



## 401(k) Plan Loans

# What Are Employees' Options When They Depart?

**E**mployees who have outstanding 401(k) plan loans when they leave their job are sometimes faced with a difficult quandary. This is because the loan generally must be repaid in full within 60 days of the termination of employment.

If the loan isn't repaid within this timeframe, employees will generally be hit with a 10 percent penalty on the outstanding loan amount. In addition, they will have to pay taxes at ordinary income tax rates on the amount, which is considered to be a deemed distribution.

### A Popular Option

Borrowing money from a 401(k) plan has become increasingly popular

among employees in recent years. According to the Employee Benefits Research Institute (EBRI), one out of five employees who are eligible for a 401(k) loan has taken one out — whether to help cover financial emergencies, finance home improvement projects, or pay for other expenses.

In the hustle and bustle that sometimes accompany a job change, though, employees sometimes don't realize the need to repay their 401(k) loan in full soon after they leave their job. When this happens, employees may get an unpleasant surprise when they receive a Form 1099-R from the IRS informing them that they underreported income and owe additional taxes and penalties.

Even if employees are aware of their 401(k) loan repayment responsibilities, it may be difficult for them to make repayment in full in so short a time period. This is especially true if the employee was laid off or let go involuntarily and is facing an uncertain employment future.

If they can't access enough liquid cash to repay their outstanding 401(k) loans in full, employees generally have two choices: They can either pay the 10 percent penalty and income taxes when they file their tax

return or borrow money from another source to repay the loan.

For example, they could possibly tap a home equity line of credit, obtain an unsecured credit line or take advantage of a zero percent credit card balance transfer option. These alternatives are often preferable to the financial consequences of having an outstanding loan classified as a deemed distribution.

### Helping Your Employees

So what can you do to help your employees — both those departing and new employees joining your company — who are facing this potential dilemma?

The first step is to establish clear communication channels to inform participants about the need to plan for repayment of their 401(k) loan soon after they leave your employment. Make this a part of your standard communication protocol for all departing employees.

Some plan sponsors allow employees to continue making 401(k) loan payments after they have left the company. Check to see if your plan documents allow this — if they don't, consider whether amending the documents to allow it makes sense.

Keep in mind that payroll deductions of loan repayments would no longer be possible after employees

*Continued on page 3*



# Monitoring Service Provider Performance

## The Role of Type II, SOC 1 Reports

**I**t's not uncommon for sponsors of employee benefit plans to outsource functions like accounting and recordkeeping to third-party service providers. But this doesn't absolve sponsors of responsibility for performing these functions adequately, or of overall financial reporting responsibility.

In fact, monitoring the performance of outside service providers is a fiduciary responsibility for sponsors. The best way to do this is to obtain a Service Organization Controls report—also known as a Type II, SOC 1 report—from service providers.

### Assuring Adequate Internal Controls

The SOC 1 report helps assure plan management that the service provider has put internal controls in place over financial reporting, as well as that appropriate policies and procedures are being followed. It includes a description of the tests of internal controls and their results to support an opinion on the effectiveness of the controls.

Auditors routinely request SOC 1 reports during the audit process. However, you should be proactive by obtaining a SOC 1 report from service providers long before your auditor requests one.

Keep in mind that the SOC 1 report not only monitors the performance of service providers. It also evaluates and describes complementary user entity controls in place at the plan sponsor. These controls help ensure proper coordination between sponsors and service providers.

Without adequate complementary user entity controls, a system of internal controls may prove to be ineffective. So it's critical to understand and implement these controls as contemplated by the third-party service providers you work with.

### Reviewing SOC 1 Reports

There are a number of things you should look for as you review SOC 1

reports provided by your service providers, including the following:

**Modifications to the service auditor's opinion:** These could indicate a deficiency in the design or effectiveness of the service organization's internal controls that may be significant enough to indicate a potential deficiency in the controls.

**Scope of the opinion:** The opinion should specify the system or systems covered, including whether sub-service organizations are covered in or carved out of the description and testing. It should also refer to complementary user entity controls contemplated at the user organization, if any.

**Period covered:** The system description and controls testing included in the report covers a specific period of time and cannot be projected to future periods. You should request updated reports when they become available so you can make appropriate decisions about user controls and be aware of any deficiency that might occur.

**Complementary user entity controls:** These are specific control activities that the service organization expects to be in place at the plan sponsor organization. While these control activities may already be part of your system of internal controls, the report may highlight areas where they should be improved.

**Exceptions:** The testing section of the report may contain information about exceptions noted during testing. If the exceptions indicate an increased risk, you should consider whether additional controls or other actions should be taken to mitigate this risk.

**Management's response/remediation:** The report may contain a management response that describes ways to resolve exceptions, such as modifying control activities or implementing additional controls. This could be valuable in considering the risk to the plan or the timeframe for testing potential errors if this is considered necessary.

### Assisting in Evaluation

Your plan auditor can assist in evaluating SOC 1 reports provided by your service providers, as well as internal controls over financial reporting and appropriate monitoring activities.

*Please contact us if you have more questions about using and reviewing Type II, SOC 1 reports.*



### What Types of Service Providers?

Plan sponsors outsource a wide variety of services to third parties, including plan administration, custody of investments, and recordkeeping/participant accounts. You should request a Type II, SOC 1 report from each of these outside service providers.

You should also request a SOC 1 report from your payroll services provider and the plan administrator that maintains participant account balances. This is because plan contributions, loan repayments, and participant account information are all contained in the payroll information your payroll provider processed.

Additional SOC 1 reports may be necessary from other service providers or sub-service organizations if they have responsibility for valuing investments and allocating income to participant accounts. Also, consider obtaining reports from service providers that perform other services that may impact the plan and are carved out of other SOC 1 reports.

# Are Your Employee Remittances Timely?

**A**ccording to the Department of Labor (DOL), plan sponsors must remit employee contributions to retirement plans in a timely manner. But what exactly does the DOL consider to be “timely”?

Fortunately, the department provides a specific definition for timely remittances: “the earliest date that is reasonably possible to segregate the contributions from the employer’s general assets, but no later than the 15<sup>th</sup> business day of the following month.”

However, this still leaves room for uncertainty because the phrase “reasonably possible” can be interpreted in different ways. Some plan sponsors interpret this liberally and consider the 15th business day the deadline—but this can end up being a costly mistake.

### Past Remittances

In determining whether employee remittances have been contributed in a timely manner, the DOL will look primarily at how quickly your company has contributed remittances in the past.

For example, let’s say that you have consistently contributed deferrals within two days of the month-end payroll date. This becomes the benchmark for what is considered reasonably possible for your company—and the standard you are held to.

In this scenario, if you suddenly started remitting employee contributions on the 15th business day of the following month, these remittances would likely be considered late. Worse, the remittances would also be considered prohibited transactions, which can result in civil penalties and excise taxes due to the IRS.

### Consistency Is Key

The best way to avoid this scenario is to be consistent with the timeliness of employee remittances. Create a remittance schedule that is reasonably possible for you, and then stick with it every pay period, with no exceptions. Remitting contributions during payroll processing is one possible way to avoid problems.

A few other ideas to consider:

- Train backup payroll staff in retirement plan contribution remittances.
- Compare the total number of remitted contributions to deferrals per payroll register for each pay period.
- Reconcile the total deferrals per W-2 forms to total deferrals received by the plan annually shortly after the end of the year.

### Small Plan Safe Harbor

Keep in mind that there is a safe harbor for small retirement plans, which the DOL defines as plans with fewer than 100 participants. Sponsors of such plans have seven business days following receipt or withholding of employee contributions to remit them.

*Now would be a good time to take a fresh look at your employee remittance processes to ensure compliance. Call us to schedule an appointment.*

## Repaying 401(k) Loans After Termination

*Continued from page 1*

have left your company, which could make this option challenging from an administrative standpoint. And if a former employee fails to make loan repayments on time and in equal installments, the outstanding loan amount is considered a deemed distribution and the 10 percent tax penalty and income taxes will be assessed.

Note that a 401(k) plan loan in default is considered to be a plan asset, so interest continues to accrue even if it’s treated as a deemed distribution. The accrued interest, however, is not included in the plan participant’s income.

Similarly, you might also consider allowing new employees joining your company to roll over outstanding 401(k) loans into your company’s plan and continue making loan payments. But this wouldn’t be an option if new employees aren’t eligible to participate in your 401(k) plan within their first 60 days of employment.

Again, you’ll need to see if your plan documents allow this and decide whether to amend them if they don’t. If you do decide to offer this option, it could be a nice enticement for potential employees who are thinking about joining your company.

### Plan Ahead Now

Given the popularity of 401(k) loans, it’s smart to plan ahead for how you can help employees who leave or join your company and have outstanding loans.

*We can assist you in planning strategies that can help you help your employees. Give us a call to discuss your situation further.*



Our goal is to provide the highest quality tax, accounting and consulting services for our clients.

DAMITZ

BROOKS

NIGHTINGALE

TURNER

MORRISSET



*Certified Public Accountants and Consultants  
A Professional Corporation*

---

200 East Carrillo, Suite 303  
Santa Barbara, CA 93101  
805-963-1837 Fax 805-564-2150

## Correcting Plan Errors: SCP vs. VCP

**D**espite your best efforts to remain compliant, operational errors are sometimes made in the administration of employee retirement plans. When errors occur, you generally have two main options for correcting them.

**The Self-Correction Program (SCP):** You can use this program to self-correct operational errors without contacting the IRS, submitting an application, or paying a fee. SCP can correct any type of insignificant operational error that occurs with 401(k), 403(b), profit-sharing, and other qualified plans, but not with SIMPLE IRAs or SEPs.

In certain circumstances, SCP can also correct significant operational errors, such as to correct mistakes

or failure of reasonable procedures that result in:

- Failure to follow the plan document
- Exclusion of eligible participants,
- Errors in calculating or remitting contributions
- Loan failures

SCP can also correct significant errors if corrected before the end of the second plan year after the failure occurred or if you substantially correct the error within a reasonable period of time.

**The Voluntary Correction Program (VCP):** This program can correct mistakes in plan document language or how a plan is being run. It requires you to mail a written sub-

mission to the IRS and pay a user fee. The IRS then reviews and approves your proposed correction methods. Note that you must use the VCP to correct plan document errors.

Using VCP to correct plan errors preserves the plan's qualification and tax-favored status by bringing it back into compliance with federal tax law. VCP might be preferable to SCP if you prefer to receive a written IRS compliance statement. Also, VCP provides certain federal income and excise tax relief that's not available under SCP.

If an error occurs with a SIMPLE IRA or SEP, you'll need to use VCP because SCP is not an option for these plans.



*This publication is distributed with the understanding that the author, publisher, and distributor are not rendering legal, accounting, tax, or other professional advice or opinions on specific facts or matters and, accordingly, assume no liability whatsoever in connection with its use. The information in this publication is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of (i) avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed in this publication. © 2018*