

Federal Tax Withholding on Retirement Plan Distributions

In general, when an institution makes a distribution of qualified retirement plan benefits, it is required to withhold income tax from the portion of the distribution includable in the recipient's gross income. Distributions are generally classified as either eligible for rollover to other plans or not eligible.

Withholding requirements apply to both types of distributions, with certain exceptions. Following is a review of the withholding rules — and the exceptions — for various retirement plan distributions.

Eligible Rollover Distributions. If a distribution is eligible to be rolled over to a qualified retirement plan, IRA, 403(b), or governmental 457(b) plan, there is a mandatory 20% withholding requirement — unless the participant requests a *direct rollover* to one of these plans. Participants may authorize a greater percentage or amount to be withheld. *Note:* Distributions from IRAs are not subject to mandatory 20% withholding.

All distributions from qualified plans, 403(b), and governmental 457(b) plans are considered eligible rollover distributions — *except* for the following:

- A series of substantially equal periodic payments made at least annually over:
 - The life or life expectancy of the employee, or
 - The joint lives or joint life expectancy of the employee and the employee's designated beneficiary, or
 - A specified period of 10 years or longer.

- Required minimum distributions.
- Corrective distributions, plus earnings.
- Plan loans that are deemed distributed.
- The cost of current life insurance protection.
- Hardship distributions.
- Distributions to an alternate payee, other than the spouse or ex-spouse, of a qualified domestic relations order.
- Dividend payments passed through under an ESOP.
- Cash distributions of less than \$200 for the year.

Periodic Payments. Periodic payments are defined as a series of payments that do not qualify as eligible rollover distributions. These payments include installments that are:

- Payable at least once a year for a specified period of 10 years or longer, or for a period based on the life expectancy of the participant and, if



elected, the life expectancy of the participant's beneficiary, or

- Minimum required distributions.
- A participant may specify the amount or percentage to be withheld, or opt not to have any tax withheld, by filing a withholding certificate (W-4P or substitute W-4P) with the employer. If no withholding instructions are received,
- (Continued on page 2)*

CONTENTS

Federal Tax Withholding on Retirement Plan Distributions

A Review of Distribution Notices

The Medical Expense Hardship Distribution

Federal Tax Withholding on Retirement Plan Distributions (Continued from page 1)



the payor must treat the taxable portion of the distribution as wages and calculate the withholding using the IRS table for married persons claiming three withholding exemptions.

Nonperiodic Distributions. A nonperiodic distribution is a distribution from

a qualified plan, 457(b), or 403(b) plan that is neither an eligible rollover distribution nor a periodic distribution. A distribution from a qualified plan to a non-spouse beneficiary is an example of a nonperiodic distribution. *Note:* All IRA distributions are nonperiodic distributions.

The participant may specify the withholding amount or choose not to have any tax withheld by filing a withholding certificate with the employer. If no instructions are received, the payor is required to withhold 10% of the distribution.

Corrective Distributions. Corrective distributions are not eligible rollover distributions and are generally not subject to either periodic or nonperiodic withholding rules. (However, if corrective distributions are taxed in the year of

distribution, they are considered to be nonperiodic distributions and the withholding rate is 10%).

Death Benefits. Since a spouse is eligible to roll over death benefit distributions to an eligible retirement plan in his or her own account, the 20% mandatory withholding rules apply to amounts that are not directly rolled over. Distributions to non-spouse beneficiaries are subject to either periodic or nonperiodic withholding rules, whichever apply.

QDRO Distributions. As with death benefits, 20% mandatory withholding applies to QDRO distributions eligible for rollover that are not directly transferred to an eligible receiving account. If the distribution is not eligible for rollover, either the periodic or nonperiodic distribution rules apply. ❖

A Review of Distribution Notices

When a distribution is requested, the IRS requires qualified plans to provide participants with certain disclosures. Plan administrators must correctly identify the required notices and provide them in a timely manner. Here is a review.

Eligible Rollover Distributions. The rollover distribution notice (or 402(f) notice) provides participants with information about direct rollovers, the 20% mandatory withholding rule, and various possible tax treatments of qualified plan distributions. The notice must be provided 30 to 90 days *before* a distribution. The participant may waive the 30-day wait after the notice has been provided, and distribution may be made as soon as administratively possible. Plans subject to the qualified joint and survivor annuity (QJSA) rules may not make payments until seven days *after* the 30-day waiver is executed.

Periodic Payments. The participant must be provided with a tax withholding notice and an explanation of the right to elect or waive withholding. The notice must be given *no earlier than* 6 months before and *no later than* the date of the first periodic payment. A notice of the right to elect or revoke withholding (Form W-4P or substitute W-4P) must be provided at least once a year.

Nonperiodic Payments. The notice of the right to elect or revoke withholding must be provided no later than the time of the distribution.

Qualified Joint and Survivor Annuity. The notice explaining the QJSA option is provided only by plans that are subject to the QJSA rules, such as defined benefit or money purchase plans. Profit sharing and 401(k) plans are often exempt from the QJSA rules. ❖



The Medical Expense Hardship Distribution

Hardship distributions, an optional form of benefit allowed by profit sharing or 401(k) plans, must be based on *heavy and immediate financial need*. Paying medical expenses is one of the six safe harbor reasons for allowing hardship distributions. Here is an in-depth look at the rules governing the medical expense hardship.

The medical expense hardship uses the definition of medical care in Internal Revenue Code Section 213(d). Deductible “medical care” expenses include amounts paid for:

- A. The diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body, or
- B. Transportation primarily for and essential to medical care referred to in A, or
- C. Qualified long-term care services, or
- D. Insurance covering medical care referred to in A and B (including amounts paid as premiums under the Social Security Act relating to supplementary medical insurance for the aged), *or* for any qualified long-term care insurance contract in C.

Using Other Assets. With a prototype plan, hardship distributions are limited by the prototype rules that apply to the safe harbor reasons. Therefore, the participant is only required to take all possible distributions from the plan, including a loan, before requesting a hardship distribution.

Individually designed plans or other plans that use the “facts and circumstances test” for hardship distributions, however, must require participants to use *all* reasonably available personal assets, whether or not the assets are plan related, before they are eligible to receive a hardship distribution.

Documentation. IRS guidance requires that hardship distributions be documented, but does not give specific details. Plan administrators may rely solely on a participant’s representation of his or her hardship on a hardship certification form, distribution form, or similar document. Many administrators prefer, however, to gather additional proof, such as copies of canceled checks, explanation-of-benefits forms, and receipts from doctors, pharmacies, and other health-care providers.

“Safe Harbor” Events Permitting Hardship Withdrawals From Prototype Plans

1. To pay medical expenses for the employee or the employee’s spouse or dependent (whether or not they are actually deductible for that participant).
2. To purchase the employee’s principal residence. (Mortgage payments do not qualify.)
3. To pay tuition and related educational fees for the next 12 months of post-secondary education for the employee or the employee’s spouse, children, or dependents.
4. To prevent eviction from, or mortgage foreclosure on, the employee’s primary residence.
5. To pay funeral expenses for the employee’s parents, spouse, children, or dependents.*
6. To cover certain expenses to repair damage to the employee’s principal residence that would qualify for the casualty deduction, such as damage from hurricanes or floods. (This is for all casualty expenses and not just the losses that exceed 10% of AGI.)*

* Added by the final 401(k) regulations; effective the beginning of the 2006 plan year.

Usually, a hardship distribution is requested to pay amounts the participant owes. In such instances, invoices (whether paid or unpaid) reflecting the amounts due after insurance provide suitable documentation. Keep in mind that some information may be hard to come by due to HIPAA restrictions on privacy.

Early Withdrawal Penalty. Last year, the IRS issued an information letter addressing the issue of whether the 10% early withdrawal penalty applies to hardship distributions for medical expenses. The IRS stated that medical expenses during the year of distribution *minus* 7.5% of “adjusted gross income” (AGI) are exempt from the 10% penalty. The expenses must be deductible under IRC Section 213, unreimbursed by insurance or other reimbursement programs, and incurred during the year of distribution. An individual does not have to itemize deductions to take advantage of this exception.

The final 401(k) regulations clarified that a hardship distribution for medical expenses is based on the entire unreimbursed amount, not just the amount above the 7.5% of AGI threshold. Thus, a participant can get a medical hardship whether or not the distribution will be exempt from the 10% penalty. ❖

recent developments

■ **DOL Obtains \$1.1 Million Judgment Restoring 401(k) Plan Assets.** The U.S. Department of Labor has obtained a judgment requiring a former trustee of the Rycenga Homes Inc. Profit Sharing 401(k) Plan in Spring Lake, Michigan, to restore \$1,132,229 to the plan. The judgment resolves a lawsuit alleging that the plan's trustee violated ERISA between August 1992 and May 2004 by transferring more than \$2.5 million in assets from the 401(k) plan to the business, and by failing to remit contributions deducted from employees' paychecks to the plan. The suit, *Chao v. Retsema*; Civil Action No. 1:05-cv-323, was filed in federal district court in Michigan.

Note: The DOL continues to aggressively pursue employers who do not deposit employee deferrals in the retirement trust in a timely way, bringing both civil and criminal actions.

■ **Plan Amendment Deadlines.** IRS Rev. Proc. 2005-66 states that *discretionary plan amendments* must be made by the end of the plan year in which they are to become effective. For example, if a plan wishes to change its ADP testing method from prior to current year, it must do so prior to the end of the plan year for which the test is to be run. Therefore, the method of testing may no longer be changed during the time after the end of the plan year when the testing is being done.

The deadlines for *legally required plan amendments*, those mandated by a law or regulatory change, depend on the underlying law or regulation. Often, the deadline is the tax-filing deadline of the sponsoring employer (unless a later date is provided in IRS guidance).

■ **Form 5500 Katrina Extension.** The Department of Labor has again extended the filing deadline for the Form 5500 series. Filers in 31 parishes in Louisiana, 46 counties in Mississippi, and 11 counties in Alabama now have until August 28, 2006, to file. (The deadline had previously been extended to February 28, 2006.) Further details may be found on the DOL website at www.dol.gov/ebsa/. ❖

The general information in this publication is not intended to be nor should it be treated as tax, legal, or accounting advice. Additional issues could exist that would affect the tax treatment of a specific transaction and, therefore, taxpayers should seek advice from an independent tax advisor based on their particular circumstances before acting on any information presented. This information is not intended to be nor can it be used by any taxpayer for the purpose of avoiding tax penalties.

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