

401k Plan – “In Service Distributions”

This Treasury Dept. regulation sets forth the rules for “in-service distributions” for all types of plans. An “in-service distribution” is defined as: a withdrawal of funds from a plan by a participant while that participant is still an active participant who is eligible to contribute to that plan.

Treasury Regulations Section 1.401(k)-1(d):

(d) Distribution limitation.

(1) General rule. A cash or deferred arrangement satisfies this paragraph (d) only if amounts attributable to elective contributions may not be distributed before one of the following events, and any distributions so permitted also satisfy the additional requirements of paragraphs (d)(2) through (5) of this section (to the extent applicable)-

(i) The employee's death, disability, or severance from employment;

(ii) In the case of a profit-sharing, stock bonus or rural cooperative plan, the employee's attainment of age 59 ½, or the employee's hardship; or

(iii) The termination of the plan.

(2) Rules applicable to distributions upon severance from employment. An employee has a severance from employment when the employee ceases to be an employee of the employer maintaining the plan. An employee does not have a severance from employment if, in connection with a change of employment, the employee's new employer maintains such plan with respect to the employee. For example, a new employer maintains a plan with respect to an employee by continuing or assuming sponsorship of the plan or by accepting a transfer of plan assets and liabilities (within the meaning of section 414(l)) with respect to the employee.

(3) Rules applicable to hardship distributions.

(i) Distribution must be on account of hardship. A distribution is treated as made after an employee's hardship for purposes of paragraph (d)(1)(ii) of this section if and only if it is made on account of the hardship. For purposes of this rule, a distribution is made on account of hardship only if the distribution both is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need. The determination of the existence of an immediate and heavy financial need and of the amount necessary to meet the need must be made in accordance with nondiscriminatory and objective standards set forth in the plan.

(ii) Limit on maximum distributable amount.

(A) General rule. A distribution on account of hardship must be limited to the maximum distributable amount. The maximum distributable amount is equal to the employee's total elective contributions as of the date of distribution, reduced by the amount of previous distributions of elective contributions. Thus, the maximum distributable amount does not include earnings, QNECs or QMACs, unless grandfathered under paragraph (d)(3)(ii)(B) of this section.

(B) Grandfathered amounts. If the plan so provides, the maximum distributable amount may be increased for amounts credited to the employee's account as of a date specified in the plan that is no later than December 31, 1988, or if later, the end of the last plan year ending before July 1, 1989 (or in the case of a collectively bargained plan, the earlier of-

(1) The later of January 1, 1989, or the date on which the last of the collective bargaining agreements in effect on March 1, 1986 terminates (determined without regard to any extension thereof after February 28, 1986); or

(2) January 1, 1991 and consisting of-

- (i) Income allocable to elective contributions;
- (ii) Qualified nonelective contributions and allocable income;
- (iii) Qualified matching contributions and allocable income.

(iii) Immediate and heavy financial need.

(A) In general. Whether an employee has an immediate and heavy financial need is to be determined based on all the relevant facts and circumstances. Generally, for example, the need to pay the funeral expenses of a family member would constitute an immediate and heavy financial need. A distribution made to an employee for the purchase of a boat or television would generally not constitute a distribution made on account of an immediate and heavy financial need. A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee.

(B) Deemed immediate and heavy financial need. A distribution is deemed to be on account of an immediate and heavy financial need of the employee if the distribution is for-

(1) Expenses for (or necessary to obtain) medical care that would be deductible under section 213(d) (determined without regard to whether the expenses exceed 7.5% of adjusted gross income);

(2) Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);

(3) Payment of tuition, related educational fees, and room and board expenses, for up to the next 12 months of post-secondary education for the employee, or the employee's spouse, children, or dependents (as defined in section 152, and, for taxable years beginning on or after January 1, 2005, without regard to section 152(b)(1), (b)(2) and (d)(1)(B));

(4) Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;

(5) Payments for burial or funeral expenses for the employee's deceased parent, spouse, children or dependents (as defined in section 152, and, for taxable years beginning on or after January 1, 2005, without regard to section 152(d)(1)(B)); or

(6) Expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under section 165 (determined without regard to whether the loss exceeds 10% of adjusted gross income).

(iv) Distribution necessary to satisfy financial need.

(A) Distribution may not exceed amount of need. A distribution is treated as necessary to satisfy an immediate and heavy financial need of an employee only to the extent the amount of the distribution is not in excess of the amount required to satisfy the financial need. For this purpose, the amount required to satisfy the financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

(B) No alternative means available. A distribution is not treated as necessary to satisfy an immediate and heavy financial need of an employee to the extent the need may be relieved from other resources that are reasonably available to the employee. This determination generally is to be made on the basis of all the relevant facts and circumstances. For purposes of this paragraph (d)(3)(iv), the employee's resources are deemed to include those assets of the employee's spouse and minor children that are reasonably available to the employee. Thus, for example, a vacation home owned by the employee and the employee's spouse, whether as community property, joint tenants, tenants by the entirety, or tenants in common, generally will be deemed a resource of the employee. However, property held for the employee's child under an irrevocable trust or under the Uniform Gifts to Minors Act (or comparable State law) is not treated as a resource of the employee.

(C) Employer reliance on employee representation. For purposes of paragraph (d)(3)(iv)(B) of this section, an immediate and heavy financial need generally may be treated as not capable of being relieved from other resources that are reasonably available to the employee, if the employer relies upon the employee's representation (made in writing or such other form as may be prescribed by the Commissioner), unless the employer has actual knowledge to the contrary, that the need cannot reasonably be relieved-

(1) Through reimbursement or compensation by insurance or otherwise;

(2) By liquidation of the employee's assets;

(3) By cessation of elective contributions or employee contributions under the plan;

(4) By other currently available distributions (including distribution of ESOP dividends under section 404(k)) and nontaxable (at the time of the loan) loans, under plans maintained by the employer or by any other employer; or

(5) By borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

(D) Employee need not take counterproductive actions. For purposes of this paragraph (d)(3)(iv), a need cannot reasonably be relieved by one of the actions described in paragraph (d)(3)(iv)(C) of this section if the effect would be to increase the amount of the need. For example, the need for funds to purchase a principal residence cannot reasonably be relieved by a plan loan if the loan would disqualify the employee from obtaining other necessary financing.

(E) Distribution deemed necessary to satisfy immediate and heavy financial need. A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if each of the following requirements are satisfied-

(1) The employee has obtained all other currently available distributions (including distribution of ESOP dividends under section 404(k), but not hardship distributions) and nontaxable (at the time of the loan) loans, under the plan and all other plans maintained by the employer; and

(2) The employee is prohibited, under the terms of the plan or an otherwise legally enforceable agreement, from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 6 months after receipt of the hardship distribution.

(F) Definition of other plans. For purposes of paragraph (d)(3)(iv)(C)(4) and (E)(1) of this section, the phrase plans maintained by the employer means all qualified and nonqualified plans of deferred compensation maintained by the employer, including a cash or deferred arrangement that is part of a cafeteria plan within the meaning of section 125. However, it does not include the mandatory employee contribution portion of a defined benefit plan or a health or welfare benefit plan (including one that is part of a cafeteria plan). In addition, for purposes of paragraph (d)(3)(iv)(E)(2) of this section, the phrase plans maintained by the employer also includes a stock option, stock purchase, or similar plan maintained by the employer. See §1.401(k)-6 for the continued treatment of suspended employees as eligible employees.

(v) Commissioner may expand standards. The Commissioner may prescribe additional guidance of general applicability, published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), expanding the list of deemed immediate and heavy financial needs and prescribing additional methods for distributions to be deemed necessary to satisfy an immediate and heavy financial need.