

# Benefit Insights



A non-technical review of qualified retirement plan legislative and administrative issues

August 2009

## Plan Distributions Are on the Rise

The primary goal of a retirement plan is to accumulate savings to provide income after retirement. Most plans also allow distributions before retirement age for a number of circumstances, including termination of employment and financial hardship. Non-taxable participant loans may also be an option.

Not surprisingly, plan administrators have witnessed an increase in the number of withdrawal requests over the past year as a result of the difficult economic times in which we live. Hardship distributions and plan loans are on the rise, as employees struggle to keep up with mortgage payments or put children through college.

This article will review the different types of withdrawals available in a qualified plan and the rules that apply.

### Financial Hardship

Salary deferral plans often allow participants to withdraw the money they contributed in the event of financial hardship. The available amount

is limited to actual deferrals, reduced by prior distributions. Earnings on deferrals may not be distributed unless they were credited to the account before 1989.

To be eligible, the participant must have exhausted all other available resources. Absent information to the contrary, a hardship withdrawal shall be deemed necessary if:

- The participant has taken all other distributions and loans available under all plans of the employer (loans must be taken first unless they would increase the financial hardship);
- The distribution amount does not exceed the amount of the financial need (taxes and penalties may be considered); and
- The participant suspends deferral contributions to the plan for six months.

There also must be an immediate and heavy financial need. Under the safe harbor hardship rules, the IRS failsafe list of financial necessities includes the following:

- Deductible medical expenses for the participant, spouse or dependents;
- Purchase of a principal residence of the participant;

- Cost of tuition and related educational expenses for the next 12 months of post-secondary education for the participant, spouse or dependents;
- Funds needed to prevent eviction from or mortgage foreclosure on the participant's principal residence;
- Funeral expenses for the participant's parent, spouse, children or dependents; and
- Deductible repairs for the participant's principal residence.

A plan may also permit a hardship distribution if the financial need for medical, tuition or funeral expenses is incurred by the participant's primary beneficiary.

Some profit sharing plans allow hardship distributions from employer contribution accounts. Such hardship distributions would be subject to rules that are similar, if not identical, to the deferral hardship rules. Hardship distributions are not permitted from Qualified Nonelective, Qualified Matching Contribution or safe harbor accounts.

## In-Service Distributions

Plans may allow in-service distributions upon attaining normal or early retirement age. Pension plans may allow distributions to employees who reach age 62 and continue to work. Profit sharing plans may have more liberal distribution rules for allowing in-service distributions prior to retirement age.

Plans that allow after-tax or rollover contributions may permit these accounts to be distributed at any time at the participant's request.

## Termination of Employment

Most plans allow benefits to be distributed when a participant terminates employment, whether the termination is due to retirement, disability, death or other separation of service. However, a

plan may delay distribution until the terminated employee reaches the plan's normal or early retirement age. Participants still employed as of the plan's normal retirement age must become fully vested in their accrued benefits. Many plans also provide full vesting upon death, disability or early retirement.

If total benefits are \$5,000 or more, the participant must consent to the distribution. Benefits of less than \$5,000 can be cashed out without consent, if provided under the plan, but if the cash-out exceeds \$1,000, it must be an automatic rollover to an IRA for the participant's benefit.

## Required Minimum Distributions

The beginning date for required minimum distributions (RMDs) is April 1<sup>st</sup> following the year a participant turns age 70½. However, a plan may provide (and most plans do) that employees who do not own more than 5% of the company will delay their RMDs until the year they actually retire. A bill was recently introduced in Congress to delay the starting age for RMDs from 70½ to 75.

Due to the severe downturn in the stock market in 2008, Congress passed a law waiving the RMD for 2009 only. This will give investors a chance to leave more of their money in their retirement accounts with the hope that losses can be recouped if the market rebounds. The waiver applies to defined contribution plans but not to defined benefit plans. It relates to death benefit distributions as well as age 70½ RMDs. A minimum distribution can still be provided upon request and, since it's not required, it would qualify for rollover treatment.

## Form of Benefit

Pension plans must provide that an annuity is the normal form of benefit distribution. If the participant is married, the normal form becomes a joint and survivor annuity providing at least a

50% survivor's annuity to the spouse. Alternative forms of distributions may also be provided, but they require spousal consent if the participant is married (see below).

Non-pension plans (e.g., 401(k) and profit sharing plans) do not have to provide an annuity distribution option but, if one is provided, the same spousal consent rules apply to a married participant electing a non-annuity option.

Death benefits must be distributed to the beneficiary within five years of the year of death, unless they are being paid out over the beneficiary's life expectancy, in which case they must begin by December 31<sup>st</sup> of the year following the year of death. Other rules apply where the participant dies after distributions have begun.

## Spousal Consent

Pension law provides that if an annuity is available as a benefit option, the spouse must consent to any form of benefit other than a joint and survivor annuity providing at least 50% to the surviving spouse. If the participant elects any other form of distribution, such as a lump sum, direct rollover, etc., the spouse must consent in writing and the signature must be witnessed by a notary or a plan representative.

Such consent must be obtained after the spouse has received timely explanations and benefit projections. A spouse must also consent to a beneficiary designation other than the spouse. Many plans require spousal consent for in-service withdrawals, including participant loans, even if an annuity option is not available.

## Taxation of Benefits

Participants and beneficiaries must be given a "Special Tax Notice" which explains the tax consequences of the various distribution options. Generally, benefits that are distributed from a

qualified plan are taxable to the participant as ordinary income at the participant's applicable tax rate. Distributions from a Roth account are not taxable if the account is at least five years old and the participant has attained age 59½, died or become disabled. If these requirements are not met, the earnings distributed are taxable.

If a distribution is eligible for rollover, mandatory 20% tax withholding is required (certain exceptions apply). Also, a 10% penalty tax applies for taxable distributions prior to age 59½. There are several exceptions including distribution due to disability, death and separation from service after attaining age 55. A bill was recently introduced in Congress to waive the 10% penalty on plan distributions in the event of unemployment or to make mortgage payments.

## Rollovers

A participant can avoid current taxation of a plan distribution by rolling it over to another qualified plan or an IRA. This is usually accomplished by a direct rollover from trustee to trustee thereby avoiding the 20% mandatory tax withholding.

Currently, a taxable distribution can be rolled over to a Roth IRA if the individual's modified adjusted gross income does not exceed \$100,000. This results in the distribution being currently taxable and treated like a Roth IRA conversion. The \$100,000 adjusted gross income restriction is repealed as of 2010 at which time anyone can do a taxable Roth rollover.

A spouse beneficiary can roll over a death benefit distribution to an IRA or another qualified employer plan and delay distribution until age 70½. As of 2007, plans were allowed to provide that nonspouse beneficiaries can directly rollover death benefit distributions to an IRA which will be treated like an inherited IRA (in 2010 this will become a mandatory provi-

sion). Inherited IRAs are subject to the same distribution rules applicable to death benefits under a qualified plan; therefore, distributions cannot be delayed until age 70½. The advantage of this option is where the decedent's plan does not allow for lifetime payments to the beneficiary, since this would now be available from the rollover IRA.

## Participant Loans

Many defined contribution plans allow active participants to borrow money against their retirement accounts. The advantages of taking a loan instead of an in-service distribution are: the loan is non-taxable and not subject to the 10% premature distribution penalty; it does not deplete retirement savings; and, in the case of participant directed accounts, it is a guaranteed investment, secured by the participant's vested interest.

Loans are limited to the lesser of \$50,000 (reduced by the highest loan balance of the prior 12

months) or 50% of the vested benefits. They must bear a reasonable rate of interest and be repaid within five years (longer terms are allowed for the purchase of a principal residence). A plan may impose other restrictions such as a minimum loan amount or a limit on the number of outstanding loans.

Loans that are in default become taxable to the participant, including the 10% penalty (unless participant has attained age 59½).

## Conclusion

Tough economic times have led to an increase in hardship distributions and participant loans over the past year. While it's a blessing to have such money available in time of need, pre-retirement withdrawals can result in reduced benefits at retirement. A plan loan may be preferable to a taxable distribution, especially since it avoids a 10% premature distribution penalty.

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. You should not act or rely on any information in this newsletter without first seeking the advice of a qualified tax advisor such as an attorney or CPA.

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