EMPLOYEE BENEFITS

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# Defaulting 401(k) Plan Borrowers in the Time of COVID

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The great majority of 401(k) plans allow participants to borrow against their plan benefits. These loans are secured by the borrowing participant's plan account and are typically repaid by withholding amounts from the borrower's paychecks.

Plan loans are subject to a number of limitations, including a repayment period of 5 years (unless the loan is used to acquire a primary residence) and a maximum borrowing limit of 50 percent of the borrower's vested account balance or $50,000.[1] Violating these limits has adverse tax consequences to the borrower, which are not addressed in this article. The focus of this piece is what happens when someone has borrowed from a 401(k) plan within the limits, terminates employment, and then defaults on the loan—in particular, changes made by the CARES Act and a 2017 change to the tax law, which are helpful to the large number of people who may find themselves in this situation during the pandemic.

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## Plan Loan Defaults by Terminated Employees = Plan Distributions

Under most 401(k) plans, borrowers who terminate employment before paying off their plan loan must either pay the entire remaining amount of the loan within a period of time specified by the plan after cessation of employment or, failing to do so, be considered to be in default on the loan, in which event the tax law treats the borrower as having received a distribution from the plan in the amount of the unpaid loan balance. The IRS refers to this amount as a *plan offset amount.*

Because plan loan offset amounts are treated as plan distributions, the borrower will be taxed on the plan offset amount *unless* an equivalent amount is contributed as a rollover to an IRA or other eligible retirement plan. Like all 401(k) plan distributions, this rollover must occur within 60 days after the default that caused the distribution. There are a couple of exceptions to the 60-day rule (which apply to plan loan offsets as well), most notably, the relief that was granted in IRS Notice 2020-23 for a number of tax deadlines. Under that notice, pursuant to emergency disaster relief in response to the COVID-19 pandemic, the IRS extended the 60-day rollover period until July 15, 2020, for distributions made after April 1, 2020, and prior to May 16, 2020.

Employees who borrow against their 401(k) account and have their employment terminated are often not in a position to repay their loan. Unless they

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are able to roll over an amount equal to the plan loan offset amount triggered by defaulting on the loan, they will not only have to pay income taxes on the plan offset amount, but in most instances, they will also owe the IRS a 10 percent additional tax if they have not attained age 59½. As a practical matter, giving a terminated employee 60 days to avoid taxation on their plan loan, by rolling over the amount they were unable to repay, provides very little relief. The CARES Act and the Tax Cuts and Jobs Act enacted in 2017 (the "TCJA"), however, have provisions that will allow many employees whose termination of employment during the pandemic produced a plan loan default and offset to have much longer periods of time to accomplish a rollover.

## Congress to the Rescue

### Coronavirus-Related Distributions

The CARES Act creates a new category of 401(k) and other employer qualified plan distributions and IRA distributions that are made to qualified individuals on or after January 1, 2020, and before December 31, 2020 (*coronavirus-related distributions*). "Qualified individuals" are individuals who are diagnosed with COVID-19, or have a spouse or dependent who is diagnosed with COVID-19, or who experience a financial hardship, or have a spouse or member of their household who experiences financial hardship, due to COVID-19. The CARES Act limits the amount of aggregate distributions from all eligible retirement plans that a person can treat as coronavirus-related distributions to no more than $100,000. *Plan loan offsets that result in plan distributions can qualify as coronavirus-related distributions.*

The CARES Act gives the recipient of a coronavirus-related distribution 3 years, beginning on the day after the date on which the distribution was received, to repay the distribution in one or more contributions to an eligible retirement plan, which includes IRAs and 401(k) and other employer qualified retirement plans that accept recontributions of coronavirus-related distributions. The recontributions do not have to be to the plan or IRA that made the distribution. The CARES Act treats the recontribution as if it were a tax-free transfer from the plan or IRA that made the distribution to the recipient's eligible retirement plan. One of the complexities associated with coronavirus-related distributions is that an individual might have to file an amended tax return for the year in which the distribution was received—if the distribution is repaid in a later year.

Under the CARES Act, if a qualified individual has a plan loan offset that is a coronavirus-related distribution, and the individual does not recontribute the plan offset amount, unless the individual elects otherwise, the individual includes the plan offset amount ratably in income on the individual's 2020, 2021, and 2022 tax returns. However, the 10 percent additional tax on pre-age 59½ distributions does not apply if the plan loan offset is a coronavirus-related distribution.

### Qualified Plan Loan Offsets

As part of the TCJA, Congress added an extended rollover period for what are referred to as *qualified plan loan offset amounts.* "Qualified" plan loan offset amounts are plan loan offset amounts that transpire as a result of the termination of a plan or the borrower's failure to repay a loan because of a severance from employment.

The TCJA extends the rollover period for qualified plan loans until the due date (including extensions) for the individual's tax return for the year in which the offset is treated as a plan distribution. This would mean, for example, that an employee with a plan loan who terminates employment on March 1, 2021, and fails to repay the entire balance of the loan by March 31, 2021 (as required by the plan) would have until April 15, 2022, or October 15, 2022, if they place their 2021 income tax return on extension, to avoid taxation of the loan by doing a

rollover…a decided improvement over the 60-day rollover rule that would require the rollover to be made by May 31, 2021.

If an employee is terminated in 2020 and defaults on a 401(k) plan loan resulting in a plan loan offset, which is not a coronavirus-related distribution that can be recontributed over a period of 3 years, the employee may be able make a rollover contribution of the plan loan offset amount. Consider for example an employee who terminates employment on March 1, 2020, and defaults on a 401(k) plan loan with a balance of $30,000 on March 31, 2020, and then takes a distribution of the employee's remaining 401(k) account in the amount of $100,000 on August 1, 2020. Assuming the employee is a qualified individual and the default produces a qualified plan loan offset, the employee could (if so inclined) maximize the period in which to avoid taxation as follows:

- Designate the $100,000 distribution as a coronavirus-related distribution, using up the dollar amount available for such distributions, and have 3 years to recontribute the $100,000; and
- Have up until October 15, 2021, by extending his or her 2020 tax return, to roll over the $30,000 loan default amount.

Recently finalized IRS regulations interpreting the qualified plan offset rules provide that a plan loan offset amount will not qualify as being because of severance from employment unless the offset results in a distribution within 12 months after the date of the severance from employment. This time constraint is generally irrelevant, since most 401(k) plans require repayment of a plan loan within a brief period after an individual terminates employment. Some employers, however, permit terminated employees to continue making loan payments after they terminate. In those instances, a default on the loan could take place more than 12 months after the employee's employment terminates, especially if the plan has a default cure period (as permitted by the IRS) until the last day of the calendar quarter following the calendar quarter in which a payment is missed. Under those circumstances, if the default triggers a plan loan offset distribution in 2020 that is not a coronavirus-related distribution, the employee would only have 60 days to accomplish a tax-free rollover.

## Where Things Now Stand

The CARES Act's favorable treatment of coronavirus-related distributions, including plan loan offsets, ended December 30, 2020. On December 27, 2020, President Trump signed the Consolidated Appropriations Act, 2021 (the "Appropriations Act"), which provides relief—similar to the CARES Act—for "qualified disaster distributions" from 401(k) and other employer retirement plans and IRAs to individuals whose principal place of residence is in an area that is declared a major disaster area during the period beginning January 1, 2020, and ending February 25, 2021, and who suffer an economic loss because of the disaster. *This relief does not apply to a disaster declared solely on account of COVID-19.*

Persons who qualify can receive aggregate retirement plan and IRA distributions between the first day of the disaster period and June 25, 2021, of up to $100,000 and have 3 years to repay the distributions. Amounts that are not repaid are not subject to the 10 percent early distribution tax.[2]

The Appropriations Act delivers potential assistance to people with 401(k) plan loans who were impacted by 2020's hurricanes and wildfires. Presumably the IRS will issue guidance confirming that a plan loan offset that results in a plan distribution is eligible for treatment as a qualified disaster distribution.

With the pandemic not yet under control, and many businesses still shutting down, it can be anticipated that employees will continue to lose their jobs at an elevated rate into at least early 2021 and, if they

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have 401(k) plan loans, face being taxed on those loans when their employment terminates. In that event, without further legislative intervention, their recourse to extend the time period to avoid taxation of their unpaid loans will be to look to the qualified plan loan offset extended rollover period in the TCJA. ■

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(1) The $50,000 limit was increased by the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") to $100,000 for qualified individuals who took out a plan loan between March 27, 2020, and September 22, 2020. The CARES Act also permits plans to suspend and delay for one year loan repayments due from qualified individuals during the period beginning on March 27, 2020, and ending on December 31, 2020, if the loan was outstanding on March 27, 2020.

(2) The Appropriations Act also increases the borrowing limit for plan loans to individuals who satisfy the eligibility test for qualified disaster distributions to the lesser of 50 percent of their account balance or $100,000, rather than $50,000, if the loan is made between December 27, 2020, and June 25, 2021. In addition, a qualifying individual's plan loan repayments that are due during the disaster period or are due on or before June 25, 2021, are permitted to be delayed for one year or, if later, until June 25, 2021.

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