subject: Section 72(p) loan cure period

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

You have asked how a cure period, as described in § 1.72(p)-1, Q&A-10(a), is applied for a participant who fails to make installment payments required under the terms of a plan loan. To help address your question, we will analyze two different factual situations.

For both factual situations, assume the following:

(a) the taxpayer is a participant in a § 401(k) plan that permits plan loans;
(b) on January 1, 2018, the participant receives a loan from the plan in an amount that does not exceed the limit provided under § 72(p)(2)(A);
(c) the loan, which is not a home loan, is repayable in five years (the last installment payment is due December 31, 2022), as required under § 72(p)(2)(B);
(d) level installment payments are due at the end of each month over the repayment term of the loan (the first installment payment is due January 31, 2018), as required under § 72(p)(2)(C);
(e) the loan is evidenced by a legally enforceable agreement, as required under § 1.72(p)-1, Q&A-3(b); and

(f) the plan allows for a cure period, as described in § 1.72(p)-1, Q&A-10(a), permitting a participant to make up a missed installment payment by the last day of calendar quarter following the calendar quarter in which the required installment payment was due.

Situation 1. The participant timely makes installment payments from January 31, 2018, through February 28, 2019. The participant misses the March 31, 2019 and April 30, 2019 installment payments. The participant makes installment payments on May 31, 2019 (which is applied to the missed March 31, 2019 installment payment) and June 30, 2019 (which is applied to the missed April 30, 2019 installment payment). On July 31, 2019, the participant makes a payment equal to three installment payments (which is applied to the missed May 31, 2019 and June 30, 2019 installment payments, as well as the required July 31, 2019 installment payment).

Situation 2. The participant timely makes installment payments from January 31, 2018, through September 30, 2019. The participant misses the October 31, 2019, November 30, 2019, and December 31, 2019 installment payments. On January 15, 2020, the participant refinances the loan and replaces it with a new loan (the replacement loan) equal to the outstanding balance of the original loan (the replaced loan), including the three missed installment payments. Under the terms of the replacement loan, the replacement loan is to be repaid in level monthly installments at end of each month through the end of the replaced loan’s repayment term, December 31, 2022. For purposes of this example, assume that the replacement loan satisfies the requirements of § 72(p)(2)(A) through (C) and § 1.72(p)-1, Q&A-3 and Q&A-20.

CONCLUSIONS

Situation 1. The participant’s missed installment payments do not violate the level amortization requirement under § 72(p)(2)(C) because the missed installment payments are cured within the applicable cure period. Accordingly, there is no deemed distribution of the loan due to the missed installment payments.

Situation 2. The participant’s missed installment payments do not violate the level amortization requirement under § 72(p)(2)(C) because the missed installment payments are cured within the applicable cure period by the refinancing of the loan. Accordingly, there is no deemed distribution of the loan due to the missed installment payments.

LAW

Section 72(p)(1) provides that if a participant receives (directly or indirectly) a loan from a qualified employer plan, the amount of the loan will be treated as having been received by the participant as a distribution from the plan. Section 72(p)(4) generally defines a qualified employer plan as a § 401(a) qualified plan, a § 403(a) annuity plan, or a § 403(b) plan.
Section 72(p)(2) generally provides that § 72(p)(1) shall not apply to a loan to the extent that the loan meets the requirements of § 72(p)(2)(A) through (C).

Section 72(p)(2)(A) generally provides that a loan, when added to the outstanding balance of all other loans from all plans of the employer, must not exceed the lesser of:

(i) $50,000, reduced by any excess, if any, of
   (I) the highest outstanding balance of loans from the plan during the 1-year period ending on the day before the date on which such loan was made, over
   (II) the outstanding balance of loans from the plan on the date on which such loan was made; or

(ii) the greater of
   (I) half of the present value of the participant’s vested accrued benefit, or
   (II) $10,000.

Section 72(p)(2)(B) provides that the loan must, by its terms, be required to be repaid within 5 years. An exception to this repayment term requirement is provided for home loans used to acquire the principal residence of the participant.

Section 72(p)(2)(C) provides that the loan must require substantially level amortization of the loan (with payments not less frequently than quarterly) over the term of the loan.

Section 1.72(p)-1, Q&A-3(a) provides that a loan from a qualified employer plan to a participant will not be a deemed distribution if the loan satisfies § 72(p)(2)(A) through (C) and is evidenced by a legally enforceable agreement. Section 1.72(p)-1,Q&A-3(b) describes the enforceable agreement requirement and provides that the agreement must specify the amount and date of the loan and the repayment schedule.

Section 1.72(p)-1, Q&A-4, provides that, for purposes of § 72, a deemed distribution occurs at the first time that the requirements of § 1.72(p)-1, Q&A-3 are not satisfied, in form or in operation. Further, if a loan initially satisfies the requirements of § 1.72(p)-1, Q&A-3, but payments are not made in accordance with the terms of the loan, then a § 72(p)(1) deemed distribution of the loan occurs as a result of the failure to make such payments (see § 1.72(p)-1, Q&A-10, regarding when such a deemed distribution occurs and the amount of the deemed distribution, and § 1.72(p)-1, Q&A-11, regarding the tax treatment of a deemed distribution).

Section 1.72(p)-1, Q&A-10(a) provides that a failure to make any installment payment when due violates the level amortization requirement in § 72(p)(2)(C) and results in a deemed distribution at the time of such failure. However, the regulations also provide that a plan administrator may allow a cure period (lasting not later than the last day of the calendar quarter following the calendar quarter in which the required installment payment was due).
Section 1.72(p)-1, Q&A-10(b) provides that if a loan, when made, satisfies the requirements of § 1.72(p)-1, Q&A-3, but there is a failure to pay an installment payment required under the loan (taking into account any cure period permitted in § 1.72(p)-1, Q&A-10(a)), then the amount of the deemed distribution is equal to the entire outstanding balance of the loan (including any accrued interest) at the time of such failure.

Section 1.72(p)-1, Q&A-20(a)(1) provides that a participant may refinance a loan if the loans collectively satisfy the amount limitations of § 72(p)(2)(A) and the replaced loan and the replacement loan each satisfy the requirements of § 72(p)(2)(B) and (C) and § 1.72(p)-1. Section 1.72(p)-1, Q&A-20(a)(1) provides that a refinancing includes any situation in which one loan replaces another loan.

ANALYSIS

For Situation 1 and Situation 2, the cure period permitted in the plan does not extend beyond the period set forth in § 1.72(p)-1, Q&A-10(a) (that is, the applicable cure period does not extend beyond the last day of the calendar quarter following the calendar quarter in which the missed installment payment was due).

In Situation 1, under the cure period, the two missed installment payments (March 31, 2019, and April 30, 2019) have separate cure periods because they occur in separate calendar quarters. For the missed March 31, 2019 installment payment, the cure period ends June 30, 2019, and for the missed April 30, 2019 installment payment, the cure period ends September 30, 2019. Each missed installment payment is cured within that missed installment payment’s applicable cure period. The missed March 31, 2019 installment payment is cured by installment payment made on May 31, 2019. Likewise, the missed April 30, 2019 installment payment is cured by the installment payment made on June 30, 2019. However, the May 31, 2019 and June 30, 2019 installment payments are missed because those installment payments are applied to the earlier missed installment payments (March 31, 2019 and April 30, 2019). The missed May 31, 2019 installment payment and the missed June 30, 2019 installment payment have a cure period that ends September 30, 2019. The missed May 31, 2019 installment payment and the missed June 30, 2019 installment payment are cured by the payment made on July 31, 2019 (which is applied to the missed May 31, 2019 and June 30, 2019 installment payments, as well as the required July 31, 2019 installment payment). Accordingly, under § 1.72(p)-1, Q&A-10, the level amortization requirement under § 72(p)(2)(C) is not violated and there is no deemed distribution from the missed March 31, 2019, April 30, 2019, May 31, 2019, and June 30, 2019 installment payments.

In Situation 2, the three missed installment payments (October 31, 2019, November 30, 2019, and December 31, 2019) have the same cure period, which ends March 31, 2020, because they occur in the same calendar quarter. The replacement loan created by the refinancing of the replaced loan on January 15, 2020, pays off the entire outstanding balance of the replaced loan (which includes the three missed installment
payments) within the missed installment payments' cure period. Accordingly, under § 1.72(p)-1, Q&A-10, the level amortization requirement under § 72(p)(2)(C) is not violated for the replaced loan and there is no deemed distribution from the three missed installment payments.

This Chief Counsel Advice does not address the tax consequences of the scenarios discussed in this writing, except as expressly provided, including the tax consequences of a § 72(p)(1) deemed distribution.

Please call Patrick Gutierrez at or Clare Diefenbach at (202) 317-4102 if you have any further questions.