WHAT HAPPENS IF I TERMINATE EMPLOYMENT WITH AN UNPAID 401(K) LOAN?

Wednesday, February 10, 2021

By Ian Berger, JD
IRA Analyst
Follow Us on Twitter: @theslottreport

One of the many unfortunate effects of the coronavirus pandemic is the number of folks who have lost their jobs. Besides the loss of income, many of these individuals also face unexpected and unpleasant tax consequences if they have an outstanding 401(k) plan loan.

If you leave your job (whether voluntarily or involuntarily) with an unpaid loan balance, your former employer may allow you a period of time to pay off the loan. But if you can't (or don't), the plan will reduce your vested account balance in order to recoup the unpaid amount. This is called a "loan offset."

If you have a loan offset, you actually don't receive anything. But the offset amount is considered a distribution potentially subject to tax and the 10% early distribution penalty if you're under age 59 ½. However, if you come up with the funds, you can avoid immediate tax and penalty by rolling over the offset amount to an IRA or another company plan.

Before 2018, the deadline for rollover of a loan offset was the usual 60 days. In the 2017 Tax Cuts and Jobs Act, Congress extended that deadline to the due date, plus extensions, of your federal tax return filing for the year the loan offset takes place. The IRS recently said that you can get the extended period to do a rollover even if you don't request an extension for your filing.

In the year of the loan offset, your plan will issue you two Form 1099Rs – *one for the loan offset amount and one for your remaining account balance*.

Example: Maya, age 45, loses her job on February 15, 2021. She has a $85,000 401(k) account balance and a $20,000 outstanding loan balance. Maya is unable to repay the loan. She elects a direct rollover of her 401(k) account balance to an IRA. On March 31, 2021, the plan offsets her $85,000 account balance by the $20,000 loan balance and transfers $65,000 to her IRA.

Maya has until October 15, 2022 to replace and roll over the $20,000. Otherwise, she will have additional taxable income of $20,000 and a $2,000 penalty.

If you were affected by COVID-19 and meet the definition of a "qualified individual" under the CARES Act, you can treat a 2020 loan offset as a coronavirus-related distribution (CRD). This would give you three years to roll over the loan offset. The loan offset would also be exempt from the 10% early distribution penalty, and you could spread taxable income on it over three years.

Finally, don't confuse a loan offset with a deemed distribution. A deemed distribution occurs when you violate one of the rules governing plan loans – for example, you stop repaying your loan while still working. Like a loan offset, a deemed distribution will subject you to taxes and possible penalty, but it isn't eligible for rollover and isn't considered a CRD.

The potential tax consequences when you leave your job should cause you to think long and hard before taking a loan from your company plan.