RETIREMENT PLANS, IRA DISTRIBUTIONS, ROLLOVERS AND ROTHS
(focus on Retirement Plans)

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Basic Start Points of Qualified Plan Distributions:

A. Qualified Plans (IRC Section 401(a)) must follow certain rules relating to distributions to remain qualified. Most of those rules reside in IRC Sections 401(a) and 417. This outline will cover the "Basics", as well as selected niche topics we believe might be of interest. The "Basics" entail:
   1. METHODS OF DISTRIBUTION
   2. PROCEDURES FOR DISTRIBUTIONS
   3. TIMING OF DISTRIBUTIONS
   4. ROLLOVERS/TRANSFERS TO INDIVIDUAL RETIREMENT ACCOUNTS (TRADITIONAL IRAS/ROTH IRAS/BENEFICIARY IRAS)
   5. LOANS TO PARTICIPANTS
   6. REQUIRED MINIMUM DISTRIBUTIONS
   7. IRC 72(t) DISCUSSION
   8. CREDITOR PROTECTION ISSUES

   Note – ESOP special rules will not be covered due to interests of time and complexity.

1. METHOD OF DISTRIBUTION (BASICS)

<u>Defined Benefit Plans (including Cash Balance Plans) and Money Purchase Pension Plans</u>

- The Normal Benefit Form for a living participant must be an IRC Section 401(a)(11) joint and (at least 50%) survivor annuity (IRC Section 417(b)) for married participants. A Plan can require marriage for one year. Unless the value of the benefit (determined without including rollover accounts) is $5,000 or less. For unmarried (or married less than one year) participants almost all DB Plans specify a lifetime annuity as the "normal" form, with most "smaller" plans offering actuarially equivalent lump sums, installment payments or combinations of the options.
- The Normal Benefit Form for a surviving spouse (Plan can require one year of marriage) of a deceased participant (dies before "annuity start date") is a "qualified preretirement survivor annuity" (as defined in IRC Section 417(e)), with options usually offered (especially in "smaller" plans) for actuarially equivalent lump sums or installments. Note – Too cumbersome to discuss but Treasury Regulations and IRC Section 417 require specific "Notice", "Disclosure" and "Timing of Notice" rules relating to distributions under Defined Benefit Plans. The Retirement Equity Act of 1984 requires spousal consent (witnessed by a notary or Plan representative) to waive a survivor annuity (as well as the required Notice and Disclosures about the annuity terms and conditions). IRC Section 417(a)(6)and (7) specifies a "180 days applicable election period" prior to the "annuity starting date" and allows a "30 days election period" following the "annuity starting date" (which 30 day period can be waived if payment starts more than 7 days later). IRC Section 411(a)(11) prohibits distribution without participant consent of benefits exceeding $5,000 (rollover contributions can be excluded).

Profit Sharing Plans and 401(k) Plans

A Profit Sharing Plan or 401(k) Plan can "opt out" of the cumbersome "annuity" rules applying to DB Plans and Money Purchase Plans. Most 401(k) Plans (that I work with) provide "lump sum only" as the benefit form. They do not want to deal with "annuity rules and disclosures". How? IRC 401(a) (11)(B) provides the annuity option does not apply if the plan provides –

A. The automatic beneficiary of a married participant is his/her surviving spouse (if married, one year rule can apply) unless the spouse properly consents otherwise.
B. The Participant does not elect a life annuity (most plans do not allow such an election so as to preclude the potential of an annuity and to eliminate the need to disclose annuity options – after all a participant who wants an annuity can transfer to an IRA, and purchase his/her own).
   Note – This "opt out" in favor of a lump sum (installments sometimes are offered) eliminates the need for spousal consent (although some PSP/401(k) Plans require spousal consent as a best "practice" – after all – usually the funds are community property and prudence might dictate caution).

2. PROCEDURES FOR DISTRIBUTIONS (PAPERWORK)

- Simplified due to limited time – Written Benefit Forms are required for all payments with forms in compliance with IRC Sections 401 (a)(11), 401(a)(17) and Regulations. Explanations of annuity options must be provided, along with spousal consent forms where applicable.
- Direct transfers to IRAs permitted under the IRC require no income tax withholding (including direct transfers to Roth IRAs)
- Taxable Distributions (US residents) require 20% Federal withholding (deposit procedures are beyond scope) for distributions that could have been transferred to an IRA in a traditional non-direct rollover.
- Participant consent is required (unless the participant is "missing" or, in some cases, when the Plan is terminated) for distributions in excess of $5,000 (IRC Section 411(a)(11)) – discussion of missing participants (rollover to missing person IRA, PBGC missing participant program).

3. TIMING OF DISTRIBUTIONS (SIMPLIFIED)

- DB Plans – Generally no distributions prior to "Normal Retirement Date" or if earlier – termination of employment. A DB can allow an "in-service" distribution at Normal Retirement Date but many do not.
  Note Special Issues –
- "Owners" cannot be paid lump sum benefits (or benefits in excess of annual accrued benefits) to the extent the Plan is less than 110% funded (this is a complex rule designed

to preclude owners from distributions in excess of "annual benefits" when the Plan is insufficiently funded for other participants). 1.401(a)(4)-5

- DB Plans covered by the Pension Benefit Guaranty Corporation insurance program (comments spoken on the floor - a PBGC discussion is beyond the scope) cannot terminate and distribute without getting PBGC approval. Note – Owners bear any shortfall in funding – non majority owners are paid in full and owners paid last (simplified discussion).
- DB Plans with less than 80% funding are under rules imposed by the Pension Protection Act of 2006 prohibited from paying lump sum distributions (IRC Section 436).

Defined Contribution Plans

Profit Sharing Plans and 401(k) Plans (this discussion does not apply to Money Purchase Plans) can offer optional added "in-service options" (rules are highlighted but detailed discussions beyond time scope). Special limits for 401(k) are highlighted below.

- Hardship Withdrawal – (meeting IRS rules) usually only for 401(k) deferrals but could apply to other vested balances.
- In-service distributions at age 59.5 (also Normal Retirement Age if later for employer contributions (normally 62 or older))
- In-service distributions of "seasoned" funds – in the plan at least two years
- In-service distributions to participants with 5 or more years of plan participation
- Qualified reservist distribution (IRC Section 72(t)(2)(G)(ii))

Special 401(k) Rules:

–IRC Section 401(k) provides "elective deferrals" cannot be distributed "in-service" unless the participant has terminated employment, attained age 59.5, qualifies for a hardship withdrawal or certain "qualifying plan terminations" (IRC Section 401(k)(10) allows plan termination lump sums to be paid if the Employer does not start or maintain another defined contribution plan within 12 months before or after the termination).

-Same Desk Rule Eliminated after 2001 (IRC Sections 401(k)(2)(B), 401(k)(10), 403(b) and 457(d)(1)) - Severance of employment for an entity due to a business sale allows distribution of 401(k) funds even if you sit at the same desk!

Comment - Shift from LLC to corporation, sole proprietorship to corporation, shift from one "controlled group member" to another member would not to qualify for this portability provision.

Comment - Terminating the services of a staff leasing company and shifting to another is a gray area needing IRS guidance. Employment has typically not been severed as almost all staff leasing arrangements are really "joint employer" arrangements, with Internal Revenue

Code Section 414(n) deeming the "lessor" of employees as the employer for benefit purposes, but the "lessee" still being the common law employer.

4. ROLLOVERS FROM QUALIFIED PLANS

Portability of Qualified Plan funds is a huge benefit. Receive a distribution from a qualified plan and "roll it" to defer taxation is the basic concept. See IRC Section 402(c) for source Code. Here is a basic primer and some specific comments will follow:

1. The distribution must qualify as an "eligible rollover distribution". Generally distributions except lifetime annuity, 10 or more year periodic distributions, hardship withdrawals or required post-age 70.5 minimum distributions.
2. Transfer must consist of the property distributed. Certain sales to third parties allow proceeds to be transferred (IRC Section 402(c)(6)).
   Note – Loans to participants can be transferred only to another Qualified Plan that allows loans (no participant loans to IRAs).
3. The rollover must occur on or before the 60th day (no exceptions for Saturdays, Sundays or holidays) following the date of distribution receipt (hardship waivers can be applied for if the reason was beyond the participant's control).
4. Mandatory 20% Federal withholding (IRC Section 3405(c)) applies to "eligible rollover distributions" unless the "rollover" is a direct transfer – i.e. a transfer directly to the IRA or qualified plan. A triangle rollover (plan-to participant–to plan/IRA) triggers 20% withholding - to avert tax on the 20% funds must be rolled over from personal sources.
5. After Tax Contributions in a Qualified Plan May Be Directly Transferred to a Defined Contribution Plan or IRA. IRC Section 402(c)(2) and 401(a)(31)(B)
   Note - After-tax contributions may not be transferred to a 457 Plan.
6. IRA Rollovers to Qualified Plans (IRC Section 408(d)(3)(A)) – IRA accounts can be rolled over to Qualified Plans, 403(b) Plans and 457 Plans. After-tax contributions and non-deductible contributions to an IRA (see 5 above for differing treatment of after-tax contributions to a qualified plan) cannot be rolled to a qualified plan.
   Comment 1 – The rollover option allows a "shakeout" of after-tax funds.
   Example - $100,000 in all of your IRAs with $10,000 nondeductible basis. The Code allows rollover of $90,000 to a Qualified Plan, leaving $10,000 basis. Then withdraw $10,000 from the IRA or convert to a Roth – no tax!
   Comment 2 - Rollover to Qualified Plan can then allow IRA funds to be available for a participant loan from a "Rollover Account".
   Comment 3 – Creditor protection will in some instances be better (and deeper-protected by more layers) in a Qualified Plan – causing a "fright flight" of IRA funds into Qualified Plans.
   Comment 4 - A rollover of IRA funds to a Qualified Plan would subject the funds to greater restrictions on a spouse being the required beneficiary, or requiring spousal

consent to distributions. Be cautious if the IRA funds are separate property! You could be increasing your spouse's rights, especially if you die!

Comment 5 - Rollover from IRA to Qualified Plan can also occur during a divorce to get IRA funds eligible for pre-age 59.5 distribution to participant's ex-spouse under a QDRO without penalty!

7. Taxation of Traditional IRA Distributions Rolled to Non-IRA (IRC Section 408(d)(3)(H)) – Distributions rolled to a non-IRA are treated as income on contract (to the extent of income from all IRAs).

   Example – H has two IRAs:

   IRA 1 - $10,000 of which $5,000 is basis.

   IRA 2 - $20,000 none of which is post-tax.

   H rolls over IRA #1 to a qualified plan. Now IRA #2 has $5,000 of basis.

8. Surviving Spouse Rollover (IRC Section 402(c)(9)) – Spouse can roll over from a Qualified Plan into a Qualified Plan, 457 Plan, 403(b) Plan or an IRA.
9. 403(b) Plan Rollovers (IRC Sections 403(b)(8)(A)(A)(ii) and 402(f)(c)(A))- Rollover is allowed to a Qualified Plan, 457 Plan, 403(b) Plan or IRA.
10. 403(b) Plans Accepting Rollovers (IRC Section 402(c)(8)(B)(vi)) – Rollovers from Qualified Plans, IRAs and 457 Plans can also be rolled into a 403(b) (after tax contributions must be through direct transfers) contributions to Qualified Plans).
11. 457 Plans Distribution and Rollover Options (IRC Sections 457(e)(16) and 457(b)(2)) - 457 Plans of Governments (tax exempts still have constructive receipt issues) are not subject to constructive receipt rule. Direct Rollovers of Government 457 Plan funds to IRAs are ok (unless the distribution is a hardship or ten year+ periodic payout)! The same post 70.5 rules as apply to Qualified Plan applies to 457 Plans. Comment - 457 Plans are not subject to pre-age 59.5 penalties. Rollover to IRA would invoke this issue for a pre-age 59.5 individual. Eliminating restrictive payout rules with an IRA rollover adds significant flexibility to government retirees. BIG RELIEF for affected people!
12. Rollovers to 457 Plans (IRC Section 402(c)(8)(B)(v)) – Government 457 Plans can allow rollovers from IRAs, Qualified Plans and 403(b) Plans (except for after-tax contributions originally made to qualified plans). Separate accounting is required for rollover funds to preserve the pre-age 59.5 penalty (Congress thought of everything! Loophole plugged!).
13. Cash Out Rule (IRC Sections 411(a)(11)(D) and 457(e)(9)(A)) - Participant has $10,000 rollover account and $1,000 employer contributions account $5,000 or more total. The rollover account is ignored. The above participant with $11,000 can be involuntarily forced out of the plan into an IRA.
14. "Rollover Only" Plan – A Profit Sharing or 401(k) Plan must have initial and recurring contributions (at least until "frozen") to be tax qualified under long standing IRS guidelines. IRS Newsletters and informal publications have indicated a zero percent Money Purchase Pension Plan can be used for rollovers.

Example – Owner terminates a Qualified Plan or has money in an IRA. Desires to maintain greater creditor protection, remain as trustee of Qualified Plan funds, has plan assets not conducive to an IRA, desires to maintain ability for a participant loan, or has "nonqualifying assets" subjecting the Plan to a "CPA audit" or 100% "ERISA Bond requirement" so long as non-owners participate. Solution is "create" a 0% Money Purchase Plan with only the owner as a "participant" and transfer his/her account (assuming a "distribution event" has occurred) to the Money Purchase Plan.

15. Beneficiary IRA Option - The Pension Protection Act of 2006 added an IRA option for the benefit of non-spouse beneficiaries of Qualified Plans. IRC Section 402(c)(11) A non-spouse beneficiary was previously allowed no IRA option. The rule allows a non-spouse beneficiary of a Qualified Plan to distribute in a direct trustee-to-trustee transfer (must be direct) of funds to an IRA that in turn qualifies for and is treated as an "inherited IRA" (IRC Section 408(d)(3)(C)). This Beneficiary IRA is treated as the deceased participant's IRA for payout purposes but is taxed to the beneficiary. The "required minimum distribution" rules apply as if the distribution was from a Qualified Plan. The distribution is a death benefit for pre-59.5 penalty rules.
    Caution – The transfer must be direct. And the IRA must be coded correctly as an "inherited IRA". You cannot simply co-mingle it with your existing IRA – ever.
    Note – The beneficiary must be an individual person or persons. An estate beneficiary does not qualify. Per IRC Section 402(c)(11)(B), certain trusts for individuals can be treated as an individual.
    Note – Even though the direct transfer to a "beneficiary IRA" is allowed – a distribution directly to the beneficiary is not an "eligible rollover distribution". Thus, mandatory 20% withholding does not apply.
16. Direct Rollover to Roth IRA – Distributions from Qualified Plans, 403(b)s and 457 Plans can be transferred directly to a Roth IRA (IRC Section 408A(e)). This streamlines the conversion of an IRA to a Roth IRA. Previously the distribution had to first transfer to a traditional IRA then you convert the IRA to a Roth IRA.
    Note – Transfers to a Roth are not tax-free. Funds to pay the tax must originate from other sources. The pre-59.5 penalty does not apply unless the transferred funds are withdrawn (under "ordering rules") within 5 tax years.
17. In-Service Roth Rollover - Assume a 401(k) Plan, 403(b) Plan or government 457(b) Plan has a "qualified Roth contribution program" (IRC Section 402A(b)) IRC Section 402A(c)(4) allows an "in-plan taxable distribution" from the non-Roth portion of a participant's plan account to his/her Plan "Roth Account".

    Eligibility
    – Permitted for "elective deferrals" only to the extent the participant attained age 59.5, died, was disabled or can receive a qualified reservist distribution.
    -Permitted for other accounts (match, non-match, etc.) if the plan could allow in-service withdrawals under the Code.
    -The plan must be amended to allow an "in-Plan Roth rollover"

Cool Feature – An employer can amend a Roth qualified 401(k) Plan to allow an "in-Plan Roth conversion" for amounts it "could" allow to be distributed outside of the plan "in-service" – but without allowing distributions out of the plan.

Example – Employer does not allow "in-service distributions" for eligible funds – and does not want to allow them (even though the IRC allows the plan to do so). Employer has no objection to allowing participants to convert eligible pre-tax accounts to post-tax accounts. It amends the plan to allow "in-plan" conversions of funds otherwise eligible for an in-service withdrawal.

Example - Associate age 35 in your law firm desires to convert his/her "seasoned" match/firm contributions from pre-tax to post-tax. The plan allows Roth contributions and "in-plan" conversions. He/she believes paying tax on funds now for tax free growth is a smart move (debatable in your associate's high tax bracket – but pros and cons are beyond scope). Note – He/she must come up with the money to pay the tax from external plan sources. Keep in mind the decision is irrevocable. The recharacterization option for an IRA does not apply to a qualified plan conversion!

Five Year Rule – Any amounts distributed from the Roth account attributable to an "in-plan" Roth conversion are subject to the pre-age 59.5 rule for 5 taxable years from the first day of the conversion taxable year.

Example - Young associate converts $6,000 in 2012. Leaves firm in 2013 and does not transfer the Roth account to (a) another firm's 401(k) with a Roth feature or (b) a Roth IRA. The distribution of $6,000 to him/her is subject to applicable pre-age 59.5 penalties.

5. LOANS TO PARTICIPANTS – QUALIFIED PLAN DISTRIBUTION RULES

IRC Section 72(p) contains rules allowing a loan to a participant to not be considered a "taxable distribution"(and subject to all that entails). Discussion in detail is beyond scope but generally these basics apply:

1. No loans unless the plan allows loans.
2. Loans must be nondiscriminatory.
3. Limited to 50% of vested account balance or $50,000 (reduced by highest balance within prior one year), if less (counting all plans of an employer).
4. Repaid in level payments within 5 years (not 5 years or 5 years plus one day).
5. Loans used to acquire a principal residence can be longer than 5 years.
6. Secured by 50% of account balance.
7. A loan failing to meet those requirements is taxable at inception (IRC Section 72(p)(1)) (or that is never intended to be paid (not even one payment)). Regulations

generally provide a previously compliant loan becomes taxable on the last day of the calendar quarter during which a loan payment is 90 days overdue.
Note – Interest on a participant loan is not deductible (IRC Section 72(p)(3)) if either (a) the participant is a "key employee" (IRC Section 416(i)) or (b) the loan is secured by 401(k) deferrals.

Defaulted Loans – Regulations do not allow a taxable loan ("deemed loans") to be distributed unless the participant has reached a "distribution event". The loan must remain in the participant's account (but need not bear more interest) until the participant reaches a distribution event.

6. REQUIRED MINIMUM LIFETIME DISTRIBUTIONS.

For "RMDs" I decided the easiest way to transmit complex information was to use modified excerpts of IRS FAQs. Note – The rules below apply to Defined Contribution Plans. Defined Benefit Plan RMD rules generally require payment of the annual accrued benefit. An "owner" with a "tax shelter type" DB Plan often is encouraged (by actuaries and advisors) to (if possible without violating any distribution rule - some "bars" were discussed elsewhere in this Program) transfer benefits to the extent funded to a Defined Contribution Plan, IRA or an internal DB Plan Rollover Account (this later method is potentially used when the "pledge of account" is necessary to comply with the rules barring a distribution when the Plan is less than 110% funded – this is a complex topic left to actuaries and experts. The "DC RMD" is almost always less annually than the "DB RMD".

FAQs

What are Required Minimum Distributions (RMDs)?

RMDs (IRC Section 401(a)(9)) generally are minimum amounts that a retirement plan account owner must withdraw annually starting with the year that he or she reaches 70.5 years of age or, if later, the year in which he or she retires. However, if the retirement plan account owner is a 5% owner of the business sponsoring the retirement plan, the RMDs must begin once the account holder is age 70 ½, regardless of whether he or she is retired. Retirement plan participants are responsible for taking the correct amount of RMDs on time every year from their accounts, and they face stiff penalties for failure to take RMDs.

Different RMD rules apply to the beneficiary of the account when a retirement plan account owner dies before RMDs have begun. Generally, the entire amount of the owner's benefit must be distributed to the beneficiary who is an individual either (1) within 5 years of the owner's death, or (2) over the life of the beneficiary starting no later than December 31 of the year following the year of the owner's death.

What types of qualified retirement plans require minimum distributions?

The RMD rules apply to all qualified retirement plans, including profit-sharing plans, 401(k) plans, 403(b) plans, 457(b) plans and defined benefit plans. The RMD rules also apply to Roth 401(k) accounts.

When is the deadline for receiving a RMD?

An account owner must take the first RMD for the year in which he or she turns 70.5. However, the first RMD payment can be delayed until April 1st of the year following the year in which he or she turns 70.5. For all subsequent years, including the year in which the first RMD was paid by April 1st, the account owner must take the RMD by December 31st of the year.

How is the amount of the RMD calculated (for a Defined Contribution Plan)?

Generally, a RMD is calculated for each account by dividing the prior December 31st balance of that retirement plan account by a life expectancy factor that IRS publishes in Tables in Publication 590, Individual Retirement Arrangements (IRAs). There are three separate tables:

- The Joint and Last Survivor Table is used by an account owner whose sole beneficiary of the account is his or her spouse and is more than 10 years younger than the account owner;

- The Uniform Lifetime Table is used by account owners whose spouse is not the sole beneficiary or whose spouse is not more than 10 years younger; and

- The Single Life Expectancy Table is used by a beneficiary of an account.

Can an account owner just take a RMD from one Plan instead of separately from each Plan?

No. RMDs required from qualified retirement plans have to be taken separately from each of those plan accounts.

Who calculates the amount of the RMD?

The retirement plan administrator calculates the RMD. The retirement plan account owner is ultimately responsible for calculating the amount of the RMD.

Can an account owner withdraw more than the RMD?

Yes.

What happens if a person does not take a RMD by the required deadline?

If an account owner fails to withdraw a RMD, fails to withdraw the full amount of the RMD, or fails to withdraw the RMD by the applicable deadline, the amount not withdrawn is taxed at 50%. The account owner should file Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts, with his or her federal tax return for the year in which the full amount of the RMD was not taken.

Can the penalty for not taking the full RMD be waived?

Yes, the penalty may be waived if the account owner establishes that the shortfall in distributions was due to reasonable error and that reasonable steps are being taken to remedy the shortfall. You must file Form 5329 and attach a letter of explanation.

Can a distribution in excess of the RMD for one year be applied to the RMD for a future year?

No.

How are RMDs taxed?

The account owner is taxed at his or her income tax rate on the amount of the withdrawn RMD. It is tax free to the extent the RMD is a return of basis or is a qualified distribution from a Roth 401(k).

Can RMD amounts be rolled over into another tax-deferred account? No.

How is a Defined Benefit Plan RMD Calculated?

A defined benefit plan generally must make RMDs by distributing the participant's entire interest as calculated by the plan's formula in periodic annuity payments for:

- the participant's life,
- the joint lives of the participant and beneficiary, or
- a "period certain" (see Treas. Reg. §1.401(a)(9)-6, A-3).

<u>Special Topics for Death Benefit RMDs</u>

Treasury Regulations discuss RMD rules in detail. Treasury Regs 1.401(a)(9)-0 to 1.401(a)(9)-9.

<u>Special Issues to Single Out</u> (these rules are complex – detailed discussion is beyond scope).

<u>Assume Participant Dies before Required Beginning Date</u>

- Spousal beneficiary has until the end of the calendar year during which the employee would have attained age 70.5 to commence a lifetime payout.
- Nonspousal beneficiary has until end of the calendar year following death to begin a lifetime payout – failure to so do triggers the requirement of distributions under the 5 year rule of IRC Section 401(a)(9)(B)(ii). See below for discussion of multiple beneficiaries.
  Note – Qualified Plans normally contain provisions allowing the election between methods (life expectancy or 5 year payouts). Regs describe timing and default settings.
  Note – Portability to IRAs (including Beneficiary IRAs for nonspouse beneficiaries) provides a huge safety relief valve for those who do not desire to or cannot keep plans intact over years for a lifetime payout. Some DC Plans also have no installment or annuity options (lump sum only).

Assume Participant Dies after Required Beginning Date

Beneficiary must receive benefits at least as rapidly as the method being used at death. IRC Section 401(a)(9)(B)

Trusts as Beneficiaries – Regs 1.401(a)(9). Trusts can qualify as designated beneficiaries. Sophisticated trust Qualified Plan beneficiary planning is beyond scope. The use of trusts as beneficiaries of Qualified Plans cannot be touched upon in this context. A properly designated trust (and Qualified Plan to go with it) can provide for Qualified Plan distributions to a trust with lives of the underlying trust beneficiaries used as the life measuring period. A QTIP Trust can be used, but be careful (Rev. Ruling 2002-2).

Lifetime for Payout Measurement with Multiple Beneficiaries - Lifetime payouts are measured based on the oldest life if there are multiple beneficiaries. A nonindividual such as a charity or estate has no "life" and subjects pre-Required Beginning Date payouts to the "5 year rule". Exception - Regs allow two options, assuming the Qualified Plan (in conjunction with the beneficiary designation) allows this: (1) split the account into separate shares – each with its own beneficiary before the September 30 described below or (2) payout the estate or charity before September 30 of the calendar year after date of death.

7. IRC SECTION 72(t) DISCUSSION.

Basics follow for Qualified Plans:

- Extra 10% (2.5% California) tax applies to distributions pre-59.5 unless an exception applies. Basic exceptions are:
  -Death
  -Disability (IRC Section 72(m)(7))
  - Separation from service during or after calendar year during or after you attain 55 (Qualified Plan only)
  Distribution due to:
  -IRS levy on plan account (must have a distribution event to pay)
  -Deductible medical expenses
  -Alternate Payees under QDROs (Qualified Plan only)
  -Health insurance premiums for unemployed
  -401(k) deferrals qualifying as a "qualified reservist distribution"
  -Periodic payouts (see discussion following): Note – Most 72(t) payouts are through IRAs. Most owners cannot qualify (separation from service is needed) for it. Nonowners in most "smaller" plans are encouraged to transfer to an IRA and do it through an IRA. IRC Section 72(t) provides way to withdraw Qualified Plan funds, without penalty, prior to attaining age 59½ (assuming the Qualified Plan allows it). Withdrawals that constitute "substantially equal periodic (at least annually) payments" allow the participant penalty-free access to funds which would otherwise only be available upon paying the 10% penalty. IRC Section 72(t)(2)(A)(iv). This exception is not allowed for "in-service" withdrawals. The participant must terminate employment (an

owner will find this standard near impossible to meet). The Internal Revenue Service, in Notice 89-25, provided three methods for determining what withdrawals may constitute "substantially equal periodic payments" for purposes of the rule: These are the minimum distribution method, the amortization of account balance method, and the annuity factor method. Each of the methods set forth in Notice 89-25 provides a manner of calculating a series of substantially equal periodic payments, based upon the life expectancy of the participant (or joint with his/her designated beneficiary) and an assumed interest rate (see below). Assuming the participant withdrew funds from the retirement account in a manner consistent with one of these methods, no penalty for early withdrawal applies. The statute includes at least one important restriction: Once a plan for withdrawing "substantially equal periodic payments" is initiated, it may not be modified (other than by reason of death or disability) for five calendar years or until the participant attains age 59.5, whichever period is longer. IRC Section 72(t)(4)(a). Accordingly, the participant must continue to withdraw the funds precisely according to the plan until the period has elapsed. For example, if the participant begins the withdrawals at age 52, they must continue until age 59.5, after which date the withdrawals may be altered as to amount, or even terminated entirely. Alternatively, if the participant begins the withdrawals at age 57, they must continue until five full years have elapsed from the date of the first withdrawal, before they may be altered or terminated.

Rev. Rule 2002-62 issued October 3, 2002, updated Notice 89-25's rules on permissible pre-age 59½ penalty exceptions. The three basic methods of Notice 89-25 were preserved (quotient method, fixed amortization or fixed annuitization). Special rules were promulgated as follows:

A. 2002-62 specifies use of either the life expectancy tables in the ruling, or § 1.401(a)(9)-9 of Income Tax Regulations.

B. Interest Rate maximums are specified as 120% of the federal mid-term rate for either of the two months preceding the distribution commencement date.

C. Account balance for the determination is based on facts and circumstances. A (impermissible) modification to the payments will occur if additions or subtractions to the account occur as a result of anything other than gains or losses.

D. An impermissible modification will not occur if the account depletes to zero.

Example. Ex-Qualified Plan participant, age 50, starts out with $200,000 and takes a periodic payment under an acceptable method. His or her account balance goes to zero and the account is worthless at age 57. There is no retroactive 10% penalty even though payments until 59½ are impossible.

E. One Time Change (huge). A participant who uses either the fixed amortization method or fixed annuitization method may switch once in a later year to the Quotient Method — and the change is not a modification.

Example: Former participant, age 50, starts in 2007 with a 401(k) with $200,000 in stock. Used a single life annuity distribution method. Account is now worth $100,000. He decided to switch methods in January 2010 to the "Quotient Method". This can be done only once.

8. CREDITOR PROTECTION ISSUES

Consider creditor protection before transferring retirement plan funds. We discuss only California rules. Some states (Texas, Florida, Washington, etc.) have better non-bankruptcy IRA protection than California. Michael Varela focuses on IRA rules – so I limit focus to Qualified Plans.

General Rule – Hierarchy of Creditor Protection in California – NonBankruptcy Context

Patterson v. Shumate (504 US 753 1992) ERISA Qualified Plans (plan has participants other than owners) – exempt under an applicable nonbankruptcy exemption.

- Private Retirement Plans (or Profit Sharing Plans) under CCP Section 704.115. In the Qualified Plan context this is usually interpreted under California case law to refer to Qualified Plans maintained by corporations that are not "abused" (set up legitimately for retirement savings, intending to be tax qualified and not rife with improper participant loans or self-dealing investments). There is case law – a detailed discussion is beyond scope. See McMullen v. Haycock No. B187748 February 13, 2007. The 2007 McMullen case also allowed creditor protection for funds traced into a rollover IRA.
- Non-ERISA Self-Employed Plans for sole proprietors (exempt under CCP Section 704.115(a)(3)) are exempt only for the sole proprietor to the extent necessary for retirement support of the debtor, spouse and dependents. Child, family or spousal support judgments are not exempt.

Special NonBankruptcy Issues -

- ERISA and California law (due to Federal preemption and ERISA's enactment clause stating it does not impair other Federal laws) does not impair collection of:
    - An IRS tax levy
    - Federal judgments (US is plaintiff)
    - QDROs (spousal support, child support, property settlements)
- There is another nonbankruptcy exemption under CCP Section 704.140(b)(10)(E) that can be elected for certain payments from a Qualified Plan but only to the extent needed for support of the debtor and dependents (but electing this is a choice between it and CCP Section 704.115 – consult a bankruptcy expert).

Bankruptcy Context

This is a confusing area to an ERISA lawyer. California has opted out of Bankruptcy Code Section 522(d) exemptions – one of them being the extensive retirement plan/IRA exemptions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (discussion of which is beyond scope except as discussed below). Thus, it appears California has opted out of the bankruptcy Federal exemptions applicable to Rollover IRAs, tax qualified Qualified Plans and up to $1,000,000 in IRAs thereby subjecting California debtors to the California Code of Civil Procedure exemption scheme. BUT, Bankruptcy Section 522(b)(3)(C) allows exemption of amounts in an account exempt under IRC Sections 401, 403, 408, 408A, 414, 457 or 501(a) even if state law exemptions otherwise apply. That, however, is not what most local bankruptcy lawyers are telling me. Bankruptcy Code Section 522(b)(4) brings Qualified Plan counsel into potential play in providing guidance and opinions. Exempt status for a Qualified Plan requires a demonstration of "tax exempt status". This is demonstrated by a current "favorable determination letter", or if there is none, IRS has not disqualified the plan and the plan is in substantial compliance (or if not, the debtor is not responsible). It is unclear if a "volume submitter letter" or IRS prototype approval for a plan following VS rules is a "determination letter"- although it should be. If in doubt, seek IRS approval through the "voluntary compliance program".