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In-Service Distribution Options in Qualified Retirement Plans

More than 80 percent of 401(k) plans today allow participants to take distributions of their plan assets while they are still working. Understanding when in-service distributions are available, who can take them and their tax consequences is important financial planning information for plan participants. Plan sponsors often view in-service distributions as a valuable plan design option that adds flexibility and plan appeal, plus may help reduce fiduciary liability.

A "triggering event" is a milestone or occurrence that a retirement plan participant must experience to be eligible to receive a distribution of assets from a retirement plan. Historically, the most common triggering events included in plan documents are the following:

- Attainment of normal retirement age or early retirement age,
- Severance of employment,
- Plan termination,
- Disability,
- Divorce, or
- Death.

Through the years, however, plan designs have evolved to provide participants access to their retirement assets prior to retirement. An "in-service distribution" option allows certain plan participants to receive some or all of their retirement assets while they are still employed, provided certain conditions are met. Rules regarding in-service distributions are detailed in federal pension law and regulations. However, a plan's governing document, ultimately, controls whether an in-service distribution provision is available, and the conditions and limitations under which the working participants may take advantage of the option. For example, a plan may limit the amount or frequency of taking an in-service distribution, or may require recipients to suspend contributions for a period of time following an in-service distribution.

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Plan sponsors may choose to include an in-service distribution provision in their plan documents for several reasons, including increasing plan appeal and participant satisfaction. Plan participants have come to expect a higher level of personal control over their retirement assets in defined contribution plans. More liberal distribution provisions are viewed by prospective hires and participants as appealing features of their overall employee benefits packages. Moreover, liberal plan distribution options can ease access to retirement assets and facilitate a phased approach to retirement for aging workers. Furthermore, by permitting participants to move their assets out of the plan early—through an in-service distribution—plan sponsors may help defuse participant dissatisfaction with the plan and reduce fiduciary liability.

Whether an in-service distribution is in the best interest of a participant is a question that can only be answered after weighing all the options (i.e., leaving the assets in the plan; withdrawing the assets; rolling them over to an Individual Retirement Account (IRA) or another employer's plan; or converting them to Roth assets). When faced with a distribution decision, plan participants should evaluate each option by carefully considering several factors, including the following: available investment options, fees and expenses, whether the plan sponsor pays plan costs, services, taxes and penalties, creditor protection, required minimum distributions and the tax treatment of employer stock.

A potential candidate for an in-service distribution and/or rollover would be someone who:

- Knows the plan document permits in-service distributions;
- Is not taking the distribution for hardship reasons (as hardship withdrawals are not eligible for rollover);
- Is dissatisfied with the overall performance of his or her retirement plan;
- Feels his or her plan investment options are limited and would like to access a wider range of investment options outside of the plan; and/or
- Has limited lifetime retirement income options in the plan and would like to explore such options outside the plan.

Types of in-service distributions

Both federal law and plan document language drive the rules for in-service distributions from retirement plans. The availability of in-service distributions can be conditioned upon various circumstances as well as the type of contribution. Participants may check with their companies' benefits representatives for details on their in-service distribution options, review copies of their plans' Summary Plan Descriptions (SPDs), or request and review actual copies of the full plan documents for clarification.

Hardship

A plan may restrict in-service distributions to participants who can demonstrate a financial hardship, as defined by the plan document. Hardship distributions are not eligible for rollover to an IRA or other eligible plan. Therefore, these distributions will be taxable, in most cases and, potentially, subject to an early distribution penalty tax, unless an exception applies. For more detail, please refer to the Hardship Distribution section later in this document.

Attainment of a specific age

Tying an in-service distribution option to the attainment of a specified age is a common restriction contained in plans. Under this restriction, an individual who is still working for his or her employer may be eligible to take a distribution of some or all contribution types once he or she reaches the plan-designated age.

Generally, employee salary deferrals, designated Roth contributions, qualified nonelective contributions (QNECs) and qualified matching contributions (QMACs) are not eligible for in-service distribution until the participant attains age 59½ (but see the Hardship Distributions section later). In contrast, employer contributions may be distributable prior to age 59½. The distribution recipient must be aware that if he or she is not age 59½ or is not rolling the distribution into an IRA or other retirement plan, the amount could be subject to a 10 percent early distribution penalty tax, as well as a mandatory 20 percent withholding for federal taxes on the gross amount distributed. Defined benefit pension plans and governmental 457 plans may allow in-service distributions to workers at age 59 ½ as well.

Completion of a specific period of service

Under this restriction, once a participant completes a plan-specified number of years of service with an employer, certain contribution types may be available for an in-service distribution. For example, a plan may state that after five years of service, a participant may access his or her vested matching contributions.

Service in the military

Generally, elective deferrals under a 401(k), 403(b) or 457(b) plan cannot be distributed prior to a triggering event (e.g., attainment of age 59½ or severance of employment). However, the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act) allows an individual on active duty in the uniformed services for at least 30 days, who is still treated as being employed for purposes of receiving "differential pay" from their employer, to be treated as if he or she were severed from employment for the purpose of taking an in-service distribution of his or her elective deferrals or after-tax contributions under a 401(k), 403(b) or 457(b) plan, if the plan document permits. If an individual receives an in-service distribution under the HEART Act:

- The distribution is exempt from the early distribution penalty tax;
- Any pretax amounts would be included in taxable income; and
- The individual is prohibited from making elective deferrals or employee contributions to the plan for a period of six months after the distribution.

In-service distributions of employer contributions

Some plans allow employed participants, who otherwise would not be eligible for distributions, to take withdrawals of their employer-provided contributions. (Remember—distributions of employee salary deferrals taken while still employed are only available under a separate set of rules for hardship or after attainment of age 59½.)

If a plan permits, a 401(k) plan/profit sharing plan participant may take an in-service withdrawal of employer contributions. The portion of the individual's account balance attributable to employer contributions that is eligible for an in-service withdrawal may depend upon the length of time the individual has participated in the plan. In some plans, participants with fewer than five years of service may only access assets that have been in the plan for at least two years. This rule is sometimes referred to as the "two-year bake" rule. Participants with five or more years of service are not subject to the two-year bake rule.

Further, a sponsoring employer may limit the withdrawal of employer contributions to situations of hardship or attainment of a specified age. In-service distributions of employer contributions as a result of hardship are not subject to the two-year bake rule. Instead, employers will frequently limit the amount of the in-service hardship withdrawal to the lesser of:

- The employee's vested balance in his or her individual account attributable to employer contributions; or
- The amount of the employee's immediate and heavy financial need.

It is important to refer to the plan language for a concise definition of what circumstances constitute a hardship under the terms of the plan. Often the plan will use the same definition of hardship that applies for distributions of employee salary deferrals (explained later). Note that hardship distributions are not eligible for rollover.

In-service distributions of rollover contributions

Rollover contributions are another important source of in-service distribution dollars. Rollover contributions are amounts a plan participant has moved into his or her current employer's plan from a prior plan or IRA. Many plans permit in-service distributions of rollover contribution amounts at any time. Considering that the average account balance of a participant over the age of 60 with 20 plus years of service is over $220,000, and most plan participants of this age have changed jobs several times, a significant portion of this balance could be attributable to rollover contributions.

In-service distribution of non-Roth, after-tax account

A 401(k) plan may allow participants to make post-tax contributions to a standard after-tax account, which is other than a designated Roth account in a 401(k) plan. Plan participants may be able to request a distribution of their 401(k) plan standard after-tax account while still working, if the plan permits. The tax consequences depend on whether the individual rolls over or converts distributed amounts to Roth assets, and whether the distribution comes from pre-1987 or post-1986 after-tax amounts. Pre-1987 after-tax contributions can, potentially, be recovered without associated earnings if the recordkeeper has tracked these dollars separately. Post-1986 after-tax contributions and earnings in the account are subject to special "basis recovery rules" that require the participant to treat recovered amounts as consisting of a pro rata share of after-tax contributions and earnings.

Considering the tax treatment of distributed pre-1987 and post-1986 after-tax amounts, and the overall ratio of after-tax contributions to earnings, plan participants should evaluate the pros and cons of a rollover to a traditional IRA; a rollover/conversion to a Roth IRA, or a mixture of both options. With the guidance in IRS Notice 2014-54, it is possible to accomplish a tax-free Roth IRA conversion from a standard after-tax account. The basis recovery rules that apply to after-tax accounts remain applicable, but IRS Notice 2014-54 allows plan participants to direct the distributing plan administrator to pay the pretax portion of the distribution to a traditional IRA (resulting in a tax-free rollover) and the after-tax portion of the distribution to a Roth IRA (resulting in a tax-free conversion). Participants should consult with their tax advisor to determine which course of action best suits their particular circumstances.

Hardship distributions

Typically, a plan may not distribute employee salary deferrals prior to severance from employment, death, disability, plan termination, attainment of age 59½ or hardship. Historically, plans had to limit distributions of employee salary deferrals due to hardship to the lesser of the participant's financial need or the participant's employee salary deferrals and certain other amounts. Effective for the 2019 plan year and later plan years, the Bipartisan Budget Act of 2018 (BBA 2018) expanded the types of plan amounts that could be available for hardship distribution to include employee salary deferrals, as well as QNECs, QMACs, safe harbor contributions and earnings from all eligible sources. It is important to review the plan language for a concise definition of what circumstances constitute a hardship under the terms of the plan. Keep in mind hardship distributions are not eligible for rollover.

Definition of hardship

In the past, plans were required to limit hardship distributions of employee salary deferrals to situations in which the following were true:

- A participant could demonstrate an immediate and heavy financial need; and
- A hardship distribution of employee salary deferrals was the only way to satisfy such need.

Final Treasury regulations mandatory for the 2020 and later plan years (optional for 2019) provide for the following new standard for hardship determination:

- A hardship distribution may not exceed the amount of the employee's need (including any amounts necessary to pay any federal, state, or local income taxes or associated penalties);
- The employee must have obtained other available distributions under all plans of the sponsor, whether qualified or nonqualified (other than plan loans); and
- The employee must represent in writing that he or she has insufficient cash or liquid assets to satisfy the financial need. (Importantly, the plan sponsor may rely on the employee's representation unless it has knowledge to the contrary.)

Prior to 2019, the IRS required a participant to first exhaust all other distribution and loan options from the plan before allowing him or her to take a hardship distribution of employee salary deferrals. Effective for 2019 as a result of BBA 2018, a participant is not required to take a plan loan, if available, before a hardship distribution is granted.

The IRS views a hardship as an immediate and heavy financial need if it is required to cover expenses for one of the following:

- Medical care for the participant, his or her spouse, his or her dependents or primary beneficiaries of the account;
- The purchase of a principal residence of the participant;
- Tuition and related fees for the post-secondary educational needs of the participant, his or her spouse, his or her dependents or primary beneficiaries of the account;
- Prevention of eviction from the participant's principal residence;
- Funeral expenses for the participant or the participant's parents, spouse, children, dependents or primary beneficiary(-ies); or
- Home damage expenses that qualify for the casualty deduction.

Optionally for the 2019 plan year and beyond, plan sponsors may permit hardship distributions on account of a federally declared disaster by the Federal Emergency Management Agency (FEMA), provided the employee's principal residence or principal place of employment at the time of the disaster was located in the area designated by FEMA for individual assistance due to the particular disaster.

- The employee must represent in writing that he or she has insufficient cash or liquid assets to satisfy the financial need. (Importantly, the plan sponsor may rely on the employee's representation unless it has knowledge to the contrary.)

Note: The above rules are considered the IRS's "safe harbor" rules. The plan document will contain the specific circumstances that constitute a hardship for distribution purposes. While the amount of the distribution cannot exceed the participant's financial need, it can be "grossed up" to include amounts to pay federal, state and local income taxes and any penalties. A 10 percent early distribution penalty may apply to the amount taken, but the participant can avoid it if a penalty exception applies, for example, in cases of disability. Prior to 2020, some plans may have suspended employee salary deferrals or after-tax employee contributions for a period of six months for participants who took hardship distributions. BBA 2018 eliminated this restriction as it relates to hardship distributions.

Does an in-service distribution make sense?

There are several questions plan participants should answer before they elect to take an in-service distribution. Some of these questions include the following:

- Does the plan allow for in-service distributions?
- If so, are there restrictions?
- Would the distribution qualify as a hardship withdrawal?
- How will taxes and penalties be addressed?
- Are there any potential drawbacks to consider?
- What are the pros and cons of leaving the assets in the plan; withdrawing the assets; rolling them over to an IRA or another employer's plan; or converting them to a Roth IRA?

Conclusion

An in-service distribution provision that allows for early access to retirement plan assets can offer benefits to both plan participants and plan sponsors. Presumably, that is why a majority of 401(k) plans today include such provisions, and allow participants to take plan distributions while they are still working. Whether utilizing an in-service distribution provision in a retirement plan is right for a plan sponsor or participants depends on the facts and circumstances of their specific situations. The plan's governing document, ultimately, controls whether an in-service distribution provision is available, and the conditions and limitations that may apply.

This material is provided solely for informational purposes and does not constitute investment, tax, legal or accounting advice on the matters addressed.

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