

Chapter 12(a)

Other topics-Modifications to Section 72(p) Regulations

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**INTERNAL REVENUE SERVICE
TAX EXEMPT AND GOVERNMENT ENTITIES**

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Overview

Introduction

Section 236 of the Tax Equity and Fiscal Responsibility Act of 1982 added IRC Section 72(p). On July 31, 2000, final regulations were published with respect to numerous issues arising under section 72(p)(2). On the same date, a notice of proposed rulemaking was published with respect to additional issues arising under section 72(p)(2) that were not addressed in the 2000 final regulations.

The issues in the 2000 proposed regulations pertained to:

1. the suspension of loan repayments during a leave of absence for military service in accordance with IRC Section 414(u)(4),
2. the effect of a new loan following a deemed distribution of a prior loan,
3. the effect of refinancing and multiple loans, and
4. the application of the Electronic Signature in Global and National Commerce Act.

Section 72 (p)

IRC Section 72(p)(1)(A) provides that a direct or indirect loan from a qualified employer plan to a participant or beneficiary is treated as a deemed distribution for purposes of IRC Section 72.

IRC Section 72(p)(1)(B) provides that an assignment or pledge (or an agreement to assign or pledge) of any portion of a participant's or beneficiary's interest in a qualified employer plan is treated as a loan from the plan.

Under IRC Section 72(p)(2), however, a loan from a qualified employer plan to a participant or beneficiary will not be treated as a distribution if the loan satisfies certain requirements relating to the terms, repayment schedule, and the amount of the loan.

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Overview, Continued

**72(p)(2)
exclusion from
a distribution
applies to the
following loans**

For example, IRC Section 72(p)(2) applies to:

1. A loan that, by its terms, is to be repaid over not more than five years. There is an exception to this limitation for certain mortgages.
2. A loan that, by its terms, is to be paid in substantially level installments that include principle and interest.
3. A loan that does not exceed the lesser of:
 - a. \$ 50,000, reduced to the extent that the participant's or beneficiary's highest balance for plan loans outstanding during the preceding 12 months exceeds the current balance for plan loans, or
 - b. 50 percent of the participant's or beneficiary's nonforfeitable benefit (or \$10,000 if greater).

These limits apply by treating the loans from all plans of the employer's controlled group as one loan.

**Definition of a
qualified plan**

A qualified employer plan, for the purposes of IRC Section 72, includes a plan that qualifies under IRC Section 401, 403(a) or 403(b). Also considered for the purposes of IRC Section 72 are plans (whether or not qualified) maintained by the United States, a State or a political subdivision thereof, or an agency or instrumentality thereof. Plans which were (or were determined to be) qualified employer plans or government plans are also included.

Suspension of loan repayment-leave for military absence

**Section
414(u)(4) and
1.72(p)-1-
proposed
regulations**

IRC Section 414(u)(4) accommodates military service personnel by permitting postponement of loan repayments while performing military service, but does not alter the accrual of interest or any conditions in IRC Section 72(p)(2). The accrual of interest provision is consistent with treating loans from qualified employer plans in the same manner as loans made by a commercial lender.

The proposed regulations stated that, under IRC Section 414(u)(4), a plan that permits suspension of loan repayment during a leave of absence for military service will not cause the loan to be deemed distributed.

The rule was conditioned on:

1. loan repayments resuming upon the completion of the military service,
2. the amount remaining due on the loan being repaid in substantially level installments, and
3. the loan being fully repaid by the end of the original term of the loan plus the period of the military service.

Under the proposed regulations, upon resuming repayment, a lender may permit a participant to choose to increase the amount of the payments or to make payments at the previous rate with a balloon payment due at the end of the required time.

**Final
regulations**

The final regulation generally adopted the proposed regulation.

However, Example 2 of the final regulations was modified to reflect the application of a maximum 6 percent interest rate during the military leave in accordance with the Soldiers' and Sailors' Civil Relief Act Amendments of 1942.

A modification was also made to clarify that loan repayments can be revised at the end of a military leave. The repayment schedule can be increased to five years but only to the extent that the original loan had a term of fewer than five years.

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Suspension of loan repayment-leave for military absence, Continued

**Example 1
from the
regulation**

The following two examples from the 2002 final regulations illustrate the interaction of the IRC Section 72(p) and IRC Section 414(u) provisions.

Example 1.

- (i) On July 1, 2003, a participant with a nonforfeitable account balance of \$80,000 borrows \$40,000 to be repaid in level monthly installments of \$825 each over 5 years. The loan is not a principal residence plan loan. The participant makes 9 monthly payments and commences an unpaid leave of absence that lasts for 12 months. The participant was not performing military service during this period. 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, 2008.
- (ii) 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, 2008 repaid the full balance remaining due

**Example 2
from the
regulations**

Example 2.

- (i) The facts are the same as in Example 1, except the participant was on leave of absence performing service in the uniformed services for two years and the rate of interest charged during this period of military service is reduced to 6 percent compounded annually under 50 App. section 526 (relating to the Soldiers' and Sailors' Civil Relief Act Amendments of 1942). After the military service ends on April 2, 2006, the participant resumes active employment on April 19, 2006, continues the monthly installments of \$825 thereafter, and on June 30, 2010, repays the full balance remaining due \$6,487.
- (ii) Because the loan satisfies the requirements of section 72(p)(2) and paragraph (b) of regulation section Q&A-9, the participant does not have a deemed distribution. Alternatively, section 72(p)(2) would also be satisfied if the amount of each monthly installment after April 19, 2006, is increased to \$930 in order to repay the loan by June 30, 2010 (without any balance remaining due then).

Additional loans after a deemed distribution (1.72(p)-1 Q&A 19)

Proposed regulation-background

Under the proposed regulations, if a loan is deemed distributed to a participant or beneficiary and has not been repaid, then, unless certain conditions are satisfied, any payment made to the participant or beneficiary thereafter will not be treated as a loan for purposes of IRC Section 72(p)(2).

To avoid this result, the proposed regulations provided that the plan must enter into an agreement under which either repayments are made by payroll withholding or adequate security for the additional loan (in addition to the participant's accrued benefit) to be obtained.

During the comment period, some practitioners expressed a concern that individuals often hold IRC Section 403(b) annuity contracts with more than one issuer and it is difficult for an issuer to determine whether an individual has defaulted on a plan loan with another issuer. They added that if upon a deemed distribution a Form 1099-R is not issued reflecting taxable income, a subsequent loan to a defaulting participant could subject the new loan issuer to penalties.

It was also stated that in order to satisfy the limitations on the maximum amount that may be loaned from plans of the employer imposed by IRC Section 72(p)(2)(A), the issuer must inquire about other loans made from the plan or any other plan of the employer before extending a loan.

Final regulations adopted regulation as proposed

The preamble to the 2002 final regulations states that as part of this process, the issuer **can condition** a new loan on a participant's disclosure of such prior loans and, for this purpose, can rely on an employee's certification (assuming the issuer has no reason to doubt the employee's certification). As a result, the final regulation adopted the regulation as proposed.

Refinancing a loan, (1.72(p)-1 Q&A 20)

May a Loan be Refinanced--background

The proposed regulations provided that a loan may be refinanced, but the refinancing arrangement must continue to satisfy the requirements of IRC Sections 72(p)(2)(B) and (C).

Pursuant to those sections loans must be repaid in substantially level installments, not less often than quarterly and over a period not in excess of five years (longer for certain home loans). Under the proposed regulations, a refinancing is treated as a continuation of the prior loan, plus a new loan to the extent of any increase in the loan balance.

Conditions for refinancing so that it is not a deemed distribution

In order for the refinancing not to result in a deemed distribution:

1. The refinanced loan can be repaid over a five-year period from the date of the refinancing, but only to the extent the refinanced loan exceeds the prior loan amount, and
2. the prior outstanding loan must continue to be repaid in substantially level installments over a period not longer than the original term remaining on the prior loan.

Refinancing okay if repaid within the original term

A refinancing can also satisfy the repayment requirements of IRC Section 72(p)(2)(B) and (C) if the refinanced loan is repaid within the original term remaining on the prior loan.

Loan and refinancing loan treated as outstanding

For purposes of the limitations under IRC Section 72(p)(2), both the prior loan and the refinanced loan are treated as outstanding at the time of the refinancing if **any portion of the refinanced loan has a later repayment date** than the original term remaining on the prior loan. (See the above noted \$ 50,000 or 50 percent loan limitations of IRC Section 72(p)(2).)

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Refinancing a loan, (1.72(p)-1 Q&A 20), Continued

Final regulations

The final regulations generally adopted the provision on loan refinancing as proposed. However, the refinancing rules were modified so that a prior loan with an original term of less than five years can be changed to a term of five years from the date of the prior loan (which is the length of time that could have been obtained initially). A similar modification was also made for repayments made following a military leave.

Examples in regulations of refinance after a deemed distribution

Example 1-facts (i) A participant with a vested account balance that exceeds \$100,000 borrows \$40,000 from a plan on January 1, 2005, to be repaid in 20 quarterly installments of \$2,491 each. Thus, the term of the loan ends on December 31, 2009. On January 1, 2006, when the outstanding balance on the loan is \$33,322, the loan is refinanced and is replaced by a new \$40,000 loan from the plan to be repaid in 20 quarterly installments. Under the terms of the refinanced loan, the loan is to be repaid in level quarterly installments of \$2,491 each over the next 20 quarters. Thus, the term of the new loan ends on December 31, 2010.

Example 1-analysis

Under section 72(p)(2)(A), the amount of the new loan, when added to the outstanding balance of all other loans from the plan, must not exceed \$50,000 reduced by the excess of the highest outstanding balance of loans from the plan during the 1-year period ending on December 31, 2005, over the outstanding balance of loans from the plan on January 1, 2006, with such outstanding balance to be determined immediately prior to the new \$40,000 loan.

Because the term of the new loan ends later than the term of the loan it replaces, both the new loan and the loan it replaces must be taken into account for purposes of applying section 72(p)(2), including the amount limitations in section 72(p)(2)(A). The amount of the new loan is \$40,000, the outstanding balance on January 1, 2006, of the loan it replaces is \$33,322, and the highest outstanding balance of loans from the plan during 2005 was \$40,000.

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Examples in regulations of refinance after a deemed distribution, Continued

**Example 1-
conclusion**

Accordingly, under section 72(p)(2)(A), the sum of the new loan and the outstanding balance on January 1, 2006, of the loan it replaces must not exceed \$50,000 reduced by \$6,678 (the excess of the \$40,000 maximum outstanding loan balance during 2005 over the \$33,322 outstanding balance on January 1, 2006, determined immediately prior to the new loan) and, thus, must not exceed \$43,322. The sum of the new loan (\$40,000) and the outstanding balance on January 1, 2006, of the loan it replaces (\$33,322) is \$73,322. Since \$73,322 exceeds the \$43,322 limit under section 72(p)(2)(A) by \$30,000, there is a deemed distribution of \$30,000 on January 1, 2006.

**Example 1 No
deemed
distribution if
certain
requirements
are met**

However, no deemed distribution would occur if, under the terms of the refinanced loan, the amount of the first 16 installments on the refinanced loan were equal to \$2,907, which is the sum of the \$2,491 originally scheduled quarterly installment payment amount under the first loan, plus \$416 (which is the amount required to repay, in level quarterly installments over 5 years beginning on January 1, 2006, the excess of the refinanced loan over the January 1, 2006, balance of the first loan (\$40,000 minus \$33,322 equals \$6,678)), and the amount of the 4 remaining installments was equal to \$416.

The refinancing would not be subject to paragraph (a)(2) of Q&A-20 of this Regulation because the terms of the new loan would satisfy section 72(p)(2) and this section (including the substantially level amortization requirements of section 72(p)(2)(B) and (C)) determined as if the new loan consisted of 2 loans, one of which is in the amount of the first loan (\$33,322) and is amortized in substantially level payments over a period ending December 31, 2009 (the last day of the term of the first loan) and the other of which is in the additional amount (\$6,678) borrowed under the new loan.

Similarly, the transaction also would not result in a deemed distribution if the terms of the refinanced loan provided for repayments to be made in level quarterly installments (of \$2,990) each over the next 16 quarters.

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Examples in regulations of refinance after a deemed distribution, Continued

**Example 2-
facts**

Example 2. (i) The facts are the same as in Example 1 (i), except that the applicable interest rate used by the plan when the loan is refinanced is significantly lower due to a reduction in market rates of interest and, under the terms of the refinanced loan, the amount of the first 16 installments on the refinanced loan is equal to \$2,848 and the amount of the next 4 installments on the refinanced loan is equal to \$406.

The \$2,848 amount is the sum of \$2,442 to repay the first loan by December 31, 2009 (the term of the first loan), plus \$406 (which is the amount to repay, in level quarterly installments over 5 years beginning on January 1, 2006, the \$6,678 excess of the refinanced loan over the January 1, 2006, balance of the first loan).

**Example 1
conclusion**

The transaction does not result in a deemed distribution because the terms of the new loan would satisfy section 72(p)(2) and this section [of the regulations] (including the substantially level amortization requirements of section 72(p)(2)(B) and (C)) determined as if the new loan consisted of 2 loans, one of which is in the amount of the first loan (\$33,322) and is amortized in substantially level payments over a period ending December 31, 2009 (the last day of the term of the first loan), and the other of which is in the additional amount (\$6,678) borrowed under the new loan.

The transaction would also not result in a deemed distribution if the terms of the new loan provided for repayments to be made in level quarterly installments of \$2,931 each over the next 16 quarters.

Multiple loans, (1.72(p)-1 Q&A 20)

**Are Multiple
Loans
Permitted-
background**

IRC Section 72(p)(2) does not prohibit a participant from borrowing from a plan more than once per year. In order to address the risk that additional loans could be taken out in order to avoid repayment of prior loans, the proposed regulations provided that a deemed distribution occurs if a participant obtains more than two loans a year.

During the comment period and at the hearings on the 2000 proposed regulations, some practitioners sought the “flexibility” of being allowed to make more than two loans per year to a participant with the most frequent example being a parent with several children in college who would have a legitimate need for multiple borrowings during a year. These practitioners noted that there is no direct statutory foundation for limiting the number of loans under IRC Section 72(p). In addition they noted that the special 12-month rule with respect to the calculation of the \$ 50,000 limitation under IRC Section 72(p)(2)(A)(i) inherently limits the number of loans that can be made for larger borrowings.

**Final
regulations**

In recognition of these comments, the final regulations do not include any limitation on the number of loans that can be made under IRC Section 72(p)(2).

Treasury and the IRS stated in the preamble to the 2002 final regulations that were proposed in 2000 that it is recognized that the absence of any limitation on the number of loans that may be made to a participant will allow certain practices that could not otherwise occur without generating taxable income through a deemed distribution under IRC Section 72(p).

An example is the use of a participant's account balance under a qualified employer plan to secure a credit card. This is a practice that would not be permissible if the regulations were to limit the number of loans that could be made to a participant from a plan. The preamble to the 2002 final regulations states that the Treasury and the IRS recognize that, because the final regulations do not include any limitation on the number of loans that can be made, there will be no IRC Section 72(p) barrier to credit card loans that otherwise meet the requirements of that IRC Section.

Application of E-Sign

Background

The 2000 final regulations require that the terms of a plan loan be set forth in an enforceable agreement. They further provide that the agreement may be set forth in an electronic medium that satisfies standards that are based on the standards for an electronic consent to a distribution contained in Income Tax Regulations Section 1.411(a)-11(f)(2).

As noted in the preamble to the proposed regulations under Section 1.417(a)(3)-1 (relating to disclosure of relative values of optional forms of benefit), the IRS and the Treasury Department are considering the extent to which notices under the various Code requirements relating to qualified retirement plans can be provided electronically, taking into account the effect of E-SIGN.

As further noted in that preamble, the IRS and the Treasury Department anticipate issuing proposed regulations regarding these issues, and invite comments on these issues. The requirements applicable to electronic plan loan agreements may be considered in connection with those upcoming proposed regulations as well.

Preamble to final regulations

In a footnote in the preamble of the 2002 final regulations, it is stated that the staff of the Board of Governors of the Federal Reserve System (Board) advised the IRS that a plan loan that satisfies IRC Section 72(p)(2) (and regulations), would constitute an extension of credit under 12 CFR 226.2(a)(14) of Regulation Z. This would result in the implementing of the Truth in Lending Act (TILA).

Thus, unless the plan or the loan is otherwise excepted from the application of Regulation Z (for example, the plan could be exempt because the plan has not made enough loans to be considered a creditor under Regulation Z, or a particular loan could be exempt because it exceeds TILA's limit of \$ 25,000 for loans not secured by real property or a dwelling), a plan loan that satisfies the requirements of Q&A-3 (b) of Income Tax Regulations Section 1.72(p)-1 would be subject to the disclosure and other requirements of Regulation Z. The staff of the Board further advised the IRS and Treasury that, pending the Board's adoption of final rules regarding electronic disclosures, creditors may provide electronic disclosures required by Regulation Z if the consumer's consent is obtained as required under E-SIGN.

Whether a Section 415(b) governmental plan can have plan loans

**May Section
457(b)
Governmental
Plans Have
Plan Loans**

During the comment period, some practitioners requested that the 2000 proposed regulations be modified to clarify that eligible governmental plans under section 457(b) are permitted to offer loans to employees in a manner consistent with section 72(p).

Separately, on May 8, 2002, proposed regulations under section 457 were published in the Federal Register that clarify the conditions under which loans can be made to participants in such plans and that section 72(p) applies to any such loan.

Effective date of regulations

**Regulation
Effective Date**

The 2002 final regulations apply to assignments, pledges, and loans made on or after January 1, 2004, but do not apply to loans made under an insurance contract that is in effect on December 31, 2003, if the insurance carrier is required to offer loans to contract holders that are not secured (other than by the participant's or beneficiary's benefit under the contract).

EXHIBIT A FINAL SECTION 72(p) REGULATIONS (as proposed in 2000)

PART 1--INCOME TAXES

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

Par. 2. Section 1.72(p)-1 is amended as follows:

1. A-9, Q&A-19, and Q-20 are revised, and A-20 is added.
2. A-22 is amended by adding paragraph (d).

The revisions and additions read as follows:

§ 1.72(p)-1 -- Loans treated as distributions.

* * * * *

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 (or such longer period as may apply under section 414(u) and paragraph (b) of this Q&A-9), that a participant is on a bona fide leave of absence, either without pay from the employer or at a rate of pay (after applicable employment tax withholdings) that is less than the amount of the installment payments required under the terms of the loan. However, the loan including interest that accrues during the leave of absence must be repaid by the latest permissible term of the loan and the amount of the installments due after the leave ends must not be less than the amount required under the terms of the original loan.

(b) Military service. In accordance with section 414(u)(4), if a plan suspends the obligation to repay a loan made to an employee from the plan for any part of a period during which the employee is performing service in the uniformed services (as defined in 38 U.S.C. chapter 43), whether or not qualified military service, such suspension shall not be taken into account for purposes of section 72(p) or this section. Thus, if a plan suspends loan repayments for any part of a period during which the employee is performing military service described in the preceding sentence, such suspension shall not cause the loan to be deemed distributed even if the suspension exceeds one year and even if the term of the loan is extended. However, the loan will not satisfy the repayment term requirement of section 72(p)(2)(B) and the level amortization requirement of section 72(p)(2)(C) unless loan repayments resume upon the completion of such period of military service and the loan is repaid thereafter by amortization in substantially level installments over a period that ends not later than the latest permissible term of the loan.

(c) Latest permissible term of a loan. For purposes of this Q&A-9, the latest permissible term of a loan is the latest date permitted under section 72(p)(2)(B) (i.e., five years from the date of the loan, assuming that the replacement loan does not qualify for the exception at section 72(p)(2)(B)(ii) for principal residence plan loans) plus any additional period of suspension permitted under paragraph (b) of this Q&A-9.

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EXHIBIT A FINAL SECTION 72(p) REGULATIONS (as proposed in 2000), Continued

(d) Examples. The following examples illustrate the rules of this Q&A-9

Example 1. (i) On July 1, 2003, a participant with a nonforfeitable account balance of \$80,000 borrows \$40,000 to be repaid in level monthly installments of \$825 each over 5 years. The loan is not a principal residence plan loan. The participant makes 9 monthly payments and commences an unpaid leave of absence that lasts for 12 months. The participant was not performing military service during this period. 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, 2008.

(ii) 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, 2008 repaid the full balance remaining due.

Example 2. (i) The facts are the same as in Example 1, except the participant was on leave of absence performing service in the uniformed services (as defined in chapter 43 of title 38, United States Code) for two years and the rate of interest charged during this period of military service is reduced to 6 percent compounded annually under 50 App. section 526 (relating to the Soldiers' and Sailors' Civil Relief Act Amendments of 1942). After the military service ends on April 2, 2006, the participant resumes active employment on April 19, 2006, continues the monthly installments of \$825 thereafter, and on June 30, 2010, repays the full balance remaining due \$6,487.

(ii) Because the loan satisfies the requirements of section 72(p)(2) and paragraph (b) of this Q&A-9, the participant does not have a deemed distribution. Alternatively, section 72(p)(2) would also be satisfied if the amount of each monthly installment after April 19, 2006, is increased to \$930 in order to repay the loan by June 30, 2010 (without any balance remaining due then).

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EXHIBIT A FINAL SECTION 72(p) REGULATIONS (as proposed in 2000), Continued

Q-19: If there is a deemed distribution under section 72(p), is the interest that accrues thereafter on the amount of the deemed distribution an indirect loan for income tax purposes and what effect does the deemed distribution have on subsequent loans?

A-19: (a) General rule. Except as provided in paragraph (b) of this Q&A-19, a deemed distribution of a loan is treated as a distribution for purposes of section 72. Therefore, a loan that is deemed to be distributed under section 72(p) ceases to be an outstanding loan for purposes of section 72, and the interest that accrues thereafter under the plan on the amount deemed distributed is disregarded for purposes of applying section 72 to the participant or the beneficiary. Even though interest continues to accrue on the outstanding loan (and is taken into account for purposes of determining the tax treatment of any subsequent loan in accordance with paragraph (b) of this Q&A-19), this additional interest is not treated as an additional loan (and thus, does not result in an additional deemed distribution) for purposes of section 72(p). However, a loan that is deemed distributed under section 72(p) is not considered distributed for all purposes of the Internal Revenue Code. See Q&A-16 of this section.

(b) Effect on subsequent loans- (1) Application of section 72(p)(2)(A). A loan that is deemed distributed under section 72(p) (including interest accruing thereafter) and that has not been repaid (such as by a plan loan offset) is considered outstanding for purposes of applying section 72(p)(2)(A) to determine the maximum amount of any subsequent loan to the participant or beneficiary.

(2) Additional security for subsequent loans. If a loan is deemed distributed to a participant or beneficiary under section 72(p) and has not been repaid (such as by a plan loan offset), then no payment made thereafter to the participant or beneficiary is treated as a loan for purposes of section 72(p)(2) unless the loan otherwise satisfies section 72(p)(2) and this section and either of the following conditions is satisfied:

(i) There is an arrangement among the plan, the participant or beneficiary, and the employer, enforceable under applicable law, under which repayments will be made by payroll withholding. For this purpose, an arrangement will not fail to be enforceable merely because a party has the right to revoke the arrangement prospectively.

(ii) The plan receives adequate security from the participant or beneficiary that is in addition to the participant's or beneficiary's accrued benefit under the plan.

(3) Condition no longer satisfied. If, following a deemed distribution that has not been repaid, a payment is made to a participant or beneficiary that satisfies the conditions in paragraph (b)(2) of this Q&A-19 for treatment as a plan loan and, subsequently, before repayment of the second loan, the conditions in paragraph (b)(2) of this Q&A-19 are no longer satisfied with respect to the second loan (for example, if the loan recipient revokes consent to payroll withholding), the amount then outstanding on the second loan is treated as a deemed distribution under section 72(p).

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EXHIBIT A FINAL SECTION 72(p) REGULATIONS (as proposed in 2000), Continued

Q-20: May a participant refinance an outstanding loan or have more than one loan outstanding from a plan?

A-20: (a) Refinancings and multiple loans- (1) General rule. A participant who has an outstanding loan that satisfies section 72(p)(2) and this section may refinance that loan or borrow additional amounts if, under the facts and circumstances, the loans collectively satisfy the amount limitations of section 72(p)(2)(A) and the prior loan and the additional loan each satisfy the requirements of section 72(p)(2)(B) and (C) and this section. For this purpose, a refinancing includes any situation in which one loan replaces another loan.

(2) Loans that repay a prior loan and have a later repayment date. For purposes of section 72(p)(2) and this section (including paragraph (a)(3) of this Q&A-20 and the amount limitations of section 72(p)(2)(A)), if a loan that satisfies section 72(p)(2) is replaced by a loan (a replacement loan) and the term of the replacement loan ends after the latest permissible term of the loan it replaces (the replaced loan), then the replacement loan and the replaced loan are both treated as outstanding on the date of the transaction. For purposes of the preceding sentence, the latest permissible term of the replaced loan is the latest date permitted under section 72(p)(2)(C) (i.e., five years from the original date of the replaced loan, assuming that the replaced loan does not qualify for the exception at section 72(p)(2)(B)(ii) for principal residence plan loans and that no additional period of suspension applied to the replaced loan under Q&A-9 (b) of this section). Thus, for example, if the term of the replacement loan ends after the latest permissible term of the replaced loan and the sum of the amount of the replacement loan plus the outstanding balance of all other loans on the date of the transaction, including the replaced loan, fails to satisfy the amount limitations of section 72(p)(2)(A), then the replacement loan results in a deemed distribution. This paragraph (a)(2) does not apply to a replacement loan if the terms of the replacement loan would satisfy section 72(p)(2) and this section determined as if the replacement loan consisted of two separate loans, the replaced loan (amortized in substantially level payments over a period ending not later than the last day of the latest permissible term of the replaced loan) and, to the extent the amount of the replacement loan exceeds the amount of the replaced loan, a new loan that is also amortized in substantially level payments over a period ending not later than the last day of the latest permissible term of the replaced loan.

(b) Examples. The following examples illustrate the rules of this Q&A-20

Example 1. (i) A participant with a vested account balance that exceeds \$100,000 borrows \$40,000 from a plan on January 1, 2005, to be repaid in 20 quarterly installments of \$2,491 each. Thus, the term of the loan ends on December 31, 2009. On January 1, 2006, when the outstanding balance on the loan is \$33,322, the loan is refinanced and is replaced by a new \$40,000 loan from the plan to be repaid in 20 quarterly installments. Under the terms of the refinanced loan, the loan is to be repaid in level quarterly installments of \$2,491 each over the next 20 quarters. Thus, the term of the new loan ends on December 31, 2010.

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EXHIBIT A FINAL SECTION 72(p) REGULATIONS (as proposed in 2000), Continued

(ii) Under section 72(p)(2)(A), the amount of the new loan, when added to the outstanding balance of all other loans from the plan, must not exceed \$50,000 reduced by the excess of the highest outstanding balance of loans from the plan during the 1-year period ending on December 31, 2005, over the outstanding balance of loans from the plan on January 1, 2006, with such outstanding balance to be determined immediately prior to the new \$40,000 loan. Because the term of the new loan ends later than the term of the loan it replaces, under paragraph (a)(2) of this Q&A-20, both the new loan and the loan it replaces must be taken into account for purposes of applying section 72(p)(2), including the amount limitations in section 72(p)(2)(A). The amount of the new loan is \$40,000, the outstanding balance on January 1, 2006, of the loan it replaces is \$33,322, and the highest outstanding balance of loans from the plan during 2005 was \$40,000. Accordingly, under section 72(p)(2)(A), the sum of the new loan and the outstanding balance on January 1, 2006, of the loan it replaces must not exceed \$50,000 reduced by \$6,678 (the excess of the \$40,000 maximum outstanding loan balance during 2005 over the \$33,322 outstanding balance on January 1, 2006, determined immediately prior to the new loan) and, thus, must not exceed \$43,322. The sum of the new loan \$40,000 and the outstanding balance on January 1, 2006, of the loan it replaces \$33,322 is \$73,322. Since \$73,322 exceeds the \$43,322 limit under section 72(p)(2)(A) by \$30,000, there is a deemed distribution of \$30,000 on January 1, 2006.

(iii) However, no deemed distribution would occur if, under the terms of the refinanced loan, the amount of the first 16 installments on the refinanced loan were equal to \$2,907, which is the sum of the \$2,491 originally scheduled quarterly installment payment amount under the first loan, plus \$416 which is the amount required to repay, in level quarterly installments over 5 years beginning on January 1, 2006, the excess of the refinanced loan over the January 1, 2006, balance of the first loan \$40,000 minus \$33,322 equals \$6,678, and the amount of the 4 remaining installments was equal to \$416. The refinancing would not be subject to paragraph (a)(2) of this Q&A-20 because the terms of the new loan would satisfy section 72(p)(2) and this section (including the substantially level amortization requirements of section 72(p)(2)(B) and (C)) determined as if the new loan consisted of 2 loans, one of which is in the amount of the first loan \$33,322 and is amortized in substantially level payments over a period ending December 31, 2009 (the last day of the term of the first loan) and the other of which is in the additional amount \$6,678 borrowed under the new loan. Similarly, the transaction also would not result in a deemed distribution (and would not be subject to paragraph (a)(2) of this Q&A-20) if the terms of the refinanced loan provided for repayments to be made in level quarterly installments of \$2,990 each over the next 16 quarters.

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EXHIBIT A FINAL SECTION 72(p) REGULATIONS (as proposed in 2000), Continued

Example 2. (i) The facts are the same as in Example 1 (i), except that the applicable interest rate used by the plan when the loan is refinanced is significantly lower due to a reduction in market rates of interest and, under the terms of the refinanced loan, the amount of the first 16 installments on the refinanced loan is equal to \$2,848 and the amount of the next 4 installments on the refinanced loan is equal to \$406. The \$2,848 amount is the sum of \$2,442 to repay the first loan by December 31, 2009 (the term of the first loan), plus \$406 which is the amount to repay, in level quarterly installments over 5 years beginning on January 1, 2006, the \$6,678 excess of the refinanced loan over the January 1, 2006, balance of the first loan.

(ii) The transaction does not result in a deemed distribution (and is not subject to paragraph (a)(2) of this Q&A-20) because the terms of the new loan would satisfy section 72(p)(2) and this section (including the substantially level amortization requirements of section 72(p)(2)(B) and (C)) determined as if the new loan consisted of 2 loans, one of which is in the amount of the first loan \$33,322 and is amortized in substantially level payments over a period ending December 31, 2009 (the last day of the term of the first loan), and the other of which is in the additional amount \$6,678 borrowed under the new loan. The transaction would also not result in a deemed distribution (and not be subject to paragraph (a)(2) of this Q&A-20) if the terms of the new loan provided for repayments to be made in level quarterly installments of \$2,931 each over the next 16 quarters.

A-22:

(d) Effective date for Q&A-19 (b)(2) and Q&A-20. Q&A-19(b)(2) and Q&A-20 of this section apply to assignments, pledges, and loans made on or after January 1, 2004.

EXHIBIT B FINAL REGULATIONS 72(P)

§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). 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 paragraph (b) of Q&A-3 of this section), with adequate security and with an interest rate and repayment terms that are commercially reasonable. (The particular interest rate used, which is solely for illustration, 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. The regulations and examples in this section do not provide guidance on whether a loan from a plan would result in a prohibited transaction under section 4975 of the Internal Revenue Code or on whether a loan from a plan covered by Title I of the Employee Retirement Income Security Act of 1974 (88 Stat. 829) (ERISA) would be consistent with the fiduciary standards of ERISA or would result in a prohibited transaction under section 406 of ERISA. The questions and answers are as follows:

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) and this section, 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) is considered a loan made under a qualified employer plan.

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EXHIBIT B FINAL REGULATIONS 72(P), Continued

(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) and this section, any assignment or pledge of (or agreement to assign or to pledge) any portion of a participant's or beneficiary's interest in a contract that has been purchased under a qualified employer plan (including a contract that has been distributed to the participant or beneficiary) is 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) and this section, 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.

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EXHIBIT B FINAL REGULATIONS 72(P), Continued

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) 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 and date of the loan and the repayment schedule. The agreement does not have to be signed if the agreement is enforceable under applicable law without being signed. The agreement must be set forth either--

(1) In a written paper document;

(2) In an electronic medium that is reasonably accessible to the participant or the beneficiary and that is provided under a system that satisfies the following requirements:

(i) The system must be reasonably designed to preclude any individual other than the participant or the beneficiary from requesting a loan.

(ii) The system must provide the participant or the beneficiary with a reasonable opportunity to review and to confirm, modify, or rescind the terms of the loan before the loan is made.

(iii) The system must provide the participant or the beneficiary, within a reasonable time after the loan is made, a confirmation of the loan terms either through a written paper document or through an electronic medium that is reasonably accessible to the participant or the beneficiary and that is provided under a system that is reasonably designed to provide the confirmation in a manner no less understandable to the participant or beneficiary than a written document and, under which, at the time the confirmation is provided, the participant or the beneficiary is advised that he or she may request and receive a written paper document at no charge, and, upon request, that document is provided to the participant or beneficiary at no charge.

or

(3) In such other form as may be approved by the Commissioner.

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EXHIBIT B FINAL REGULATIONS 72(P), Continued

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. 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 paragraph (b) of Q&A-3 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 section 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 paragraph (b) of Q&A-3 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 the introductory text of this section:

Example 1. (i) 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.

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

(ii) 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).)

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EXHIBIT B FINAL REGULATIONS 72(P), Continued

Example 3. (i) 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.

(ii) 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. (i) On August 1, 2002, 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 2003, the participant fails to make any of the payments due thereafter.

(ii) 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 paragraph (c) of Q&A10 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 121.

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.

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EXHIBIT B FINAL REGULATIONS 72(P), Continued

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

A-8: (a) *Refinancings.* In general, no, a refinancing cannot qualify as a principal residence plan loan. 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 the introductory text of this section:

Example. (i) On July 1, 2003, a participant requests a \$50,000 plan loan to be repaid in level monthly installments over 15 years. On August 1, 2003, the participant acquires a principal residence and pays a portion of the purchase price with a \$50,000 bank loan. On September 1, 2003, the plan loans \$50,000 to the participant, which the participant uses to pay the bank loan.

(ii) 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)), the 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 (or such longer period as may apply under section 414(u)), that a participant is on a bona fide 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 (including interest that accrues during the leave of absence) must be repaid by the latest date permitted under section 72(p)(2)(B) (e.g., the suspension of payments cannot extend the term of the loan beyond 5 years, in the case of a loan that is not a principal residence plan loan) and the amount of the installments due after the leave ends (or, if earlier, after the first year of the leave or such longer period as may apply under section 414(u)) must not be less than the amount required under the terms of the original loan.

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EXHIBIT B FINAL REGULATIONS 72(P), Continued

(b) *Military service.* See section 414(u)(4) for special rules relating to military service.

(c) *Example.* The following example illustrates the rules of paragraph (a) of this Q&A-9 and is based upon the assumptions described in the introductory text of this section:

Example. (i) On July 1, 2002, a participant with a nonforfeitable account balance of \$80,000 borrows \$40,000 to be repaid in level monthly installments of \$825 each over 5 years. The loan is not a principal residence plan loan. The participant makes 9 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 in full (including interest that accrued during the leave of absence). The amount of each monthly installment is increased to \$1,130 in order to repay the loan by June 30, 2007.

(ii) 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, 2007 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 cure period and section 72(p)(2)(C) will not be considered to have been violated if the installment payment is made not later than the end of the cure period, which period cannot 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 cure period allowed under paragraph (a) of this Q&A-10), then the amount of the deemed distribution equals the entire outstanding balance of the loan (including accrued interest) at the time of such failure.

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EXHIBIT B FINAL REGULATIONS 72(P), Continued

(c) *Example.* The following example illustrates the rules in paragraphs (a) and (b) of this Q&A-10 and is based upon the assumptions described in the introductory text of this section:

Example. (i) On August 1, 2002, a participant has a nonforfeitable account balance of \$45,000 and borrows \$20,000 from a plan to be repaid over 5 years in level monthly installments due at the end of each month. After making all monthly payments due through July 31, 2003, the participant fails to make the payment due on August 31, 2003 or any other monthly payments due thereafter. The plan administrator allows a three month cure period.

(ii) 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, 2003, which is the last day of the three-month cure period for the August 31, 2003 installment. The amount of the deemed distribution is \$17,157, which is the outstanding balance on the loan at November 30, 2003. Alternatively, if the plan administrator had allowed a cure period through the end of the next calendar quarter, there would be a deemed distribution on December 31, 2003 equal to \$17,282, which is the outstanding balance of the loan at December 31, 2003.

Q-11: Does section 72 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) *Section 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.

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, the distribution restrictions of section 401(k)(2)(B) or 403(b)(11), or the vesting requirements of §1.411(a)-7(d)(5) (which affects the application of a graded vesting schedule in cases involving a prior distribution)?

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EXHIBIT B FINAL REGULATIONS 72(P), Continued

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 is not considered an impermissible distribution of an amount attributable to elective contributions in a section 401(k) plan. 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*. See also Q&A-19 of this section for rules regarding the treatment of a loan after a deemed distribution.

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EXHIBIT B FINAL REGULATIONS 72(P), Continued

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&A11, 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: No, 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 or is otherwise not a bona fide loan, 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).

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EXHIBIT B FINAL REGULATIONS 72(P), Continued

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: (a) 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. A loan will not be considered as made under an investment program if--

(1) Any of the loans made under the program matures upon a participant's termination from employment;

(2) Any of the loans made under the program is an earmarked asset of a participant's or beneficiary's individual account in the plan; or

(3) The loans made under the program are made available only to participants or beneficiaries in the plan.

(b) Paragraph (a)(3) of this Q&A-18 shall not apply to a plan which, on December 20, 1995, and at all times thereafter, has had in effect a loan program under which, but for paragraph (a)(3) of this Q&A-18, the loans comply with the conditions of paragraph (a) of this Q&A-18 to constitute residential mortgage loans in the ordinary course of an investment program.

(c) No loan that benefits an officer, director, or owner of the employer maintaining the plan, or their beneficiaries, will be treated as made under an investment program.

(d) This section does not provide guidance on whether a residential mortgage loan made under a plan's investment program would result in a prohibited transaction under section 4975, or on whether such a loan made by a plan covered by Title I of ERISA would be consistent with the fiduciary standards of ERISA or would result in a prohibited transaction under section 406 of ERISA. See 29 CFR 2550.408b-1.

Q-19: If there is a deemed distribution under section 72(p), is the interest that accrues thereafter on the amount of the deemed distribution an indirect loan for income tax purposes?

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EXHIBIT B FINAL REGULATIONS 72(P), Continued

A-19: (a) *General rule.* Except as provided in paragraph (b) of this Q&A-19, a deemed distribution of a loan is treated as a distribution for purposes of section 72. Therefore, a loan that is deemed to be distributed under section 72(p) ceases to be an outstanding loan for purposes of section 72, and the interest that accrues thereafter under the plan on the amount deemed distributed is disregarded in applying section 72 to the participant or beneficiary. Even though interest continues to accrue on the outstanding loan (and is taken into account for purposes of determining the tax treatment of any subsequent loan in accordance with paragraph (b) of this Q&A-19), this additional interest is not treated as an additional loan (and, thus, does not result in an additional deemed distribution) for purposes of section 72(p). However, a loan that is deemed distributed under section 72(p) is not considered distributed for all purposes of the Internal Revenue Code. See Q&A-11 through Q&A-16 of this section.

(b) *Exception for purposes of applying section 72(p)(2)(A) to a subsequent loan.* In the case of a loan that is deemed distributed under section 72(p) and that has not been repaid (such as by a plan loan offset), the unpaid amount of such loan, including accrued interest, is considered outstanding for purposes of applying section 72(p)(2)(A) to determine the maximum amount of any subsequent loan to the participant or beneficiary.

Q-20: May a participant refinance an outstanding loan or have more than one loan outstanding from a plan?

A-20: [Reserved]

Q-21: Is a participant's tax basis under the plan increased if the participant repays the loan after a deemed distribution?

A-21: (a) *Repayments after deemed distribution.* Yes, if the participant or beneficiary repays the loan after a deemed distribution of the loan under section 72(p), then, for purposes of section 72(e), the participant's or beneficiary's investment in the contract (tax basis) under the plan increases by the amount of the cash repayments that the participant or beneficiary makes on the loan after the deemed distribution. However, loan repayments are not treated as aftertax contributions for other purposes, including sections 401(m) and 415(c)(2)(B).

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EXHIBIT B FINAL REGULATIONS 72(P), Continued

(b) *Example.* The following example illustrates the rules in paragraph (a) of this Q&A-21 and is based on the assumptions described in the introductory text of this section:

Example. (i) A participant receives a \$20,000 loan on January 1, 2003, to be repaid in 20 quarterly installments of \$1,245 each. On December 31, 2003, the outstanding loan balance (\$19,179) is deemed distributed as a result of a failure to make quarterly installment payments that were due on September 30, 2003 and December 31, 2003. On June 30, 2004, the participant repays \$5,147 (which is the sum of the three installment payments that were due on September 30, 2003, December 31, 2003, and March 31, 2004, with interest thereon to June 30, 2004, plus the installment payment due on June 30, 2004). Thereafter, the participant resumes making the installment payments of \$1,245 from September 30, 2004 through December 31, 2007. The loan repayments made after December 31, 2003 through December 31, 2007 total \$22,577.

(ii) Because the participant repaid \$22,577 after the deemed distribution that occurred on December 31, 2003, the participant has investment in the contract (tax basis) equal to \$22,577 (14 payments of \$1,245 each plus a single payment of \$5,147) as of December 31, 2007.

Q-22: When is the effective date of section 72(p) and the regulations in this section?

A-22: (a) *Statutory effective date.* Section 72(p) generally applies to assignments, pledges, and loans made after August 13, 1982.

(b) *Regulatory effective date.* This section applies to assignments, pledges, and loans made on or after January 1, 2002.

(c) *Loans made before the regulatory effective date--(1) General rule.* A plan is permitted to apply Q&A-19 and Q&A-21 of this section to a loan made before the regulatory effective date in paragraph (b) of this Q&A-22 (and after the statutory effective date in paragraph (a) of this Q&A-22) if there has not been any deemed distribution of the loan before the transition date or if the conditions of paragraph (c)(2) of this Q&A-22 are satisfied with respect to the loan.

(2) *Consistency transition rule for certain loans deemed distributed before the regulatory effective date.--(i)* The rules in this paragraph (c)(2) of this Q&A-22 apply to a loan made before the regulatory effective date in paragraph (b) of this Q&A-22 (and after the statutory effective date in paragraph (a) of this Q&A-22) if there has been any deemed distribution of the loan before the transition date.

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EXHIBIT B FINAL REGULATIONS 72(P), Continued

(ii) The plan is permitted to apply Q&A-19 and Q&A-21 of this section to the loan beginning on any January 1, but only if the plan reported, in Box 1 of Form 1099-R, for a taxable year no later than the latest taxable year that would be permitted under this section (if this section had been in effect for all loans made after the statutory effective date in paragraph (a) of this Q&A-22), a gross distribution of an amount at least equal to the initial default amount. For purposes of this section, the initial default amount is the amount that would be reported as a gross distribution under Q&A-4 and Q&A-10 of this section and the transition date is the January 1 on which a plan begins applying Q&A-19 and Q&A-21 of this section to a loan.

(iii) If a plan applies Q&A-19 and Q&A-21 of this section to such a loan, then the plan, in its reporting and withholding on or after the transition date, must not attribute investment in the contract (tax basis) to the participant or beneficiary based upon the initial default amount.

(iv) This paragraph (c)(2)(iv) of this Q&A-22 applies if--

(A) The plan attributed investment in the contract (tax basis) to the participant or beneficiary based on the deemed distribution of the loan;

(B) The plan subsequently made an actual distribution to the participant or beneficiary before the transition date; and

(C) Immediately before the transition date, the initial default amount (or, if less, the amount of the investment in the contract so attributed) exceeds the participant's or beneficiary's investment in the contract (tax basis). If this paragraph (c)(2)(iv) of this Q&A-22 applies, the plan must treat the excess (the loan transition amount) as a loan amount that remains outstanding and must include the excess in the participant's or beneficiary's income at the time of the first actual distribution made on or after the transition date.

(3) *Examples.* The rules in paragraph (c)(2) of this Q&A-22 are illustrated by the following examples, which are based on the assumptions described in the introductory text of this section (and, except as specifically provided in the examples, also assume that no distributions are made to the participant and that the participant has no investment in the contract with respect to the plan). *Example 1, Example 2, and Example 4* of this paragraph (c)(3) of this Q&A-22 illustrate the application of the rules in paragraph (c)(2) of this Q&A-22 to a plan that, before the transition date, did not treat interest accruing after the initial deemed distribution as resulting in additional deemed distributions under section 72(p). *Example 3* of this paragraph (c)(3) of this Q&A-22 illustrates the application of the rules in paragraph (c)(2) of this Q&A-22 to a plan that, before the transition date, treated interest accruing after the initial deemed distribution as resulting in additional deemed distributions under section 72(p). The examples are as follows:

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EXHIBIT B FINAL REGULATIONS 72(P), Continued

Example 1. (i) In 1998, when a participant's account balance under a plan is \$50,000, the participant receives a loan from the plan. The participant makes the required repayments until 1999 when there is a deemed distribution of \$20,000 as a result of a failure to repay the loan. For 1999, as a result of the deemed distribution, the plan reports, in Box 1 of Form 1099-R, a gross distribution of \$20,000 (which is the initial default amount in accordance with paragraph (c)(2)(ii) of this Q&A-22) and, in Box 2 of Form 1099-R, a taxable amount of \$20,000. The plan then records an increase in the participant's tax basis for the same amount (\$20,000). Thereafter, the plan disregards, for purposes of section 72, the interest that accrues on the loan after the 1999 deemed distribution. Thus, as of December 31, 2001, the total taxable amount reported by the plan as a result of the deemed distribution is \$20,000 and the plan's records show that the participant's tax basis is the same amount (\$20,000). As of January 1, 2002, the plan decides to apply Q&A-19 of this section to the loan. Accordingly, it reduces the participant's tax basis by the initial default amount of \$20,000, so that the participant's remaining tax basis in the plan is zero. Thereafter, the amount of the outstanding loan is not treated as part of the account balance for purposes of section 72. The participant attains age 59-1/2 in the year 2003 and receives a distribution of the full account balance under the plan consisting of \$60,000 in cash and the loan receivable. At that time, the plan's records reflect an offset of the loan amount against the loan receivable in the participant's account and a distribution of \$60,000 in cash.

(ii) For the year 2003, the plan must report a gross distribution of \$60,000 in Box 1 of Form 1099-R and a taxable amount of \$60,000 in Box 2 of Form 1099-R.

Example 2. (i) The facts are the same as in *Example 1*, except that in 1999, immediately prior to the deemed distribution, the participant's account balance under the plan totals \$50,000 and the participant's tax basis is \$10,000. For 1999, the plan reports, in Box 1 of Form 1099-R, a gross distribution of \$20,000 (which is the initial default amount in accordance with paragraph (c)(2)(ii) of this Q&A-22) and reports, in Box 2 of Form 1099-R, a taxable amount of \$16,000 (the \$20,000 deemed distribution minus \$4,000 of tax basis (\$10,000 times (\$20,000/\$50,000)) allocated to the deemed distribution). The plan then records an increase in tax basis equal to the \$20,000 deemed distribution, so that the participant's remaining tax basis as of December 31, 1999, totals \$26,000 (\$10,000 minus \$4,000 plus \$20,000). Thereafter, the plan disregards, for purposes of section 72, the interest that accrues on the loan after the 1999 deemed distribution. Thus, as of December 31, 2001, the total taxable amount reported by the plan as a result of the deemed distribution is \$16,000 and the plan's records show that the participant's tax basis is \$26,000. As of January 1, 2002, the plan decides to apply Q&A-19 of this section to the loan. Accordingly, it reduces the participant's tax basis by the initial default amount of \$20,000, so that the participant's remaining tax basis in the plan is \$6,000. Thereafter, the amount of the outstanding loan is not treated as part of the account balance for purposes of section 72. The participant attains age 59-1/2 in the year 2003 and receives a distribution of the full account balance under the plan consisting of \$60,000 in cash and the loan receivable. At that time, the plan's records reflect an offset of the loan amount against the loan receivable in the participant's account and a distribution of \$60,000 in cash.

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EXHIBIT B FINAL REGULATIONS 72(P), Continued

(ii) For the year 2003, the plan must report a gross distribution of \$60,000 in Box 1 of Form 1099-R and a taxable amount of \$54,000 in Box 2 of Form 1099-R.

Example 3. (i) In 1993, when a participant's account balance in a plan is \$100,000, the participant receives a loan of \$50,000 from the plan. The participant makes the required loan repayments until 1995 when there is a deemed distribution of \$28,919 as a result of a failure to repay the loan. For 1995, as a result of the deemed distribution, the plan reports, in Box 1 of Form 1099-R, a gross distribution of \$28,919 (which is the initial default amount in accordance with paragraph (c)(2)(ii) of this Q&A-22) and, in Box 2 of Form 1099-R, a taxable amount of \$28,919. For 1995, the plan also records an increase in the participant's tax basis for the same amount (\$28,919). Each year thereafter through 2001, the plan reports a gross distribution equal to the interest accruing that year on the loan balance, reports a taxable amount equal to the interest accruing that year on the loan balance reduced by the participant's tax basis allocated to the gross distribution, and records a net increase in the participant's tax basis equal to that taxable amount. As of December 31, 2001, the taxable amount reported by the plan as a result of the loan totals \$44,329 and the plan's records for purposes of section 72 show that the participant's tax basis totals the same amount (\$44,329). As of January 1, 2002, the plan decides to apply Q&A-19 of this section. Accordingly, it reduces the participant's tax basis by the initial default amount of \$28,919, so that the participant's remaining tax basis in the plan is \$15,410 (\$44,329 minus \$28,919). Thereafter, the amount of the outstanding loan is not treated as part of the account balance for purposes of section 72. The participant attains age 59-1/2 in the year 2003 and receives a distribution of the full account balance under the plan consisting of \$180,000 in cash and the loan receivable equal to the \$28,919 outstanding loan amount in 1995 plus interest accrued thereafter to the payment date in 2003. At that time, the plan's records reflect an offset of the loan amount against the loan receivable in the participant's account and a distribution of \$180,000 in cash.

(ii) For the year 2003, the plan must report a gross distribution of \$180,000 in Box 1 of Form 1099-R and a taxable amount of \$164,590 in Box 2 of Form 1099-R (\$180,000 minus the remaining tax basis of \$15,410).

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EXHIBIT B FINAL REGULATIONS 72(P), Continued

Example 4. (i) The facts are the same as in *Example 1*, except that in 2000, after the deemed distribution, the participant receives a \$10,000 hardship distribution. At the time of the hardship distribution, the participant's account balance under the plan totals \$50,000. For 2000, the plan reports, in Box 1 of Form 1099-R, a gross distribution of \$10,000 and, in Box 2 of Form 1099-R, a taxable amount of \$6,000 (the \$10,000 actual distribution minus \$4,000 of tax basis (\$10,000 times (\$20,000/\$50,000)) allocated to this actual distribution). The plan then records a decrease in tax basis equal to \$4,000, so that the participant's remaining tax basis as of December 31, 2000, totals \$16,000 (\$20,000 minus \$4,000). After 1999, the plan disregards, for purposes of section 72, the interest that accrues on the loan after the 1999 deemed distribution. Thus, as of December 31, 2001, the total taxable amount reported by the plan as a result of the deemed distribution plus the 2000 actual distribution is \$26,000 and the plan's records show that the participant's tax basis is \$16,000. As of January 1, 2002, the plan decides to apply Q&A-19 of this section to the loan. Accordingly, it reduces the participant's tax basis by the initial default amount of \$20,000, so that the participant's remaining tax basis in the plan is reduced from \$16,000 to zero. However, because the \$20,000 initial default amount exceeds \$16,000, the plan records a loan transition amount of \$4,000 (\$20,000 minus \$16,000). Thereafter, the amount of the outstanding loan, other than the \$4,000 loan transition amount, is not treated as part of the account balance for purposes of section 72. The participant attains age 59-1/2 in the year 2003 and receives a distribution of the full account balance under the plan consisting of \$60,000 in cash and the loan receivable. At that time, the plan's records reflect an offset of the loan amount against the loan receivable in the participant's account and a distribution of \$60,000 in cash.

(ii) In accordance with paragraph (c)(2)(iv) of this Q&A22, the plan must report in Box 1 of Form 1099-R a gross distribution of \$64,000 and in Box 2 of Form 1099-R a taxable amount for the participant for the year 2003 equal to \$64,000 (the sum of the \$60,000 paid in the year 2003 plus \$4,000 as the loan transition amount).

[Reg. §1.72(p)-1.]

.. [T.D. 8894, 7-28-2000.]