THE EMPLOYEE BENEFIT
Forum
current issues in retirement benefit planning

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Electing Out of Federal Tax Withholding

SITUATION: We have an employee who has requested a hardship distribution from her 401(k) account and does not want to have any federal income tax withheld.

QUESTION: Can employees choose to elect out of withholding on withdrawals such as hardship distributions?

ANSWER: Generally, any employee who receives a distribution that is not an eligible rollover distribution may choose not to have federal income tax withheld. A hardship withdrawal would be an example of a distribution not eligible for rollover. The right to elect out of withholding applies whether the distribution is periodic or nonperiodic.

DISCUSSION: Plan administrators must inform employees of their right to elect out of withholding. If an employee chooses not to have withholding, that choice will remain in effect until the employee notifies his or her employer of a change.

Generally, any time the participant clearly indicates his or her election, it must be given effect. However, if the payment is periodic, the plan administrator may require the employee to make the election up to 30 days before the first payment is due. If the distribution is nonperiodic, such as a hardship withdrawal, the plan administrator must abide by any election made as of the time of distribution.

The plan administrator also must notify employees that any prior election is applicable until revoked. In addition, the notification must inform employees how to revoke a previous election and give notice that if the amount of tax withheld is less than the employee's estimated tax payment requirements, penalties may apply.

For nonperiodic withdrawals, the plan administrator must notify employees of their right to elect out of withholding no sooner than six months before the distribution and not later than the time an application for benefits is provided.

Employees receiving periodic distributions, such as required minimum distributions, need to be informed of their right to elect out of withholding no earlier than six months before the first payment and no later than the date of the first payment. Subsequently, plan administrators must inform employees of the right to make and revoke the election at least once each calendar year.

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Preretiree Concerns

When communicating with employees about the need to plan for retirement, it helps to know what concerns they have about their retirement finances. A new survey* offers insight into what worries older workers (age 45 and over). Some of the retirement issues that concern preretirees are:

- Paying for long-term care (69%)
- The effect of inflation on savings (69%)
- Paying for health care (67%)
- Maintaining a reasonable standard of living (63%)
- Depleting all of their savings (62%)

Many preretirees hold debt, such as mortgages (52%), credit card balances (48%), and car loans (40%). It's not surprising then that 56% state that debt has negatively affected how much they are able to save each month for retirement.

What steps are preretirees taking to prepare for the future? Most (90%) say they're saving or plan to save as much as they can, 88% are either eliminating or plan to eliminate their consumer debt, and 81% have cut back on or plan reductions in spending.

* *2015 Risks and Process of Retirement Survey*, Society of Actuaries, 2016

New Compliance Questions on 2015 Form 5500

The IRS has added new compliance questions to the 2015 version of Form 5500 (Annual Return/Report of Employee Benefit Plan) and Form 5500-SF (Short Form Annual Return/Report of Small Employee Benefit Plan). Though the IRS has announced that plan sponsors should not complete these questions for the 2015 plan year, reporting may be required for 2016.

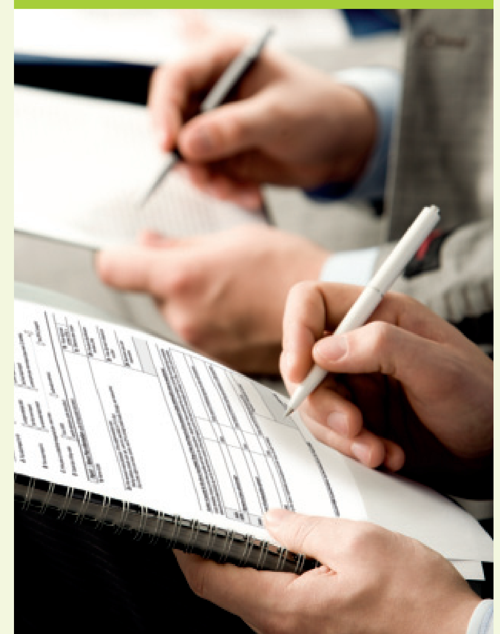
Four new questions have been added to Schedule H (Financial Information) and Schedule I (Financial Information — Small Plan) of Form 5500. The questions ask for the name and phone number of the plan's trustee or custodian, whether the plan incurred unrelated business taxable income, and whether the plan made any in-service distributions during the plan year.

In addition, Schedule R (Retirement Plan Information) includes a new Part VII, which asks:

- Whether the plan is a safe harbor plan or uses the actual deferral percentage (ADP)/actual contribution percentage (ACP) test
- If the ADP/ACP test is used, whether the current year testing method is also used
- Whether coverage testing is satisfied by the ratio percentage or the average benefit test
- Whether the plan was timely amended for all required tax law changes
- For the date of the plan's last favorable IRS determination, opinion, or advisory letter
- Whether the plan is located in a U.S. territory

Similarly, Form 5500-SF, which is generally available for qualifying plans with fewer than 100 participants, includes all of these new questions, and also asks whether required minimum distributions were made to 5% owners who have reached age 70½. Presumably, this question seeks to address an omission common to smaller plans.

. . . the IRS has announced that plan sponsors should not complete these questions for the 2015 plan year. . . .



Choosing a Suitable Vesting Schedule

A retirement plan's vesting schedule, which establishes when employer contributions to the plan become nonforfeitable, plays a role in how effective the plan is in helping to attract and retain employees. Employers will want to carefully consider their goals and the available options when selecting a vesting schedule for their plan.

What are the available vesting schedules? The simplest schedule — from an administrative perspective — is to allow immediate vesting in 100% of the employer contributions allocated to the employee. However, immediate vesting offers little incentive for employees to stay with the company and therefore may become more counterproductive as the rates of employee turnover increase.

For this reason, sponsors concerned about employee retention often turn to a delayed vesting schedule. Instead of allowing 100% vesting up front, they seek to maximize employee retention by tying the vesting percentage to the participant's years of service. Generally, for defined contribution plans, such as 401(k) plans, delayed vesting is available in two forms: three-year ("cliff") vesting and two-to-six-year ("graded") vesting.

Three-year Vesting Schedule	
Years of Service	% Vested
1	0%
2	0%
3	100%

Two-to-six-year Vesting Schedule	
Years of Service	% Vested
1	0%
2	20%
3	40%
4	60%
5	80%
6	100%

Employers may choose a schedule that provides for vesting at a more rapid rate but not one that provides for less rapid vesting. Many plan sponsors choose a graded vesting schedule that provides for 20% vesting after the first year and each year thereafter, resulting in the employee becoming fully vested after five years.

How do employers calculate years of service? A year of service is any vesting computation period in which the employee completes the number of hours of service (not exceeding 1,000) required by the plan. Typically, the vesting computation period is the plan year, but it may be any other 12-consecutive-month period.

Are all employer contributions subject to a vesting schedule? Several types of employer contributions must always be 100% vested. These include both nonelective and matching contributions in a SIMPLE 401(k) plan or a "safe harbor" 401(k) plan.

Can vesting schedules be changed? Generally, a vesting schedule may be changed, but the vested percentage of the existing participants may not be reduced by the amended schedule. Moreover, an employee with three or more years of service by the end of the applicable election period can choose to select the previous vesting schedule. The election period begins no later than the date of adoption of the amended schedule and ends on the latest of the following dates:

- Sixty days after the modified vesting schedule is adopted;
- Sixty days after the modified vesting schedule is made effective; or
- Sixty days after the participant is provided a written notice of the change in vesting schedule.

What situations would cause vesting of an employee's entire balance? In certain circumstances, the participant's interest in a 401(k) plan is required by law to be 100% vested. These circumstances include attainment of normal retirement age (as defined in the plan), termination or partial termination of the plan, and complete discontinuance of contributions to the plan. Additionally, though not required by law, nearly all 401(k) plans provide for 100% vesting upon the participant's death or disability.

The general information in this publication is not intended to be nor should it be treated as tax, legal, investment, accounting, or other professional advice. Before making any decision or taking any action, you should consult a qualified professional advisor who has been provided with all pertinent facts relevant to your particular situation.

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RECENT DEVELOPMENTS In Benefit Plans

Index Funds Increase in Popularity. A recent study by BrightScope and the Investment Company Institute revealed an increase in both the availability and use of index funds in 401(k) plans. From 2012 to 2013, offerings of index funds in 401(k) plans increased from 86% to 90%. During the same time frame, the percentage of 401(k) plan assets held in index funds increased from 22% to 26%.

Voluntary Compliance Fees Reduced. Effective February 1, 2016, the IRS has lowered its Voluntary Correction Program (VCP) fees for most plans eligible to file VCP applications. The IRS has cautioned that the most recent version of Form 8951 (last revised in September 2015) does not reflect the new fee schedule. Taxpayers should use the existing form until the new version is published and pay the applicable user fee determined by using the tables on its website.

Single Retirees Face Higher Health Costs. According to a study by the Employee Benefit Research Institute, single retirees were likely to spend more on certain health care expenses than retired couples over the same two-year period. Average per-person out-of-pocket spending for recurring expenses (such as doctor visits and prescription drugs) was roughly equal for both single and couple households. In contrast, the average total expense incurred by single retirees for non-recurring costs (such as hospital and nursing home stays) was more than double that of retired couples. The study suggests that non-recurring expenses decrease when spouses or partners are able to act as caregivers.

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