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INSIGHT: 2017 Tax Law Change Provides Relief to Workers With 401(k) Plan Loans Who Lose Their Jobs

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Increasingly, 401(k) plans have become the primary retirement savings vehicle for workers in U.S. private industry, and according to the Investment Company Institute, at the end of 2015, 87 percent of 401(k) plan participants were in plans that had a loan feature. Loans are often viewed as an important 401(k) plan design component that reconciles the desire of employers to encourage their employees to contribute money to the plan with the desire of employees to be able to access those contributions while still working.

A key characteristic of a 401(k) plan loan is that it places the borrowing participant squarely counter to the advice offered by Polonius to his son Laertes in Shakespeare's play, *Hamlet*, ''neither a borrower nor a lender be.'' In a sense, because the loan is funded and secured by the participant's plan account, the participant is both the borrower and the lender.

The Investment Company Institute reports that at the end of 2015, 19 percent of 401(k) plan participants had borrowed against their plan accounts, which based upon a 2016 estimate of 55 million 401(k) plan participants, means that there was something on the order of 10.5 million workers with 401(k) plan loans.

Plan Loans—An Easy Source of Borrowing

Plan loans provide 401(k) plan participants with a relatively uncomplicated mechanism to obtain borrowing by skipping the delays and formalities associated with loans from a financial institution. Under the tax law, a participant can borrow up to the lesser of 50 percent of their vested plan account balance or $50,000. The loans, which must carry a commercially reasonable interest rate (taking into account that the loans are fully secured), are typically repaid by payroll withholding. The loans repayment period can be up to five years, except that a longer repayment period is permissible, if the purpose of the loan is to enable the borrower to purchase a principal residence.

How Having a 401(k) Plan Loan Can Make a Termination of Employment That Much More Painful

If a 401(k) plan participant terminates employment and fails to repay a plan loan, the outstanding balance of the loan is treated as a taxable distribution from the plan and is potentially subject to a 10 percent additional tax on early distributions. In that event, the participant experiences the double misery of the loss of income from their job, plus the possibility of a large tax bill. This phenomenon, and the broader implications of loan defaults on retirement savings, is discussed in Deloitte Consulting's *Loan Leakage—How can we keep loan defaults from draining $2 trillion from America's 401(k) accounts?*

The 2017 Tax Law Changes Come to the Rescue (at least a little bit)

Although the Tax Cuts and Jobs Act (the Act) did not solve all of the problems associated with plan loan defaults, it does provide some welcome relief.

Prior to 2018, the only way a participant who had terminated employment and defaulted on a 401(k) plan loan could avoid taxation was to roll over the amount of the defaulted loan balance to an IRA within 60 days after the default.

Beginning in 2018, the Act provides meaningful breathing room to participants who lose their jobs at the time that they have a 401(k) plan loan outstanding by extending the period in which they can avail themselves of an IRA rollover to escape taxation on a loan default until the due date, including extensions, for their income tax return for the year in which the default occurs. The extended rollover period is also applicable if the default results from the termination of the plan from which the loan was made.

Importantly, the Act defines the employment termination event that triggers the extended rollover period as a ''severance from employment.'' This terminology is likely to be consequential in a situation in which a company sells some of its assets—for example, the company sells a division—and transfers some of its employees to the buyer. Because the transferred employees are in many instances doing the same work both before and after the transaction, they are sometimes referred to as working at the ''same desk,'' with the potential implication that they did not really terminate employment, even though the transfer to the buyer's payroll means that their loans with the selling company's 401(k) plan are called. Based upon other Internal Revenue Service authority, a ''severance from employment'' should enable an individual, who transfers employment in an asset sale and defaults on a 401(k) plan loan, to avoid taxation by doing an IRA rollover in the extended period.

Implications of the Change

Unlike many statutory changes impacting 401(k) plans, the new loan default rollover rule does not require employers who sponsor 401(k) plans offering loans to amend their plans. On the other hand, the change is especially important to accountants and other tax return preparers, because it may provide an incentive to extend an individual's tax return, to maximize the period in which to accomplish a loan default rollover.

Putting aside the possibility of a future recession and the associated downsizings and business closings, as companies restructure and combine, the additional rollover breathing room should prove to be helpful to at least some employees who are confronted with 401(k) plan loan defaults in connection with those changes.

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