

TRISTAR PENSION CONSULTING

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Guide to Distributions from 401(k) Plans

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A 401(k) plan permits employees to defer a portion of their salaries on a pre-tax basis with the objective of accumulating assets for retirement. Additional assets are accumulated if the employer makes matching and/or profit sharing contributions to the participant's account.

With today's mobile workforce, many distributions are made before retirement because employees usually become eligible to receive distributions when they terminate employment. Distributions also become payable due to death, disability or a Qualified Domestic Relations Order (QDRO). In addition, many 401(k) plans permit hardship withdrawals. Sometimes active participants are forced to take minimum distributions after reaching age 70½.

In the following pages we will explore the rules and tax consequences associated with the various types of distributions from a 401(k) plan.

ROLLOVER VS. CASH DISTRIBUTION

Distributions from 401(k) plans are generally made in a lump sum, although some plans permit participants to elect installment payments or an annuity. If the distribution is eligible for rollover, the participant can avoid immediate taxation by rolling it over to a traditional IRA (e.g., not a Roth IRA) or another qualified plan. Distributions eligible for rollover include:

- Lump sum payments to terminated participants (including disabled or retired);
- Death benefits paid to a spouse beneficiary;
- QDRO distributions to a spouse or former spouse;
- In-service distributions unless made on account of hardship; and
- Installment payments over a period of less than ten years.

Distributions ineligible for rollover include:

- Death benefits to a non-spouse beneficiary;
- Age 70½ required minimum distributions;
- Hardship distributions from all accounts;
- Corrective distributions due to failed nondiscrimination tests or exceeding legal limits;
- Loans treated as distributions; and
- Installment payments of ten years or more or over the life expectancy of the participant or the joint lives of the participant and beneficiary.

The portion not directly rolled over and distributed in cash is taxed in the year received and is generally subject to mandatory federal income tax withholding and possibly subject to a penalty as described below. The participant gets a second chance to roll over the cash distribution within 60 days of its receipt. However, he must find money to replace the tax withheld if he wants to roll over 100% of the distributed amount.

MANDATORY FEDERAL TAX WITHHOLDING

If the participant elects to receive a cash distribution and it is eligible to be rolled over, the taxable portion is subject to 20% mandatory income tax withholding (state tax withholding may also apply). For example, if the participant's taxable cash distribution is \$100,000, he will only receive \$80,000 and the other \$20,000 will be forwarded to the IRS (which may not necessarily be

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sufficient to cover the tax on the distribution). Participants may waive tax withholding for distributions ineligible for rollover.

10% PREMATURE DISTRIBUTION PENALTY

If the participant is under age 59½, the distribution will generally be subject to a 10% premature distribution penalty unless one of the following exceptions apply:

- Participant is totally and permanently disabled;
- Participant separated from service during or after the calendar year in which he attained age 55;
- Death benefits paid to a beneficiary;
- QDRO distributions to an alternate payee;
- Payments made directly to the government to satisfy an IRS tax levy;
- Corrective distributions due to failed nondiscrimination tests or exceeding legal limits;
- Medical expense distributions that do not exceed deductible medical payments; and
- Substantially equal payments made after separation from service over the life expectancy of the participant or the joint lives of the participant and beneficiary.

The 10% penalty is reported and paid to the IRS along with the participant's income tax return.

RETIREMENT AND TERMINATION

Participants who attain the plan's early or normal retirement age become 100% vested in the employer's account balance and are often eligible to receive a distribution, even if still employed.

If the participant terminates employment before the plan's retirement age, his employer account balance is subject to the plan's vesting schedule (salary deferrals are always 100% vested). Many 401(k) plans provide for distribution of the participant's account balance shortly after termination of employment.

If the terminated participant's account balance is over \$5,000, it cannot be distributed without the participant's consent. The plan may permit an involuntary cash-out if the vested account balance is \$5,000 or less. Effective March 28, 2005, involuntary cash-outs between \$1,000 and \$5,000 are required to be rolled over to an IRA established by the plan sponsor on behalf of the participant.

DEATH BENEFITS

Participants should complete beneficiary designation forms naming both primary and alternate beneficiaries. Generally, the death benefit is required to be paid to the participant's spouse unless the spouse has consented in writing, witnessed by a notary public or a plan representative, to another beneficiary designated by the participant.

Plans typically provide for 100% vesting upon the death of the participant. The participant's spouse is permitted to roll over the death benefit to avoid immediate taxation. Rollovers are not permitted by non-spouse beneficiaries.

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DISABILITY BENEFITS

Plans may permit distributions due to total and permanent disability. The plan document will specify the criteria for determining eligibility for disability benefits. Most plans provide for 100% vesting if the participant becomes disabled.

REQUIRED MINIMUM DISTRIBUTIONS

The minimum distribution rules require that participants and beneficiaries begin receiving distributions by certain deadlines and limit the period over which benefits can be paid. The following participants are required to begin receiving minimum distributions:

- More than 5% owners who have reached age 70½ even if they are still actively employed; and
- Non-owner employees who have terminated employment and have reached age 70½.

For more than 5% owners, annual distributions must begin by the April 1st of the year following the year in which the participant attains age 70½ (unless a special written election was made before 1984). For actively employed non-5% owners who have attained age 70½, the required beginning date is the April 1st following the year in which the participant terminates. (Prior to 1996, all actively employed participants who turned age 70½ were required to begin receiving minimum annual distributions and some plans may still include this provision.)

The amount of the distribution is generally calculated by dividing the participant's account balance by life expectancy factors provided by the IRS.

QUALIFIED DOMESTIC RELATIONS ORDER

A QDRO provides child support or alimony payments or divides marital property as part of a divorce or separation. Many plans permit the immediate cash-out of benefits to the alternate payee, usually the spouse or child, which avoids the need for segregated accounts. Payments to a participant's spouse (or former spouse) are taxable to the spouse in the year distributed unless rolled over. Distributions to a child of the participant are taxed as income to the participant and are not eligible for rollover.

HARDSHIP DISTRIBUTIONS

Many plans permit hardship withdrawals of salary deferrals. Only the amount the participant deferred may be distributed. Earnings on the deferrals may not be distributed unless they were credited to the participant's account generally before 1989.

The IRS rules regarding hardship withdrawals are very specific and regulations require the satisfaction of two conditions:

- There is an immediate and heavy financial need; and
- Other resources are not available to satisfy the need.

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A safe harbor method of satisfying these requirements is utilized by many 401(k) plans which permits a hardship distribution if it is due to:

- Medical expenses incurred by the employee, the employee's spouse or other dependents not reimbursed by insurance;
- Costs directly related to the purchase of a principal residence of the employee;
- Payment of tuition and related college/graduate school expenses for the next twelve months for the employee, the employee's spouse, children or other dependents; or
- Payment necessary to prevent the eviction or foreclosure of the employee from his primary residence.

Final 401(k) regulations, which generally become effective for plan years beginning on or after January 1, 2006, expand the list of safe harbor hardship events to include:

- Burial or funeral expenses for the employee's parent, spouse, child or dependent; and
- Repair of damage to the employee's principal residence that would qualify as deductible casualty expenses.

Participants must first have taken all other permitted withdrawals and loans available from all plans maintained by the employer and are not permitted to make any contributions to any plan sponsored by the employer for at least six months after receipt of the hardship withdrawal.

The above mandated requirements are only applicable to salary deferrals. Some plans also permit hardship withdrawals from profit sharing and matching contribution accounts, which are permitted to have less restrictive hardship withdrawal requirements. To simplify plan administration, some plans apply the salary deferral rules to all accounts.

IRS SPECIAL TAX NOTICE AND REPORTING

Before making a distribution election, each participant must be given a "Special Tax Notice Regarding Plan Payments" which explains the tax consequences of distributions. Plan distributions are reported to the IRS on Form 1099-R which includes information concerning the type of distribution, taxable amount, taxes withheld and whether or not the 10% penalty is applicable.

SUMMARY

Distribution decisions hold myriad consequences. Employees who do not consider the tax consequences may be in for a rude awakening when they complete their tax returns and discover that not only do they owe additional income taxes on the distributed amount but also a 10% penalty. Plan administrators need to be aware of these complex rules in order to communicate effectively with participants seeking to take distributions from the plan.

This newsletter is intended to provide general information on matters of interest in the area of qualified retirement plans and is distributed with the understanding that the publisher and distributor are not rendering legal, tax or other professional advice. Readers should not act or rely on any information in this newsletter without first seeking the advice of an independent tax advisor such as an attorney or CPA.

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