

RETIREMENT PLAN TERMINATION OPTIONS

In the ever changing employer landscape, it is not uncommon to experience the acquisition or merger of an employer. The headlines often focus on the financials of the business transaction, but the financial impact on the individual employees can be just as important of a consideration.

While employees may initially react with concern about the future, once the dust settles, some employees may find a change in ownership creates a unique retirement planning opportunity which simply would not exist in the absence of a change. In cases of merger or acquisition, companies generally terminate the former employer-sponsored retirement plan. With any termination, the participant will have an opportunity to decide what to do with the assets currently in the plan. When this occurs, employees typically have three broad choices for their former retirement plan assets – roll the assets into an IRA, transfer the assets to the new employer-sponsored plan, or take a lump sum distribution. Each of these choices has benefits and restrictions worth considering.

When considering the options, it is important to remember one of the greatest advantages of qualified plans (including 401(k) and IRA accounts) is the ability to save for retirement on a tax-deferred basis. Therefore, when making this important decision, it is essential to consider options that will continue tax deferral and avoid current taxes and penalties.

OPTION SUMMARY

Multiple options can be considered for the retirement assets upon the termination of the employer sponsored plan, which can be categorized as follows:

Distribution
(taxable)

Roll Into IRA
(non-taxable)

Roll Into New 401(k)
(non-taxable)

OPTION 1 - LUMP-SUM DISTRIBUTION

A lump sum distribution is often offered when an employer-sponsored retirement plan is terminated. Though tempting, sound financial planning suggests this option is rarely in a participant's long-term best interest. A lump sum distribution creates three important consequences. First, the tax-deferred nature of the retirement assets would be lost, which can have a significant impact on retirement income potential. Second, the significant creditor protection available in an IRA or employer-sponsored plan would be lost. Those funds are now available to creditors should a participant encounter a personal financial crisis.

Finally, the lump sum distribution would be subject to federal, and in some cases state, income tax on amounts representing pre-tax contributions and earnings. In addition to the income tax, if a participant is under the age of 59 ½, there is an additional 10 percent penalty charged by the IRS for premature distributions unless qualified for an exception. Since the amount of distribution is added to taxable income for the year, a participant may even be pushed into a higher tax bracket. Based on these unavoidable tax consequences, careful consideration should be given to other options before choosing a lump sum distribution.

OPTION 2- DIRECT ROLLOVER TO INDIVIDUAL RETIREMENT ACCOUNT (IRA)

Another option when an employer-sponsored retirement plan terminates is transferring all the assets into an

Individual Retirement Account (IRA), which is referred to as “rolling” the balance over. A rollover will not incur income tax or penalty and the retirement assets will remain tax deferred, when properly executed. The key advantages of IRAs include a wider set of investment options, an ability to add professional management, certain exceptions allowing penalty-free early withdrawals, and provisions which currently allow “stretching” the tax deferral beyond an individual’s lifetime. Rolling retirement assets into an IRA is a two-step process. First, a participant selects an appropriate financial services firm to create an IRA account. Then distribution paperwork is properly completed to roll the account from the 401(k) to the IRA. An IRA account creates an opportunity to gain greater control over investment choices and opens up a larger set of investment vehicles from individual stocks, any sector of the public bond market, thousands of mutual funds, exchange traded funds and separately managed accounts. Additionally, assets in an IRA may be managed in two basic types of accounts:

1. Self-managed
2. Investment advisor managed

Self-managed accounts may be appropriate for a person who is very actively engaged in reviewing investments on a regular basis and has the required training and knowledge to make investment choices on their own. Many people choose to work with a professional financial advisor to assist with this process and leverage the knowledge and experience of a dedicated set of financial analysts. Even in cases where the IRA account will be managed by an investment advisor, the client always retains directive control over the account and can choose to defer to the knowledge of the advisor in varying degrees, based on a level of comfort.

Per IRS rules, distributions taken from an IRA prior to age 59-½ will generally be subject to an early withdrawal tax penalty of 10% of the amount of the withdrawal, though some exceptions exist. An account holder is permitted to withdraw \$10,000 for a first time home purchase and is also permitted to withdraw funds to pay for qualified education expenses. Withdrawals for education expenses may not

exceed the amount owed for expenses incurred during the calendar year of the withdrawal. While these exceptions are penalty-free, they are still considered taxable and will therefore be subject to Federal and perhaps state income tax. Withdrawals are also permitted when taken in accord with IRS Regulation 72t, a rule allowing access to IRA accounts before age 59-½ provided strict rules are followed. Consult with a tax professional before making any distribution decisions.

Tax deferral on retirement assets is not only important for retirement, it may also be important for future generations. Proper beneficiary planning on an IRA may allow for both spousal and non-spousal beneficiaries to continue the tax deferral of the account even after a participant’s death. This is often referred to as the “stretch” strategy. Current tax laws allow 401(k) plans to offer the stretch option, however many plans choose to offer it to spousal beneficiaries only. These stretch provisions for non-spousal beneficiaries do not carry the same creditor protections and may be subject to tax law changes in the future. For now, it can be a useful planning option.

Another planning wrinkle may exist for the individual considering marriage. Rolling the retirement plan assets to an IRA may avoid the automatic attachment of Federal spousal rights to the plan benefits. Unlike qualified plan benefits, an IRA offers the flexibility to handle state-law spousal rights via a prenuptial agreement, rather than Federal dictate.

Additionally flexibility with an IRA account allows for conversion to a ROTH IRA, an option not provided in every employer-sponsored plan. Converting from a traditional IRA to a ROTH IRA involves choosing to pay taxes on an account today so that qualified distributions from the ROTH IRA are distributed tax-free in the future. For certain participants, the uncertainty regarding future tax rates and the potential for higher future tax bracket during retirement, it may be appropriate to convert retirement assets to a ROTH IRA. Conversions from a traditional IRA to a ROTH IRA are subject to income tax in the year of conversion. Consulting a tax

professional is recommended before considering any such conversion to ensure it is appropriate.

Federal law provides creditor protection from bankruptcy for contributory IRAs of up to \$1 million in aggregate for all IRAs held per individual. Further protection of IRAs from claims outside of bankruptcy vary by state. However, rollover balances from qualified retirement plans are given full protection from attachment by creditors regardless of whether the individual files for bankruptcy, subject to certain exceptions. In order to maintain this protection, rollover balances must be kept separate from other IRA dollars and must be clearly identified as “rollover” IRAs.

OPTION 3 – TRANSFERRING FUNDS TO THE NEW EMPLOYER-SPONSORED PLAN

Transferring retirement assets into the new employer sponsored plan is another alternative, and often viewed as the simplest option. Just as in the IRA approach, this approach also avoids any immediate taxation and preserves the tax-deferred nature of your retirement funds. An employer-sponsored plan offers significant creditor protection, and may also offer useful benefits such as loan provisions and hardship withdrawals. Many people consider transferring to the employer-sponsored plan simply because it is the most convenient option.

Some employer-sponsored plans allow for participant loans from their retirement account. A loan from a retirement account allows access to funds prior to retirement without immediately incurring income tax or penalty. There are typically stated limits on loan amounts, interest rate, and length of time for repayment of the loan. A loan from a retirement account involves paying interest on the loan back to the account rather than a financial institution, but the costs involved can be substantial. The funds out on loan are obviously not invested during the duration of the loan, which may lead to lost growth opportunity during the period of re-payment. Failure to repay the loan not only permanently removes those funds from retirement savings, it may also trigger significant tax penalties immediately in the year of non-payment.

Another way of accessing retirement funds in an employer-sponsored plan prior to retirement may be through Hardship Withdrawals. Subject to approval by the Plan Administrator of the employer-sponsored plan, IRS rules do allow participants to access their retirement funds in cases of severe financial hardship. The amount withdrawn may not exceed the amount of the immediate financial need, and proper documentation will be required to prove the existence of the hardship. Possible approved hardship expenses include the payment of medical or education bills, the purchase of a primary residence, the prevention of eviction, payment of burial and funeral costs, or the repair of damage to a primary residence. It is important to remember, although hardship withdrawals may be allowed by the IRS and the employer-sponsored retirement plan, these withdrawals still incur income tax at the Federal, and possibly state level, and in some cases may incur penalties for premature withdrawal.

Another unique option exists for a very small sub-set of participants who plan to retire or separate from service after attaining age 55 but before age 59 ½. IRS tax code allows for an exception for qualified retirement plans (such as a 401(k)) which allow such participants to take penalty-free distributions from their retirement account early. Those who separate from service before reaching age 55 would still be able to take penalty-free distributions before age 59 ½ through IRS Regulation 72t, which are available for funds in an IRA, but are not available on funds from qualified retirement plans.

One final consideration is the robust creditor protection afforded to employer-sponsored retirement plans. Most qualified retirement plans (including most 401(k) accounts) receive unlimited protection from creditors under federal law. With certain exceptions, creditors cannot seize an individual's retirement plan funds to satisfy any debts and obligations, even in cases of bankruptcy. Funds in an IRA have similar protections, but currently only up to a set limit.

CONCLUSION

Choosing what to do with a 401(k) balance in the case of a plan termination can be a complicated decision. Engaging experienced financial professionals can help a participant navigate the decision-making process for retirement plan assets. An effective advisor should help estimate an individual's future retirement income needs and help determine how to allocate retirement assets to meet those needs. The decision comes down to a personal choice. However, many recognize this can be an opportunity to gain additional control over investment selection and add additional investment choices. Working with an experienced investment advisor, those choices become much more manageable. Prior to making your ultimate decision, we recommend discussions with a qualified tax professional and investment advisor. Johnson Financial Group's team of wealth advisors is here to help you navigate these types of decisions.



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	IRA	401(k)
Investment Options	Any publicly-traded investments with a few limitations	Limited to small set of investment options predetermined by Plan Administrator.
Movement of Funds	Unlimited transfers and reallocations. Short-term redemption fees may apply.	Limits defined by plan. Short-term redemption fees may apply.
Loans	Not allowed.	May be allowed by some plans.
Education Expenses	Can withdraw for qualified education expenses of owner, spouse, children and grandchildren of owner. Withdrawal is taxable, but penalty-free.	Can apply for withdrawal under plan hardship provision. Taxable and generally subject to 10% penalty.
Medical Expenses	Can withdraw for qualified unreimbursed medical expenses that exceed 7.5% of AGI, for medical insurance during period of unemployment and disability.	Depends on plan provisions.
Normal Distributions	Can begin at 59 1/2. Can start earlier without penalty under rule 72(t). Taxed at ordinary income rates.	Can begin at 59 1/2. Can start if separation from service occurs after age 55. Taxed at ordinary income rates.
Tax Withholding	At owners discretion may withhold at time of withdrawal or pay tax later in year.	Most plans have automatic withholding.
Fees	Controlled by owner based on investments made or investment advisor chosen.	Determined by plan sponsor.
Estate Issues	Unless in marital property state, can name anyone as primary beneficiary. Both spouse and non-spouse beneficiaries can allow tax deferral to stretch to the next generation.	Federal law dictates spouse as primary beneficiary unless spouse legally agrees to change. Under law both spouse and non-spouse beneficiaries can stretch however plan may not allow.
Creditor Protection	Rollover balances receive full protection under federal law. Protection of non-rollover balances varies by state and only applies when filing for bankruptcy.	Generally full protection under federal law regardless of whether you file for bankruptcy.

1 See IRS Publication 590, available at: <https://www.irs.gov/pub/irs-pdf/p590b.pdf>

2 See IRS Publication 590, available at: <https://www.irs.gov/pub/irs-pdf/p590b.pdf>

3 Choate, Natalie B., Life and Death Planning for Retirement Benefits, A Tax Plan Publications, 2010, 7th edition, p.200

4 See IRS "Retirement Plans FAQs regarding Hardship Distributions" at <https://www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-hardship-distributions>

5 See IRS, "Retirement Topics - Exceptions to Tax on Early Distributions," at <https://www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-tax-on-early-distributions>

6 See "Protection From Creditors for Retirement Plan Assets", The Tax Adviser, published by the American Institute of CPAs at <https://www.thetaxadviser.com/issues/2014/jan/naegele-jan2014.html>