Law & Policy Group

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# New IRS snapshot tackles deemed distributions

*By Matthew Calloway and Margaret Berger*
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A new IRS issue snapshot explains when different kinds of participant loan failures will cause a taxable deemed distribution. The snapshot also highlights the provisions of the Coronavirus Aid, Relief and Economic Security (CARES) Act (Pub. L. No. 116-136) that gave more loan flexibility to participants affected by COVID-19. While the snapshot summarizes existing guidance rather than providing new information, it may alert plan sponsors and taxpayers to the kinds of issues IRS agents review during audits.

## Plan loan failures and deemed distributions

Though not required to offer participant loans, many defined contribution (DC) plans do. Internal Revenue Code (IRC) Section 72(p) limits the amount of participant loans and generally requires repayment within five years in equal installments made at least quarterly. A legally enforceable written agreement must contain the terms of the loan. Failing to meet any of these conditions will cause all or part of a loan to be treated as a deemed distribution that is taxable to the participant as of the date of the failure. The deemed distribution is then subject to the additional 10% tax on distributions before age 59-1/2 (if applicable) and reportable on Form 1099-R.

When the failure occurs after the date the loan is made, a partial deemed distribution may occur. This typically happens when a participant doesn't make a payment on time: The remaining amount of the loan — including accrued but unpaid interest — is treated as a deemed distribution. If the plan provides a cure period for the participant to make up a late payment, the deemed distribution occurs on the last day of that period, which can be as late as the end of the next calendar quarter.

## Optional CARES Act changes provided more flexibility

The CARES Act allowed plan sponsors to provide temporary flexibility to certain participants affected by the COVID-19 pandemic. Nongovernmental plan sponsors have until the end of the 2022 plan year to adopt an amendment implementing this relief.

- **Increased loan limit.** From March 27, 2020, through Sept. 22, 2020, the aggregate loan limit for qualifying participants doubled to 100% of the participant's vested account balance, capped at $100,000.

- **Payment suspension and extension of loan period.** Sponsors also could allow qualified participants to suspend loan payments between March 27, 2020, and Dec. 31, 2020, and extend the loan term for one year. Loan repayments must be adjusted to add interest accrued during that time.

## Audit tips

In addition to examining the plan document and loan policy, IRS auditors will also review outstanding loan documentation to see if any deemed distributions have occurred and validate that Form 1099-Rs were properly filed. The snapshot also notes that agents should look out for indicators of fraud, which might occur if participants claimed special COVID relief but weren't eligible for it.

## Related resources

### Non-Mercer resources

- Issue snapshot: Deemed distributions — participant loans (IRS, Sept. 28, 2021)
- Notice 2020-50 (IRS, June 19, 2020)
- Pub. L. No. 116-136, the Coronavirus Aid, Relief, and Economic Security Act (Congress, March 27, 2020)

### Mercer Law & Policy resources

- Delving into CARES Act relief for retirement plan participants (revised) (June 22, 2020)
- IRS releases FAQs on CARES Act distributions and loans (May 5, 2020)

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