Winning by Default

George White, from Custodia Financial, discusses how the IRS’ new distribution code for retirement plan loan defaults could help inform the retirement industry.

MANY people were caught off guard last summer when the IRS announced a change to Form 1099-R, the tax form used to report distributions from retirement plans and pensions. After all, the government is not known for acting fast. Yet the IRS added a new distribution code to signify a loan offset after a participant loan defaults due to job separation or termination of the plan.

The IRS knows that loan defaults and the resulting loan offsets most often occur after separation[1] and that these amounts, estimated at $6 billion more than five years ago, are not separately reported today. How is it that billions of dollars can go unreported at a time when no number seems too small to be scrutinized?

While loan offsets are, technically, reported, they are lumped together with other types of distributions and reported as general benefit payments on Form 5500, so policymakers don’t know how big the problem is or who it affects the most. It can even be difficult for plan sponsors to see their own default information. As Ned Johnson, former chairman of Fidelity Investments once said, “You can’t manage what you can’t measure.” Hence the need for a new distribution code.

Loan default leakage diminishes retirement outcomes

What’s more, loan defaults act as a catalyst for other losses or “leakage”—the early payment of retirement plan assets intended for, well, retirement. By failing to repay a loan, the plan participant forfeits the future investment earnings those dollars would have gained over as much as decades of compounding. Add in the acceleration of federal and state income taxes and penalty taxes, and a defaulting borrower stands to lose up to four times—or, 400%—of the original investment.

With the average loan for an uncovered medical emergency at $7,800, that translates to a large gap at retirement. Furthermore, participants often elect to withdraw their entire account balance the following year to pay those taxes and fare much worse. According to a recent study by Deloitte[2], these workers can lose up to $300,000 in future retirement value—effectively returning to the starting point as far as saving for retirement.

Sure, it’s their money—but it could have been so much more

When you hear someone say, “It’s their money,” it’s likely that person has not looked at the problem through this lens. True, the $7,800 loan represents assets the employee had already saved. But what about the rest of the loss? The government is happy, it received an early payment. In fact, the government gets extra money due to the penalty taxes most defaulters owe. Unfortunately, the investment gains belong to no one because that money was never earned. As Jimmy Stewart’s character reminded us in “It’s a Wonderful Life,” money that is never invested never has a chance to earn anything.

Besides, why shouldn’t it be entitled to a free 10% once in a while—the amount most defaulting participants have to pay? But government leaders are also worried—worried that American workers won’t have enough money to live on when they do retire and that maybe this whole 401(k) “experiment” won’t work out. So they are taking action.

Even before the revisions to Form 1099-R were enacted last year, Congress added a provision to the 2017 Tax Cuts and Jobs Act (TCJA) that extends the time participants have to roll over a previously defaulted loan into another qualified plan or individual retirement account (IRA) from 60 days to the date they file the following year’s tax return.

Will it work? Nobody knows, but most practitioners shrug and think not much will change. They feel that the average participant, aside from not understanding the law or how it applies to them, simply won’t have the money to contribute or they wouldn’t have borrowed in the first place. Some experts have even voiced concern about how the IRS might use the new data it collects.

Plan sponsor worries—and a new solution

The government is turning its attention toward the problem of loan defaults in workplace retirement plans. But are retirement industry stakeholders—a web of recordkeepers, investment managers, consultants and the plan sponsors that hire them—getting the message? Some providers seem satisfied with efforts that promote restricting access to loans. But, after seeing those ideas fail to meaningfully affect loan volumes or reduce defaults, many plan sponsors are unsure what to do.

One solution now available to plan sponsors is an evolving program that prevents defaults in the first place: loan insurance. Loan insurance will automatically protect participants’ loans when they borrow from a 401(k) plan, keeping the borrower on track through timely financial counseling and payment assistance, and, most importantly, repaying the loan if a participant remains unemployed for an extended period after losing a job. For today’s plan sponsors and the people they employ, that turns a loss into a win.

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[2] “Loan Leakage: How can we keep loan defaults from draining $2 trillion from America’s 401(k) accounts?” Deloitte (October 2018)