Plan Loans & Past Participants:

What Happens to a Participant's Loan Balance When They Terminate Employment?

Facts

We have a participant who took a loan from his 401(k) account at the beginning of the year. Yesterday, we received he gave us notice of his resignation, effective in two weeks, but he still has an outstanding loan balance.

Question

Is it possible for the participant to pay off the balance before he terminates? What happens if he is not able to do so?

Answer

Let's answer your second question first, as it provides some context for the first question.

Many plan loan policies provide that participant loans immediately become due and payable when a participant terminates employment. That means if a participant terminates and does not immediately repay the his or her outstanding loan balance, that amount is reported as taxable income to the participant. If the participant is younger than age 59 ½ at the time, the outstanding balance is also subject to the 10% early withdrawal penalty. Definitely no fun come tax time.

That brings us back to the first question, and the answer is generally yes. We say "generally" because some plans allow participants to continue making regularly scheduled payments via personal check following termination of employment rather than accelerating the due date of the loan. That is not a setup we see very often, but it is a nuance to be aware of. With that said, many plans include a provision that allows pre-payment of an outstanding loan as long as it is paid off in full. If your plan has that provision, then the participant can fully repay the loan when he terminates even if the loan is not accelerated.

All is not lost, however, if the participant is not able to repay his loan now. Under the new tax law that became effective in 2018, participants now have until the due dates of their individual tax returns (for the year in which the loan defaulted) to repay the outstanding loan balance to an IRA to avoid taxes and penalties. Based on your participant's employment termination occurring in 2019, he would have until the due date for his 2019 tax return (sometime in 2020) to repay the loan balance to an IRA.

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