

EXPLORING IN-SERVICE DISTRIBUTIONS

Many individuals mistakenly believe that all retirement benefits are not available until retirement or at least until they separate from their employer. This misconception may have originated in the defined benefit plan environment, where the retirement benefit has typically been an annuity payable to the retiree at age 65 or when they retire. The reality is both defined contribution and defined benefit plans can offer in-service distributions.

One dimension of the defined contribution plan revolution over the past 40 years is the liberalization of plan distribution rules that give participants access to retirement assets prior to retirement. But just because a plan participant may be able to take a distribution doesn't mean that he or she should. Whether a plan distribution is in the best interest of a participant is a question that can only be answered after weighing all the options (e.g., leaving the assets in the plan, withdrawing the assets, or rolling them over to an IRA or another employer's plan). When faced with a distribution decision, plan participants should evaluate each option by considering several factors, including the following: available investment options, fees and expenses, whether the plan sponsor pays plan costs, services, taxes and penalties, creditor protection, required minimum distributions and the tax treatment of employer stock.

Most defined contribution plans allow distributions once the individual leaves employment. However, many 401(k) and profit-sharing plans today give participants the ability to take all or a portion of their retirement benefits out of the plan before they leave employment. This early payout provision is known as an in-service/non-hardship distribution and rollover option. Income taxes and penalties may apply to these distributions, but if handled properly, they may not. That's why it is important for individuals to consult with their tax advisors before initiating any distribution. Even defined benefit plans have gotten into the in-service distribution act. Prior to 2007, defined benefit pension plans could not permit in-service distributions before normal retirement age (often defined as age 65). Pursuant to provisions of the Pension Protection Act of 2006 (PPA '06), defined benefit plans may include an in-service distribution option at age 62. The Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 lowered the earliest age to 59½. Consequently, if the plan document includes the appropriate language, defined benefit plan participants who have reached age 59½ may take a distribution while still working. Even governmental 457(b) plans can offer in-service distributions at age 59½ as a result of the Bipartisan American Miners Act of 2019. Most recently, SECURE Act 2.0 allows plans to offer in-service distributions to cover expenses resulting from emergencies, domestic abuse, disaster, terminal illness and/or long-term care insurance.

The in-service distribution option allows certain plan participants to receive some or all of their retirement assets while they are still employed. Rules regarding in-service distributions are detailed in federal pension law. The plan document will specify whether an in-service distribution provision is available to participants and any requirements and limitations that may apply. For example, a plan may limit the amount or frequency of taking an in-service distribution. The plan document specifies whether an in-service distribution provision is available, the conditions under which the working participant may take an in-service distribution, and, if eligible for rollover, any conditions that apply.

If a plan participant has the option of an in-service distribution and withdraws an amount, unless specified otherwise, he or she would have the following portability options:

- Roll over the assets to a new employer's plan, if permitted
- Roll over the assets to a traditional IRA
- Convert the assets in-plan to a designated Roth account or out-of-plan to a Roth IRA
- Cash out the account

The optimal choice is a question of suitability for the investor, and a distribution decision should only be made after reviewing information that is fair, balanced and not misleading.

EXPLORING IN-SERVICE DISTRIBUTIONS

Who should consider an in-service/non-hardship distribution and rollover?

Generally, investment and distribution options for plan participants can be very different from options available on individual IRAs. However, the decision to initiate a rollover should only be made after considering several factors, including available investment options, fees and expenses, services, penalties, creditor protection, required minimum distributions (RMDs) and the tax treatment of employer stock.

A potential candidate for an in-service/non-hardship distribution and rollover would be someone who:

- Is dissatisfied with the overall performance of his or her retirement plan
- Feels his or her investment options are limited in the plan and would like to access a wider range of investment options
- Has limited lifetime retirement income options in the plan and would like to explore options outside the plan

Availability of in-service distributions in retirement plans

Not all plans allow for in-service/non-hardship distributions, but many do. For example, more than 75% of all 401(k) plans today offer in-service distributions.¹ Of those that do, eligibility criteria vary. There is a general federal framework that sets limits as to when distributions can be permitted, but plan sponsors can establish more restrictive rules in their plan documents. Changes in plan design strategies have increased the ability for plan participants to take distributions. These design changes, such as allowing distributions once an employee leaves employment and permitting in-service/non-hardship distributions, have resulted in less focus on normal retirement age distributions. There are several reasons for easing plan distribution restrictions, including increasing plan appeal, supporting the concept of a phased retirement for employees and reducing plan sponsor liability.

Plan appeal

In many industries, such as technology, the competition for quality employees is intense. Plan sponsors must design their plans to be as appealing as possible to attract the best employees. Plan participants have come to expect some level

of control over their retirement assets. More liberal distribution provisions are positive plan features that have become an important part of the employee benefits package design process.

Supporting the concept of a phased retirement

More liberal distribution provisions, especially with respect to rollover dollars, have become almost a given. Many plans allow employees to roll money into company plans from former employers' retirement plans. Employers that permit rollovers into their plans will often also allow participants to take out their rollover balances at any time. This open-door distribution option for rollover dollars assures the participant that he or she will retain control over money that has already been liberated once from a plan, which makes the new plan more appealing.

The availability of in-service distribution options supports a phased approach to retirement. Today's workers are living longer and healthier lives than those of previous generations.² As a result, a growing number of workers either want or have to ease into retirement for financial reasons. The phased retirement concept allows employees to remain employed while reducing their work hours. An in-service distribution provision may be an ideal adjunct to a phased approach to retirement, allowing for access to retirement assets for income or to implement alternative investment options not available in the plan while reducing work hours.

Plan sponsor liability

The issue of employer liability is another consideration for the sponsoring employer when determining whether to include in-service distributions in a plan. The larger a participant's plan balance, the more financially feasible it may be for the participant to pursue some legal action against the employer sponsoring the plan, should the participant perceive there is a problem. For purely economic reasons, a participant with a \$10,000 plan balance is less likely to initiate legal action against the employer sponsoring the plan than a participant with a \$300,000 balance. By allowing in-service distributions, a dissatisfied participant with a larger balance may opt to move his or her assets out of the plan long before considering litigation. According to a 2025 report from the Employee Benefits Research Institute, the average balance of a participant in his or her 60s with 30 years of service was \$431,000, compared with an average balance of approximately \$30,000 for a participant in his or her 20s with a few years of service.³

¹ Plan Sponsor Council of America, 67th Annual Survey, 2024, and the Retirement Learning Center plan document database, 2025.

² Central Intelligence Agency Factbook, 2025.

³ EBRI Issue Brief, No. 641, August 28, 2025.

EXPLORING IN-SERVICE DISTRIBUTIONS

Types of in-service distributions

Different contribution types are often subject to different in-service distribution rules. The rules are driven by both legal requirements and plan document language. The availability of in-service distributions can be conditioned upon various circumstances, including the following:

Hardship: A plan may restrict in-service distributions to participants who can demonstrate a financial hardship. Hardship distributions are not eligible to be rolled into an IRA or other eligible plan.

Attainment of a specific age: Under this restriction, an individual still working for his or her employer may be eligible to take a distribution of some or all contribution types once reaching the designated age as outlined in the plan document. The in-service distribution option tied to the attainment of a specified age is a common feature with employers. Generally, employee salary deferrals, qualified Roth contributions, qualified nonelective contributions (QNECs) and qualified matching contributions (QMACs) are not eligible for in-service distribution until the participant attains age 59½. Employer contributions may be distributable prior to age 59½. The distribution recipient must be aware that if he or she is not age 59½ or is not rolling the distribution into an IRA or other retirement plan, the amount could be subject to a 10% early distribution penalty tax, as well as a mandatory 20% withholding for federal taxes on the gross amount distributed. As previously mentioned, defined benefit pension plans also may allow in-service distributions to workers at age 59½.

Completion of a specific period of service: Under this restriction, once a participant completes a specified number of years of service with an employer, certain contribution types may be available for an in-service distribution. For example, a plan may state that after five years of service, a participant may access vested matching contributions.

The following is a review of plan contribution types and their respective in-service distribution rules.

Special circumstances

Plan sponsors have some discretion to draft their plans to allow for in-service distribution options under "special circumstances." As a result of several law changes, in-service distributions may be available to certain eligible plan participants, such as:

- Active duty military personnel
- Eligible firefighters
- Domestic abuse victims

- Those who are terminally ill
- Long-service public safety employees

Similarly, plans can, but are not required to, allow eligible participants to take in-service distributions for:

- Birth or adoption expenses
- Emergencies
- Qualified federal disasters
- Long-term care insurance

The language of the governing plan document will specify which types, if any, of in-service distributions are available and the contribution sources that can be tapped.

In-service distributions of employer contributions

Some plans allow employed participants, who otherwise would not be eligible for distributions, to take withdrawals of their employer-provided contributions. Distributions of employee salary deferrals taken while still employed are only available under a separate set of hardship rules or after attaining age 59½.

If the plan permits, a 401(k) plan/profit-sharing plan participant may take an in-service withdrawal of employer contributions. The portion of the individual's account balance attributable to employer contributions that is eligible for an in-service withdrawal may depend upon the length of time the individual has participated in the plan. In some plans, participants with fewer than five years of service may only access assets that have been in the plan for at least two years. This rule is sometimes referred to as the "two-year bake" rule. Participants with five or more years of service are not subject to the two-year bake rule. The sponsoring employer may condition the withdrawal of employer contributions to situations of hardship, attainment of a specified age or completion of a specified period of service.

In-service distributions of employer contributions restricted to hardship

An employer may choose to limit in-service distributions of employer contributions to situations of hardship. In-service distributions as a result of hardship are not subject to the two-year bake rule. Instead, employers will frequently limit the amount of the in-service hardship withdrawal to the lesser of:

- The employee's vested balance in his or her individual account attributable to employer contributions
- The amount of the employee's immediate and heavy financial need

EXPLORING IN-SERVICE DISTRIBUTIONS

It is important to refer to the plan language for a concise definition of what circumstances constitute a hardship under the terms of the plan. Often, the plan will use the same definition of hardship that applies for distributions of employee salary deferrals. Note that hardship distributions are not eligible for rollover.

Hardship distributions of employee salary deferrals

Typically, employee salary deferrals may not be distributed prior to severance from employment, death, disability, plan termination, attainment of age 59½ or hardship. Hardship distributions of employee salary deferrals are not subject to the two-year bake rule, but the plan must limit the amount of the distribution to the lesser of the financial need or the participant's employee salary deferrals and certain other amounts. Effective for the 2019 plan year and beyond, the Bipartisan Budget Act of 2018 (BBA 2018) expanded the types of plan amounts that could be available for hardship distribution to include employee salary deferrals, qualified nonelective contributions, qualified matching contributions, safe harbor contributions and earnings from all eligible sources.

It is important to review the plan language for a concise definition of what circumstances constitute a hardship under the terms of the plan. Hardship distributions of employee salary deferrals are not eligible for rollover.

Self-Certification of Hardship

Under the original hardship distribution rules, a hardship distribution must meet three conditions:

1. There is an immediate and heavy financial need,
2. The amount of the distribution request does not exceed the amount required to meet the need, and
3. The participant does not have other assets reasonably available to meet this need.

The IRS has identified a number of "safe harbor" situations that are deemed to meet the first requirement [see Treasury Regulation 1.401(k)-1(d)(3)(iii)(B)]. If the plan follows the safe harbor definitions of hardship, then a participant could self-certify the second and third requirements above, but prior to 2023, the plan was required to substantiate the first requirement — that a distribution was for one of the safe harbor events that constitute an immediate and heavy financial need.

Effective for plan years after December 29, 2022, SECURE Act 2.0 expanded the self-certification to include all three requirements. Plan sponsors can rely on a participant's self-certification unless it has actual knowledge to the contrary. A similar rule applies to unforeseeable emergency distributions from governmental 457(b) plans.

Prior to 2019, the IRS required a participant to first exhaust all other distribution and loan options from the plan before allowing him or her to take a hardship distribution of employee salary deferrals. Effective for 2019 and later years as a result of BBA 2018, a participant is not required to take a plan loan, if available, before a hardship distribution is granted unless the plan document specifies otherwise. The IRS views a hardship as an immediate and heavy financial need if it is required to cover expenses for one of the following:

- Medical care for the participant, his or her spouse, their dependents and primary beneficiaries of the plan
- The purchase of a principal residence of the participant
- Tuition and related fees for the postsecondary educational needs of the participant, his or her spouse, their dependents or primary beneficiaries of the plan
- Prevention of eviction from the participant's principal residence
- Funeral expenses for the participant, parents, spouse, children, dependents or primary beneficiary
- Home damage expenses that qualify for the casualty deduction
- Certain expenses and losses (including loss of income) incurred by the employee on account of a disaster declared by the Federal Emergency Management Agency (FEMA)

Note: These rules are considered the "safe harbor" rules. Review the plan document to determine which circumstance may be considered a hardship for distribution purposes.

While the amount of the distribution cannot exceed the participant's financial need, it can be "grossed up" to include amounts to pay federal, state and local income taxes and any penalties. A 10% early distribution penalty may apply to the amount taken, but the participant can avoid it if a penalty exception applies, for example, in cases of disability. For hardship distributions made on or after January 1, 2020, no suspension of employee contributions is permitted in connection with a hardship withdrawal from any qualified plan, 403(b) plan or governmental 457(b) plan.

EXPLORING IN-SERVICE DISTRIBUTIONS

In-service distributions of rollover contributions

Rollover contributions are another important source of in-service distribution dollars. Rollover contributions are amounts a plan participant has moved into his or her current employer's plan from a prior plan or IRA. Many plans permit in-service distributions of rollover contribution amounts at any time. Considering that the average account balance of a participant over the age of 60 is \$431,000, and most plan participants of this age have changed jobs more than a dozen times, a significant portion of this balance could be attributable to rollover contributions.⁴

In-service distribution of after-tax account

If the plan document permits, it may be possible for a participant to request a distribution of 401(k) plan after-tax contributions while still working. The tax consequences typically depend on whether the individual rolls over or converts the amount to Roth assets and whether the distribution comes from pre-1987 or post-1986 after-tax amounts. Pre-1987 after-tax contributions can potentially be recovered without associated earnings if the recordkeeper has tracked these dollars. Post-1986 after-tax contributions and earnings in the account are subject to special "basis recovery rules" that require the participant to treat recovered amounts as consisting of a pro rata share of after-tax contributions and earnings.

Note: Based on the distribution treatment of pre-1987 after-tax contributions and the overall ratio of after-tax contributions to earnings, plan participants should consider whether to roll over an after-tax distribution to a traditional IRA or make a rollover conversion to a Roth IRA, or a mixture of both options. With the IRS guidance in Notice 2014-54, it is possible to accomplish a tax-free Roth IRA conversion.

The basis recovery rules that apply to after-tax accounts remain applicable, but Notice 2014-54 allows plan participants to direct the distributing plan administrator to pay the pretax portion of the distribution to a traditional IRA (resulting in a tax-free rollover) and the after-tax portion of the distribution to a Roth IRA (resulting in a tax-free conversion).

Conclusion

The first step in determining in-service distribution availability is to examine the governing plan documents. In-service distribution provisions, if available, will be included in the plan's Distribution section, or perhaps in an Amendments section, which is often found in the back of the document.

Second, one must look at the contribution types involved and when they are available for distribution and compare that information to the participant's plan statement. Employee salary deferrals may be subject to the most restrictive in-service distribution rules that are generally limited to situations of hardship, attainment of age 59½ or for special circumstances as allowed by the plan. The rules related to in-service distributions of employer-provided contributions and rollover contributions are usually more liberal.

Third, if a plan participant chooses not to leave the assets in the plan, he or she should determine the most suitable portability options. He or she should consider the availability of investment options, fees and expenses, services, potential taxes and penalties, creditor protection, RMDs and the tax treatment of employer stock.

Unless they are rolled over, in-service distributions are includible in taxable income and potentially subject to a 10% early distribution penalty if the amount is taken prior to age 59½ and no penalty exception applies.

It's important to remember that the option to take in-service distributions from an eligible retirement plan can be an important financial planning consideration for individuals and their advisors. The timing and nature of plan distribution choices could significantly affect participants' overall retirement income strategies. Plan participants are often unaware of their in-service distribution options and, therefore, could find it beneficial to work with a financial advisor to determine the best option for distributions and preretirement rollover possibilities.

EXPLORING IN-SERVICE DISTRIBUTIONS

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Columbia Management Investment Distributors, Inc., 290 Congress Street, Boston, MA 02210

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