Pioneer Bank & Trust
Trust & Investments
Local.

704 7th Ave, PO Box 729
Belle Fourche, SD 57717-0729
Phone (605) 892-3494
Fax (605) 892-2115

2001 W Omaha St, PO Box 9189
Rapid City, SD 57709-9189
Phone (605) 341-2265
Fax (605) 341-7425

140 E Jackson Blvd, PO Box 10
Spearfish, SD 57783-0010
Phone (605) 642-2725
Fax (605) 642-1736

The last resort

A loan from a qualified retirement plan can provide emergency funding during a cash crunch, and be a bridge to a more prosperous time when the emergency passes. But if the financial pressure is sustained, the plan loan just might make the problem worse, as shown in two recent Tax Court cases.

The layoff

David borrowed $36,248 from his 401(k) account in 2011. Such loans are typically allowed up to the *lesser* of $50,000 or 50% of the plan balance, a test David passed easily. Unfortunately, he was laid off later that year. To avoid "being a burden on society," David requested a plan distribution of $127,140. That would be taxable income, so $18,000 in taxes was sent to the IRS, and the plan loan had to be repaid from the proceeds. David thus received just $73,490. He was 49 years old at the time.

The distribution was reported properly on David's income tax return for 2011. However, he did not pay the additional 10% tax that is required for plan distributions that occur too early in life—that is, before reaching age 59 ½. In the Tax Court, David asked to be excused from the additional tax because of his genuine economic hardship. Not only did he lose his job in 2011, but also the family had over $9,000 in unreimbursed medical expenses that year. The Court was sympathetic, but it concluded that there is no "hardship" exception in the tax law for premature plan distributions.

But does the 10% penalty apply to the loan? David thought that it shouldn't, because the family didn't get any more cash when the loan was forgiven as part of the distribution. The penalty does apply to the loan forgiveness as well, the Court ruled. When a plan loan, even from an earlier year, is offset in a plan distribution, that is a "deemed distribution" from the plan. As such, it is fully taxable in the year of the loan forgiveness.

The boundary

Ralim participated in the New York State and Local Retirement System (NYSLRS), saving a total of $17,017. He requested several loans over the years. In 2009 Ralim requested a "maximum loan" from the plan, and he received a check for $5,993. That brought his loan balance to $12,802.

Small plan loans are permitted to the *greater* of 50% of the plan balance or $10,000. Ralim's loan crossed both of these boundaries. Accordingly, the IRS said that $2,802 (the amount in excess of $10,000) was taxable income as a deemed plan distribution.

What's more, the IRS asked for the 10% tax on premature distributions. Ralim's age was not included in the materials presented to the Court by either the taxpayer or the government. The IRS argued that the burden of proving the taxpayer's age was on the taxpayer, not on the government.

For that assertion to prevail, the Tax Court held, the 10% additional tax on premature distributions must not be a "penalty" as that word is used in the tax code. With penalties the burden of proof is on the IRS; with taxes it is on the taxpayer. After close reading of the tax code, the Court sustained the IRS' position. Although the taxpayer undoubtedly feels "penalized," the extra 10% due is a tax, not a penalty. Because Ralim did not prove that he was over age 59 ½, the additional 10% tax also must be paid on the excess loan amount. Note that the 10% tax also applies to the income tax paid.

Start the clock

The proper taxation of IRA distributions has proved tricky for many taxpayers. When there is a distribution, Form 5329 needs to be filed with Form 1040 to document the transaction. If the Form is not filed, the IRS may assess additional taxes—such as the excess contributions tax, the failure to take a required minimum distribution tax, or the premature distributions tax—at any time in the future. It's also important to keep IRA records, perhaps indefinitely, to help resolve such questions should they come up in the future.

See your tax advisors to learn more on this subject.

(October 2015)