

# Plan Administration

## Actual Distributions Compared to Deemed Distributions

Recent litigation at the U.S. Tax Court highlights the importance of keeping up with plan loan repayments.

In *Ryan v. Comm’r*, T.C. Memo. 2011-139 (2011), the petitioners Raymond and Ana Ryan questioned the authority of the IRS to impose a 10-percent additional tax on a loan Raymond Ryan received against his qualified retirement plan in 2006. The petitioners argued that they did not receive a deemed distribution from the loan, so they should not have to pay the 10-percent additional tax. (See the box for the definition of a “deemed distribution.”)

### Deemed Distributions

If a loan is not repaid in a timely manner (see ¶430 of the *Handbook*), the outstanding amount on the loan, including the outstanding principal and interest, is taxable to the participant. This is called a “deemed distribution” for tax purposes. A deemed distribution is not treated as an actual distribution with respect to the plan’s qualification requirements, distribution provisions or vesting requirements. It is not an actual distribution until the participant’s account balance is reduced in satisfaction of the loan obligation.

### Background

Raymond Ryan, a 17-year employee of the Air Force, took out a \$50,000 loan from his Thrift Savings Plan (TSP) account in 2003. The loan had the repayment term of four years on a biweekly repayment schedule.

Two years later, he was reassigned from his Texas location to one in Oklahoma. Ryan, who claimed his medical condition prevented him from fulfilling duties at the new location, refused the reassignment, and did not report for duty. After he used months of sick leave, the Air Force labeled Ryan as absent without leave and removed him from service in March 2006. A legal battle ensued, concluding with Ryan being asked to report to work a second time, but Ryan again failed to report to the new location. The Air Force removed him from federal employment the second time in February 2008.

In May 2006, because of Ryan’s first removal from service, the TSP requested him to repay the outstanding amount on his loan, \$13,976, by Aug. 4, 2006. The TSP advised Ryan that failure to repay the balance would result in the remaining loan balance being treated as a deemed

taxable distribution for the year, and Ryan could incur an early withdrawal penalty as well. Ryan did not repay the full balance on time, and the TSP closed the loan and mailed Ryan a Form 1099-R indicating he received a distribution of \$9,789 from his TSP account. Because the outstanding loan balance became a deemed distribution, it was subject to a 10-percent tax from the IRS.

### Arguments

Ryan argued before the U.S. Tax Court that he was not liable for the 10-percent additional tax; since he did not sever his connection with the Air Force in 2006, he claimed, the loan was erroneously closed and labeled a deemed distribution.

The IRS countered that the timing of the separation from service was moot. The service argued that because Ryan did not comply with the terms of the loan agreement (namely, stopping payments on it in August 2006), his loan no longer met the exception under Code Section 72(p) to avoid taxation on the distribution; after Ryan stopped making repayments, the balance became a deemed distribution. Because that outstanding balance was then categorized as an early distribution, the IRS claimed, Ryan was liable for the 10-percent additional tax on it under Section 72(t).

The Tax Court agreed with the IRS’ reasoning. The court held that despite reinstatement in 2007, Ryan neither reported for work nor contacted the TSP to inform it of reinstatement; thus Ryan’s failure to repay the loan by Aug. 21, 2006, made the outstanding balance a taxable deemed distribution. The court also upheld the IRS’ 10-percent penalty fee for an early distribution, since Ryan did not file for an exception to it.

In addition to highlighting the importance of knowing when a loan balance becomes a deemed distribution, this case also stresses the value of effective plan communications. At every turn the TSP informed Ryan of potential outcomes of his actions; when the matter went to trial, the court found in favor of the plan’s actions.

### Finding out More

For more on deemed distributions, see the column on page 4, or read relevant IRS guidance on the matter on page 8. To read the U.S. Tax Court’s full opinion on the matter, go to <http://www.ustaxcourt.gov/InOpHistoric/ryanraymond.TCM.WPD.pdf>. 🏠