

Common But Costly Mistakes in 401(k) Plan Loans

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COMMON BUT COSTLY MISTAKES IN 401(K) PLAN LOANS

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Many 401(k) plans allow participants to borrow amounts from their vested 401(k) plan accounts and repay such amounts, typically through payroll deductions, back to their own accounts. Plan loans must comply with IRS rules which govern the amount of the loan (lesser of \$50,000 or 50% of the vested account balance), the loan term (5 years unless used to purchase the participant's principal residence), loan repayments (must be substantially level), and interest rates (must be reasonable).

Participant loans are often pre-approved other than home loans which require extra administration and documentation. Participants can apply on-line or call the 401(k) plan service provider to request a loan. The approval process is short and participants often receive loan proceeds within 7 – 10 days following loan initiation. This means that loan repayments must be set up quickly in the employer's payroll system.

One common mistake is that loan repayments do not begin on a timely basis. This delay is often caused by a lack of communication and coordination between the 401(k) plan

provider and the employer's human resources and payroll departments. Repayment delays are also caused by administrative errors. Loan repayments should be deducted from a participant's wages as soon as possible after loan proceeds are received, but the participant's payroll deduction sometimes starts weeks or even months late. This delay results in a shortfall under the participant's loan amortization repayment schedule. If a participant has not paid the required amount, the loan is in default, and the outstanding loan balance becomes a taxable distribution.

The problem is that many 401(k) plan providers automatically default a loan which is not current. Most 401(k) plans permit a grace period for late or unpaid amounts. The grace period expires on the last day of the calendar quarter after the calendar quarter in which a payment is missed or the loan shortfall is not brought current. Upon default, the 401(k) plan provider will send the participant IRS Form 1099 which reports to the IRS that the outstanding balance is a taxable distribution. A 10% early distribution penalty tax will apply if the participant is under age 59 ½. The participant must also continue to repay the loan so what began as a tax-favored method to borrow money turns into an unexpected and unwanted tax bill, frequently at no fault of the participant.

Loan defaults can only be reversed under very limited circumstances such as loan payments are credited to the wrong person or are applied as contributions rather than loan payments. Another way to reverse a loan default is for the

employer to submit a Voluntary Compliance Program ("VCP") filing with the IRS showing that the default was attributable to an administrative failure or other error. The cost of the VCP filing ranges from \$1,500 to \$3,500 and is based on the amount of plan assets. Most 401(k) plan providers will not prepare a VCP filing for a loan default, so the employer also has legal costs associated with the filing.

The best approach to avoid loan defaults, costly correction activities and unpleasant employee relations is to establish an efficient IRS-compliant loan administration program. The Employee Benefits Group is available to assist in developing your 401(k) plan loan procedures and in correcting loan failures to potentially minimize or reverse negative tax consequences to participants.

If you have any questions, please contact Roberta Granadier in the Troy, Michigan office at 248-433-7552.

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