ROLLOVER OF QUALIFIED PLAN LOAN OFFSETS: WILL THE TAX BILL HAVE AN IMPACT?

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Retirement plan "leakage" — premature distribution of retirement plan assets — has been a significant focus of retirement plan policy for a number of years. One primary source of leakage is retirement plan loan defaults. In a perfect world, leakage due to participant loans is minimal. A participant takes a loan and repays it with interest. There is no leakage of principal and the repayment of interest offsets the impact of lost investment earnings for the period during which the loan was outstanding. Alas, the world is not perfect. Loans are frequently not repaid, and upon default, the retirement plan assets loaned to the participant are unavailable to fund the participant's future retirement.

The tax reform bill enacted late last year includes a provision intended to address plan loan defaults. The new provision addresses defaults that result in "plan loan offsets." While this new provision may offer some relief, ***it does not prevent plan loan defaults***.

What are plan loan offsets? Plan loan offsets result when loans are defaulted after a participant's account is eligible for distribution — e.g., following separation from employment. Most plans provide that upon termination of employment, the outstanding principal balance of the loan is accelerated. If that balance (plus interest) is not immediately repaid (or repaid by the end of the plan's cure period), that amount is treated as a taxable distribution to the participant. In technical tax terms, the participant's account balance includes the participant's promissory note and the outstanding principal balance of the loan is "offset" against that account balance by cancelling the note — thus, the term "plan loan offset amount." The plan loan offset amount is treated as distributed and is subject to federal (and possibly state) income tax. The amount treated as distributed is eligible for a tax-free rollover (e.g., to an individual retirement account); the rollover opportunity effectively gives the participant an additional period of time (through the end of the rollover window) to repay the loan and avoid a taxable distribution.

The new provision in the tax reform bill extends the rollover window for a plan loan offset amount from 60 days following the date that it is treated as having been distributed to the participant to the due date of the participant's federal income tax return (including extensions) for the year in which the plan treats the plan loan offset amount as distributed. For a participant who files for an extension of his or her federal income tax return due date, that means that the rollover window can be extended to, generally, October 15th of the following year. Note that this extension applies only to plan loan offsets that occur solely by reason of plan termination or the failure of the participant to meet the repayment terms of the loan because of the participant's severance from employment.

How does this address retirement plan leakage? It gives a participant who terminates employment more time to find the resources necessary to repay the loan in the form of a rollover. Under the new law, that rollover window would now be at least 4-1/2 months and could be as long as 22 months (depending on when the plan loan offset distribution is treated as occurring and whether the participant files for an extension of the due date for his or her federal income tax return). But there are obstacles to accomplishing this:

- First, a participant must be aware that an accelerated loan repayment was even due and remember that the failure to repay the loan resulted in a taxable distribution that he or she has a right to rollover to avoid taxes. It's highly unlikely that a participant would be aware of any of these consequences. The participant's promissory note would describe the accelerated repayment obligation, but many participants do not read the note or recall at the time of termination of employment that the note contained an acceleration provision. At the time of the offset, the plan is required to provide the participant with a tax notice that includes a brief description of the right to rollover a distribution resulting from a plan loan offset; however, most participants will not read or understand that notice. While the participant will receive a Form 1099-R, many participants will not understand the significance of that tax form. And if they do understand its significance, they may not understand that they have a rollover right because the tax notice that advised them of their right to rollover the plan loan offset distribution is not received at the same time. They would normally receive the tax notice at the time of the offset but would not normally receive the Form 1099-R until January of the following year.
- Second, the participant must have the resources (however unlikely) to fund the rollover to an individual retirement account or another retirement plan before the end of the rollover window. In the typical case, the participant does not have those resources. If the participant had those resources, the participant would presumably not have borrowed the money in the first place (or would have repaid the outstanding loan balance when his or her employment terminated). Where the termination of employment is involuntary — e.g., due to layoff — there is even less likelihood that the participant will have sufficient resources to fund the rollover, as the participant will likely have no immediate replacement source of income. So, in most cases, termination of employment results in permanent leakage. The borrowed amount will never be repaid and will permanently leave the retirement system.

While the bill may provide relief to some, consider what this tax law change does not do:

- It does not postpone the date on which offsets and taxable distributions (and the 10 percent early distribution penalty, if applicable) are treated as having occurred. Plans will still likely accelerate loans at termination of employment and will, thus, still offset the loan balance and treat that offset amount as a distribution at the end of the plan's cure period. And record keepers are likely to continue current administrative protocols and insist that plans accelerate loans upon termination of employment.
- It does not include any changes to the disclosure rules that would increase a participant's awareness of the acceleration of the loan, the consequences of that acceleration and failure to timely repay and the right to rollover the plan loan offset distribution.
- It does not address the fact that the participant still has to come up with funds equal to the outstanding loan balance to avoid being taxed on that amount. A participant who has been planning on repaying a general-purpose loan over five years now must repay it in a lump sum much more quickly due to an unanticipated termination of employment beyond his or her control. It is still doubtful that the participant will be in a position to fund a rollover after the tax bill.

- It applies only to loan offsets resulting from plan termination or severance from employment. It does not apply to other situations in which plans commonly accelerate loans — e.g., disability. It also does not apply where a loan has been deemed distributed (and taxed to the participant) due to failure to pay in accordance with the normal repayment terms of the loan. This deemed distribution is not eligible for rollover at all.

So the tax bill may be a step in the right direction with respect to loan-related leakage from retirement plans. However, most participants will likely not find the change particularly useful, and the unexpected termination of employment will continue to result in a permanent reduction in their retirement savings.

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