Defaulting on Retirement Plan Loans Causes Taxable Distributions

Want to borrow money from your retirement plan? Not so fast. Retirement plan loans can be a viable way to get money in a crunch, but you need to follow the rules about repaying them. If you don't, it could lead to unfavorable tax consequences, as two taxpayers recently learned the hard way in U.S. Tax Court.

The Basics

A participant in an employer-sponsored qualified retirement plan can borrow money from the plan if it allows loans. The loan amount generally can't exceed the lesser of:

- $50,000, or
- 50% of the employee's vested account balance or accrued benefit.

However, a loan of up to $10,000 is allowed even if it exceeds the 50% limit. Plan loans must call for substantially level payments that are made at least quarterly and they generally must be repaid within five years.

There's an exception for principal residence loans; these can have longer repayment periods. These loans must be used to acquire a home that will be used as the plan participant's principal residence. Like other types of retirement plan loans, principal residence loans must be repaid in substantially level amounts that are paid at least quarterly.

The Dark Side: Loan Defaults

If a plan participant (borrower) fails to make a plan loan payment by the due date or within the specified grace period, the failure can trigger a loan default and a deemed taxable distribution equal to the entire amount of the outstanding loan balance. In other words, the loan is extinguished, but it's deemed to be paid off with the taxable distribution from the plan. This treatment would increase your taxable income — and your tax liability for the year.

To add insult to injury, an early qualified plan distribution, including a deemed distribution caused by a plan loan default, can also trigger a 10% early distribution penalty tax depending on your age. The 10% penalty applies if the plan participant (borrower) is under age 59-1/2, unless an exception is available.

Cautionary Tales

In two recent decisions, the U.S. Tax Court sided with the IRS, by determining that taxpayers who failed to make timely repayments on loans from their employer's qualified retirement plans were considered to have defaulted on the loans. Accordingly, they were deemed to have received taxable distributions from the plans, which triggered a federal income tax hit and, because the taxpayers were under age 59-1/2, the 10% penalty tax on early retirement plan distributions.

In the first recent decision, *Louelia Salomon Frias v. Commissioner*, TC Memo 2017-139, the court concluded that a 401(k) plan loan, which the taxpayer took before she went on leave, was a taxable distribution when she failed to begin making repayments on time and failed to make the repayments in substantially level amounts. It didn't matter that the taxpayer's employer disregarded her instructions to deduct loan repayments from her paychecks during the period she was on leave or that she eventually repaid the loan.

In the second case, *Gregory J. Gowen v. Commissioner,* TC Summary Opinion 2017-57, the taxpayer defaulted on his 401(k) plan loan after he lost his job. After an audit, the IRS determined the default was a taxable distribution in the year the plan's grace period for repayment expired. A plan loan's grace period can't continue beyond the last day of the calendar quarter following the calendar quarter in which the required installment payment was due. The court agreed with the IRS on all points.

Could a Retirement Plan Loan Work for You?

Taking out a retirement plan loan can make sense in the right circumstances. But it doesn't take much to be considered in default under the tax rules — and defaulting on plan loans can trigger dire tax consequences. If you have questions or want more information about retirement plan loans, contact your tax advisor.

Looser Retirement Plan Loan Rules for Disaster Victims

The Disaster Tax Relief and Airport and Airway Extension Act of 2017 was enacted in late September. It provides looser retirement plan loan rules to victims of Hurricanes Harvey, Irma and Maria and the California wildfires.

Increased Loan Limit

The new law increases the maximum amount that can be borrowed from a retirement plan from the usual $50,000 to $100,000. This increase in the maximum loan amount is available to qualified victims of recent hurricanes, which means individuals:

- Whose principal place of residence on August 23, 2017, was in the Hurricane Harvey disaster area and who sustained an economic loss due to Harvey,
- Whose principal place of residence on September 4, 2017, was in the Hurricane Irma disaster area and who sustained an economic loss due to Irma, or
- Whose principal place of residence on September 16, 2017, was in the Hurricane Maria disaster area and who sustained an economic loss due to Maria.

To qualify for the larger loan limit, a plan loan must be made to the qualified Hurricane Harvey, Irma or Maria individual between September 29, 2017, and December 31, 2018.

Delayed Repayments

The usual tax rules require retirement plan loans to be repaid within five years unless the loan is used to buy a principal residence. However, the new law carves out an exception for eligible recent hurricane victims. If a qualified Hurricane Harvey, Irma or Maria individual has an outstanding plan loan, the due date for any loan repayment that's due between the qualified beginning date and December 31, 2018, is delayed by one year.

The qualified beginning date is:

- August 23, 2017, for a qualified Hurricane Harvey victim,
- September 4, 2017, for a qualified Hurricane Irma victim, or
- September 16, 2017, for a qualified Hurricane Maria victim.

Any subsequent repayment dates, amounts due and interest will be adjusted to reflect the delay.

Relief for California Wildfire Victims

In a vaguely worded announcement, the IRS extends liberalized retirement plan loan rules to victims of the October fires in Northern California who live or work in areas identified for individual assistance by the Federal Emergency Management Agency. Specifically, the relief is available to individuals whose principal residence or place of employment on October 8, 2017, was located in one of those areas or whose lineal ascendant or descendant, dependent or spouse had a principal residence or place of employment in one of these areas on October 8, 2017.

The IRS is also waiving some of the procedural rules that usually apply to qualified plan hardship distributions. For a retirement plan loan to qualify for this relief, it must be made between October 8, 2017, and March 15, 2018. Contact your tax advisor for more information.

The Law Office of Eugene Gorrin, LLC
17 Watchung Avenue, Suite 204
Chatham, NJ 07928
973.701.9300
egorrin@gorrinlaw.com
www.gorrinlaw.com