. Thus, the agreement must specify the amount of the loan, the term of the loan, and the repayment schedule.

Q–4: If a loan from a qualified employer plan to a participant or beneficiary fails to satisfy the requirements of Q&A-3 of this section, when does a deemed distribution occur?

A–4: (a) *Deemed distribution*. For purposes of section 72, a deemed distribution occurs at the first time that the requirements of Q&A–3 of this section are not satisfied, in form or in operation, with respect to that amount. This may occur at the time the loan is made or at a later date. If the terms of the loan do not require repayments that satisfy the repayment term requirement of section 72(p)(2)(B) or the level amortization requirement of section 72(p)(2)(C), or the loan is not evidenced by an enforceable agreement satisfying the requirements of Q&A–3(b) of this section, the entire amount of the loan is a deemed distribution under section 72(p) at the time the loan is made. If the loan satisfies the requirements of Q&A–3 of this section except that the amount loaned exceeds the limitations of 72(p)(2)(A), the amount of the loan in excess of the applicable limitation is a deemed distribution under section 72(p) at the time the loan is made. If the loan initially satisfies the requirements of section 72(p)(2)(A), (B) and (C) and the enforceable agreement requirement of Q&A–3(b) of this section, but payments are not made in accordance with the terms applicable to the loan, a deemed distribution occurs as a result

of the failure to make such payments. See Q&A–10 of this section regarding when such a deemed distribution occurs and the amount thereof and Q&A–11 of this section regarding the tax treatment of a deemed distribution.

(b) *Examples*. The following examples illustrate the rules in paragraph (a) of this Q&A–4 and are based upon the assumptions described in ASSUMPTIONS FOR EXAMPLES:

*Example 1*. (a) A participant has a nonforfeitable account balance of $200,000 and receives $70,000 as a loan repayable in level quarterly installments over five years.

(b) Under section 72(p), the participant has a deemed distribution of $20,000 (the excess of $70,000 over $50,000) at the time of the loan, because the loan exceeds the $50,000 limit in section 72(p)(2)(A)(i). The remaining $50,000 is not a deemed distribution.

*Example 2*. (a) A participant with a nonforfeitable account balance of $30,000 borrows $20,000 as a loan repayable in level monthly installments over five years.

(b) Because the amount of the loan is $5,000 more than 50% of the participant's nonforfeitable account balance, the participant has a deemed distribution of $5,000 at the time of the loan. The remaining $15,000 is not a deemed distribution. (Note also that, if the loan is secured solely by the participant's account balance, the loan may be a prohibited transaction under section 4975 because the loan may not satisfy 29 CFR § 2550.408b–1(f)(2)).

*Example 3*. (a) The nonforfeitable account balance of a participant is $100,000 and a $50,000 loan is made to the participant repayable in level quarterly installments over seven years. The loan is not eligible for the section 72(p)(2)(B)(ii) exception for loans used to acquire certain dwelling units.

(b) Because the repayment period exceeds the maximum five-year period in section 72(p)(2)(B)(i), the participant has a deemed distribution of $50,000 at the time the loan is made.

*Example 4*. (a) On August 1, 1998, a participant has a nonforfeitable account balance of $45,000 and borrows $20,000 from a plan to be repaid over five years in level monthly installments due at the end of each month. After making monthly payments through July 1999, the participant fails to make any of the payments due thereafter.

(b) As a result of the failure to satisfy the requirement that the loan be repaid in level monthly installments, the participant has a deemed distribution. See Q&A–10(c) *Example* of this section regarding when such a deemed distribution occurs and the amount thereof.

Q–5: What is a principal residence for purposes of the exception in section 72(p)(2)(B)(ii) from the requirement that a loan be repaid in five years?

A–5: Section 72(p)(2)(B)(ii) provides that the requirement in section 72(p)(2)(B)(i) that a plan loan be repaid within five years does not apply to a loan used to acquire a dwelling unit which will within a reasonable time be used as the principal residence of the participant (a principal residence plan loan). For this purpose, a principal residence has the same meaning as a principal residence under section 1034.

Q–6: In order to satisfy the requirements for a principal residence plan loan, is a loan required to be secured by the dwelling unit that will within a reasonable time be used as the principal residence of the participant?

A–6: A loan is not required to be secured by the dwelling unit that will within a reasonable time be used as the participant's principal residence in order to satisfy the requirements for a principal residence plan loan.

Q–7: What tracing rules apply in determining whether a loan qualifies as a principal residence plan loan?

A–7: The tracing rules established under section 163(h)(3)(B) apply in determining whether a loan is treated as for the acquisition of a principal residence in order to qualify as a principal residence plan loan.

Q–8: Can a refinancing qualify as a principal residence plan loan?

A–8: (a) *Refinancings*. In general, no. However, a loan from a qualified employer plan used to repay a loan from a third party will qualify as a principal residence plan loan if the plan loan qualifies as a principal residence plan loan without regard to the loan from the third party.

(b) *Example*. The following example illustrates the rules in paragraph (a) of this Q&A–8 and is based upon the assumptions described in ASSUMPTIONS FOR EXAMPLES:

*Example*. (a) On July 1, 1999, a participant requests a $50,000 plan loan to be repaid in level monthly installments over 15 years. On August 1, 1999, the participant acquires a principal residence and pays a portion of the purchase price with a $50,000 bank loan. On September 1, 1999, the plan loans $50,000 to the participant, which the participant uses to pay the bank loan.

(b) Because the plan loan satisfies the requirements to qualify as a principal residence plan loan (taking into account the tracing rules of section 163(h)(3)(B)), such plan loan qualifies for the exception in section 72(p)(2)(B)(ii).

Q–9: Does the level amortization requirement of section 72(p)(2)(C) apply when a participant is on a leave of absence without pay?

A–9: (a) *Leave of absence*. The level amortization requirement of section 72(p)(2)(C) does not apply for a period, not longer than one year, that a participant is on a leave of absence, either without pay from the employer or at a rate of pay (after income and employment tax withholding) that is less than the amount of the installment payments required under the terms of the loan. However, the loan must be repaid by the latest date permitted under section 72(p)(2)(B) and the installments due after the leave ends (or, if earlier, after the first year of the leave) must not be less than those required under the terms of the original loan.

(b) *Example*. The following example illustrates the rules of paragraph (a) of this Q&A-9 and is based upon the assumptions described in ASSUMPTIONS FOR EXAMPLES:

*Example*. (a) On July 1, 1997, a participant with a nonforfeitable account balance of $80,000, borrows $40,000 to be repaid in level monthly installments of $825 each over five years. The loan is not a principal residence plan loan. The participant makes nine monthly payments and commences an unpaid leave of absence that lasts for 12 months. Thereafter, the participant resumes active employment and resumes making repayments on the loan until the loan is repaid. The amount of each monthly installment is increased to $1,130 in order to repay the loan by June 30, 2002.

(b) Because the loan satisfies the requirements of section 72(p)(2), the participant does not have a deemed distribution. Alternatively, section 72(p)(2) would be satisfied if the participant continued the monthly installments of $825 after resuming active employment and on June 30, 2002 repaid the full balance remaining due.

Q–10: If a participant fails to make the installment payments required under the terms of a loan that satisfied the requirements of Q&A–3 of this section when made, when does a deemed distribution occur and what is the amount of the deemed distribution?

A–10: (a) *Timing of deemed distribution*. Failure to make any installment payment when due in accordance with the terms of the loan violates section 72(p)(2)(C) and, accordingly, results in a deemed distribution at the time of such failure. However, the plan administrator may allow a grace period, and section 72(p)(2)(C) will not be considered to have been violated until the last day of the grace period. Any such grace period shall be given effect for purposes of section 72(p)(2)(C) only to the extent it does not continue beyond the last day of the calendar quarter following the calendar quarter in which

the required installment payment was due.

(b) *Amount of deemed distribution*. If a loan satisfies Q&A–3 of this section when made, but there is a failure to pay the installment payments required under the terms of the loan (taking into account any grace period allowed under the preceding paragraph (a) of this Q&A–10), then the amount of the deemed distribution equals the entire outstanding balance of the loan at the time of such failure.

(c) *Example*. The following example illustrates the rules in Q&A–10(a) and (b) of this section and is based upon the assumptions described in ASSUMPTIONS FOR EXAMPLES:

*Example*. (1) On August 1, 1998, a participant has a nonforfeitable account balance of $45,000 and borrows $20,000 from a plan to be repaid over five years in level monthly installments due at the end of each month. After making all monthly payments due through July 31, 1999, the participant fails to make the payment due on August 31, 1999 or any other monthly payments due thereafter. The plan administrator allows a three-month grace period.

(2) As a result of the failure to satisfy the requirement that the loan be repaid in level installments pursuant to section 72(p)(2)(C), the participant has a deemed distribution on November 30, 1999, which is the last day of the three-month grace period for the August 31, 1999 installment. The amount of the deemed distribution is $17,157, which is the outstanding balance on the loan at November 30, 1999. Alternatively, if the plan administrator had allowed a grace period through the end of the next calendar quarter, there would be a deemed distribution on December 31, 1999 equal to $17,282, which is the outstanding balance of the loan at December 31, 1999.

Q–11: Do sections 72 and 4980A apply to a deemed distribution as if it were an actual distribution?

A–11: (a) *Tax Basis*. If the employee's account includes after-tax contributions or other investment in the contract under section 72(e), section 72 applies to a deemed distribution as if it were an actual distribution, with the result that all or a portion of the deemed distribution may not be taxable.

(b) *Sections 72(t) and (m)*. Section 72(t) (which imposes a 10 percent tax on certain early distributions) and section 72(m)(5) (which imposes a separate 10 percent tax on certain amounts received by a 5-percent owner) apply to a deemed distribution under section 72(p) in the same manner as if the deemed distribution were an actual distribution.

(c) *Section 4980A*. For purposes of section 4980A, a deemed distribution under section 72(p) is taken into account in determining an individual's excess distributions, as provided in §54.4981A–1T, Q&A a–8.

Q–12: Is a deemed distribution under section 72(p) treated as an actual distribution for purposes of the qualification requirements of section 401, the distribution provisions of section 402, or the distribution restrictions of section 401(k)(2)(B) or 403(b)(11)?

A–12: No. Thus, for example, if a participant in a money purchase plan who is an active employee has a deemed distribution under section 72(p), the plan will not be considered to have made an in-service distribution to the participant in violation of the qualification requirements applicable to money purchase plans. Similarly, the deemed distribution is not eligible to be rolled over to an eligible retirement plan and the participant is not eligible to elect income averaging with respect to the deemed distribution. See also §§1.402(c)–2, Q&A–4(d) and §1.401(k)–1(d)(6)(ii).

Q–13: How does a reduction (offset) of an account balance in order to repay a plan loan differ from a deemed distribution?

A–13: (a) *Difference between deemed distribution and plan loan offset amount*. (1) Loans to a participant from a qualified employer plan can give rise to two types of taxable distributions—

(i) A deemed distribution pursuant to section 72(p); and

(ii) A distribution of an offset amount.

(2) As described in Q&A–4 of this section, a deemed distribution occurs when the requirements of Q&A–3 of this section are not satisfied, either when the loan is made or at a later time. A deemed distribution is treated as a distribution to the participant or beneficiary only for certain tax purposes and is not a distribution of the accrued benefit. A distribution of a plan loan offset amount (as defined in §1.402(c)–2, Q&A–9(b)) occurs when, under the terms governing a plan loan, the accrued benefit of the participant or beneficiary 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, a loan be repaid immediately or treated as in default.

(b) *Plan loan offset*. In the event of a plan loan offset, the amount of the account balance that is offset against the loan is an actual distribution for purposes of the Internal Revenue Code, not a deemed distribution under section 72(p). Accordingly, a plan may be prohibited from making such an offset under the provisions of section 401(a), 401(k)(2)(B) or 403(b)(11) prohibiting or limiting distributions to an active employee. See §1.402(c)–2, Q&A–9(c) *Example 6*.

Q–14: How is the amount includible in income as a result of a deemed distribution under section 72(p) required to be reported?

A–14: The amount includible in income as a result of a deemed distribution under section 72(p) is required to be reported on Form 1099–R (or any other form prescribed by the Commissioner).

Q–15: What withholding rules apply to plan loans?

A–15: To the extent that a loan, when made, is a deemed distribution or an account balance is reduced (offset) to repay a loan, the amount includible in income is subject to withholding. If a deemed distribution of a loan or a loan repayment by benefit offset results in income at a date after the date the loan is made, withholding is required only if a transfer of cash or property (excluding employer securities) is made to the participant or beneficiary from the plan at the same time. See §§35.3405–1(f)(4) and 31.3405(c)–1, Q&A–9 and Q&A–11 of this chapter for further guidance on withholding rules.

Q–16: If a loan fails to satisfy the requirements of Q&A–3 of this section and is a prohibited transaction under section 4975, is the deemed distribution of the loan under section 72(p) a correction of the prohibited transaction?

A–16: A deemed distribution is not a correction of a prohibited transaction under section 4975. See §§141.4975–13 and 53.4941(e)–1(c)(1) of this chapter for guidance concerning correction of a prohibited transaction.

Q–17: What are the income tax consequences if an amount is transferred

from a qualified employer plan to a participant or beneficiary as a loan, but there is an express or tacit understanding that the loan will not be repaid?

A–17: If there is an express or tacit understanding that the loan will not be repaid, or, for any reason, the transaction does not create a debtor-creditor relationship, then the amount transferred is treated as an actual distribution from the plan for purposes of the Internal Revenue Code, and is not treated as a loan or as a deemed distribution under section 72(p).

Q–18: If a qualified employer plan maintains a program to invest in residential mortgages, are loans made pursuant to the investment program subject to section 72(p)?

A–18: Residential mortgage loans made by a plan in the ordinary course of an investment program are not subject to section 72(p) if the property acquired with the loans is the primary security for such loans and the amount loaned does not exceed the fair market value of the property. An investment program exists only if the plan has established, in advance of a specific investment under the program, that a certain percentage or amount of plan assets will be invested in residential mortgages available to persons purchasing the property who satisfy commercially customary financial criteria. Loans will not be considered as made under an investment program if the loans are only made available to, or any loan is earmarked for, any person or persons who are participants or beneficiaries in the plan, or if such loans mature upon a participant's termination from employment. In addition, no loan that benefits an officer, director, or owner of the employer maintaining the plan, or his or her beneficiaries, will be treated as made under an investment program. No inference should be drawn that a transaction under such an investment program is not a prohibited transaction under section 503 or 4975 or is not a violation of the applicable fiduciary standards for an employee benefit plan, so that such a loan could be a prohibited transaction if it does not satisfy the requirements of 29 CFR §2550.408b–1.

Q–19: When is the effective date of these regulations?

A–19: This section applies to assignments, pledges, and loans made on or after the date that is three months after the date of publication of the final regulations in the Federal Register.

Margaret Milner Richardson,
*Commissioner of Internal Revenue.*

(Filed by the Office of the Federal Register on December 20, 1995, 8:45 a.m., and published in the issue of the Federal Register for December 21, 1995, 60 F.R. 66233)