

Benefit Insights®

December 2016

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RETIREMENT ♦ PLAN ♦ EXPERTS

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Rules and Taxation of 401(k) Plan Distributions

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 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 disability, death 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.

This newsletter will examine the rules and tax consequences associated with the various types of distributions from a 401(k) plan.

Rollover vs. Cash Distribution

This new guidance was prompted by the changing landscape of retirement plans over the past 40 years with the shift from employer-sponsored defined benefit plans, with no participant investment responsibility, to participant directed 401(k) plans. When the old fiduciary rules were issued in 1975, 401(k) plans did not exist nor did the now common practice of rolling assets of ERISA plans into IRAs. Under the old rules, a person or institution is considered a fiduciary adviser only if a five-part investment advice test is satisfied. 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 (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 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:

- 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, the participant must find money to replace the tax withheld if he or she 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 or she will only receive \$80,000 and the other \$20,000 will be forwarded to the IRS (which may not necessarily be 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 or she 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;
- Substantially equal payments made after separation from service over the life expectancy of the participant or the joint lives of the participant and beneficiary; and
- Qualified reservist distributions.

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 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. 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.

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.

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 beneficiary is permitted to roll over the death benefit to an IRA. Whereas the spouse can delay distributions from the IRA until age 70½, the non-spouse beneficiary must begin required minimum distributions immediately.

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.

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

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.

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:

- Certain unreimbursed medical expenses for the participant or the participant's spouse, children, dependents or beneficiaries;
- Costs related to the purchase of a participant's principal residence, excluding mortgage payments;
- Tuition, related educational fees and room and board expenses for up to the next 12 months of post-secondary education for the participant or the participant's spouse, children, dependents or beneficiaries;
- Payments necessary to prevent the eviction of the participant from the participant's principal residence or foreclosure on the mortgage on that residence;
- Burial or funeral expenses for the participant's parents, spouse, children, dependents or beneficiaries; or
- Certain expenses to repair damage to the participant's principal residence.

Participants must first have taken all other permitted withdrawals and loans available from all plans maintained by the employer. A loan is not required if the burden of loan repayments would worsen the participant's financial situation. Participants 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. Safe harbor employer contributions are not available for in-service distribution prior to age 59½.

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.

2017 IRS Annual Limits

Each year the U.S. government adjusts the limits for qualified plans and Social Security to reflect cost of living adjustments and changes in the law. Many of these limits are based on the “plan year.” The elective deferral and catch-up limits are always based on the calendar year. Here are the 2017 limits as well as the 2016 limits for

	2017	2016
Maximum compensation limit	\$270,000	\$265,000
Defined contribution plan maximum contribution	\$54,000	\$53,000
Defined benefit plan maximum benefit	\$215,000	\$210,000
401(k), 403(b) and 457 plan elective maximum elective deferrals	\$18,000	\$18,000
Catch-up contributions	\$6,000	\$6,000
SIMPLE plan elective deferrals	\$12,500	\$12,500
Catch-up contributions	\$3,000	\$3,000
IRA	\$5,500	\$5,500
Catch-up contributions	\$1,000	\$1,000
“Highly Compensated” employee threshold	\$120,000	\$120,000
“Key Employee” (officer) threshold	\$175,000	\$170,000
Social Security taxable wage base	\$127,200	\$118,500

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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