HR insights

Common and Costly Mistakes: 401(k) Plan Loans

IRS section 401(k) plans are the most popular retirement plan in the United States, with over 60 million employees opting to receive coverage. Despite this, some employers fall short of adhering to the plan's requirements. The following are common mistakes employers make and corrective actions that need to be taken to keep costs down and the company on the right side of the law.

Allowing employees to take loans from 401(k) plans can be complex to administer. If not done properly, 401(k) plan loans can be deemed a taxable distribution to the participant. Employers should be careful to avoid this common and costly mistake.

The Problem

Some 401(k) plans permit participants to borrow from the plan. The plan sets forth loan limits in accordance with IRS Code §72(p)(2) so that a loan to a plan participant will not be treated as a distribution to the participant. Thus, the plan provides for the appropriate dollar limit on loans, for level amortizations over no longer than five years (longer if the loan is used to purchase a principle residence), and for payments to be made at least quarterly. If a loan does not satisfy the Code's requirements, then the loan is deemed to be a taxable distribution to the participant. This can happen if the participant does not make the payments required under the terms of the loan.

Example: On June 1, 2013, Jane took a $10,000 loan from her employer's 401(k) plan. The interest rate on the loan was 8 percent. Her loan was for a five-year period and required monthly payments of $203. Her loan payment was to be made by payroll withholding. The plan did not provide for a "cure period" for missed installments. Paychecks are issued at the beginning of the month. Jane's loan information was not forwarded to the payroll department and, as a result, no payments were withheld in 2013. The problem was discovered on Dec.15, 2013, during an annual review of the plan's records. July 1, 2013 is considered to be the first missed payment, and her outstanding loan balance of $10,067 (loan plus accrued interest) is treated as a deemed distribution. Jane is required to report $10,067 in income on her 2013 Form 1040.

Finding the Mistake

At the beginning of each month, the plan should reconcile the aggregate payroll deposits to the plan (employees' elective contributions and loan repayments), with the payroll amounts that should have been deposited to the plan, including Jane's in the above example. If there are gaps, then payroll records, election forms, and loan documents should be analyzed individually to determine whether the correct amounts (including loan repayments) were withheld from the employees' paychecks and deposited into the plan.

Fixing the Mistake

A loan's outstanding balance will be a "deemed distribution" to the participant if the plan does not receive a required loan payment by its due date. To remedy this, the employer may request and obtain relief from the IRS under its Voluntary Correction Program (VCP). In order to obtain relief, the mistake must be corrected. In the example, if the failure was corrected on Jan. 1, 2014, the plan administrator could have asked Jane to:

(1) Make a lump sum payment of $1,245 for the six missed installments (adjusted for interest at 8 percent) and continue making the $203 installment payment for the remaining period of the loan

(2) Reamortize the outstanding balance of the loan, resulting in increased installment payments of $230 per month for the remainder of the loan period: or

(3) Make a partial lump-sum payment (an amount less than $1,245—the six missed payments, adjusted for interest) and reamortize the outstanding balance of the loan, resulting in a monthly payment that is higher than $203 per month but less than $230 per month.

Correction Program Available

In appropriate cases, under VCP, the plan may correct certain participant loan failures and obtain relief from reporting the loans as deemed distributions under §72(p) (for details, see section 6.07 of Revenue Procedure 2008-50). SCP and Audit CAP are not available for the purpose of obtaining relief from reporting a defaulted participant loan as a deemed distribution.

Avoiding the Mistake

(1) Require transmittal of loan information to payroll before making the loan.

The plan should institute procedures that would include evidence of receipt of the loan information by the payroll department, before a check is issued for the loan. For example, procedures could provide that an application form that has been reviewed and approved by the plan administrator must be initialed by an authorized individual in the payroll department, before a check for the loan is issued.

(2) The plan could permit a cure period.

A plan may provide that a loan does not become a deemed distribution until the end of the calendar quarter following the quarter in which the payment was missed. A cure period gives the plan administrator time to take corrective action without negative consequences. In the example, if the plan administrator followed such a procedure, then upon discovery on Dec. 15, 2013, the plan administrator would have had the opportunity to secure the missed payments from Jane and prevent the loan from being treated as a deemed distribution (the first missed payment that was due on July 1, 2013, could have been secured by Dec. 31, 2013).

Source: IRS