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INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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The Honorable Paul Sarbanes
United States Senate
Washington, D.C. 20510-2002

Dear Senator Sarbanes:

This letter is in response to your correspondence of [REDACTED], on behalf of your constituent, [REDACTED]. Her former employer recently told her that it could not rehire her as a part-time employee after her retirement if she takes a distribution from her 401(k) account. [REDACTED] would like to know if there is a public law, rule or regulation that prevents her from taking a distribution from her 401(k) account upon retirement and then being rehired immediately as a part-time employee without benefits.

There is no definitive rule prohibiting the rehiring of an employee who has received a distribution from her 401(k) account. However, certain sections of the Internal Revenue Code (the "Code"), as well as case law and revenue rulings, impose restrictions on distributions from 401(k) plans that would explain the reluctance of [REDACTED] former employer to rehire her if she takes such a distribution. The underlying issue in her inquiry is whether she will have experienced a bona fide "separation from service" if she retires from full-time employment but returns to work, as was intended before she retired, as a part-time employee. The following authorities should help you to respond to her inquiry:

- **Distribution Rules For Qualified 401(k) Plans.** A qualified 401(k) plan must meet the requirements of section 401(k)(2)(B) of the Code which lists the circumstances under which distributions can be made from the plan. A qualified 401(k) plan may not distribute amounts attributable to the participant's elective contributions earlier than:
 - The employee's separation from service, death, or disability, or
 - An event described in section 401(k)(10) [which does not apply here].

In addition, if the plan document so provides, distributions can be made from certain (but not all) types of 401(k) plans under the following circumstances:

- The employee's attainment of age 59 ½ ; or

- The employee's hardship.¹

See section 401(k)(2)(B)(i) of the Code.

- **Determining If a Participant Has Experienced a Separation From Service.** Based on the information ██████████ has provided, the plan administrator is apparently treating her request for a distribution as due to her separation from service. The plan administrator or the employer has also apparently concluded that she will not have experienced a qualifying separation from service if the employer rehires her as a part-time employee after she retires.

The term "separation from service" is not defined by either the Code or regulations. However, its meaning has been explained in revenue rulings and case law. The basic rule is that, to receive a distribution from a 401(k) plan on account of a separation from service, the participant must have experienced a bona fide termination of employment in which the employer/employee relationship is *completely severed*. See e.g. Rev. Rul. 56-214, 1956-1 C.B.196; See also *Barrus v. United States*, 23 AFTR 2d 990 (DC NC 1969) (finding the participant had a true separation from service, even though he returned to employment with his former employer five months after he retired, because at the time of his retirement he had no intention of returning to work and was only able to return to employment following an unforeseen change in circumstances).²

Though relatively few authorities have considered whether a participant has experienced a separation from service when she changes from full-time to part-time employment with one employer, such a change apparently would not qualify as a separation from service. This is because the employer/employee relationship is not completely severed, but is simply modified when the employee changes her work schedule.

¹To find out if her 401(k) plan allows distributions upon reaching age 59 ½ or experiencing a hardship, ██████████ should ask the plan administrator or review a copy of the plan document or its Summary Plan Description.

²The rulings and cases cited analyze the meaning of "separation from service" for a Code provision other than 401(k)(2)(B), but the IRS has applied these analyses of "separation from service" to 401(k)(2)(B). See e.g. Rev. Rul. 2000-27.

In applying the above rule to [REDACTED] situation, compare, for example, the discussion in *Edwards v. Commissioner*, T.C. Memo 1989-409, 57 T.C.M. 1217 (1989) (stating that "...the statute leaves no room for a finding or conclusion that the reduction in [a participant's] work schedule from full-time to part-time constitutes a separation from the service") with the conclusion in Revenue Ruling 69-647, 1969-2 C.B. 100 (holding that a participant sustained a "separation from service" upon retiring from the service of his former employer, even though he subsequently performed services for the same employer on a part-time basis, because he performed those part-time services as a bona fide independent contractor and not as an employee of the employer).

[REDACTED] former employer may be reluctant to rehire her as a part-time employee after she takes a distribution from the 401(k) plan, as they had previously discussed, because she may not have had a bona fide separation from service as a result. Failing to enforce the separation from service requirement if a participant takes a plan distribution could be very serious. If a 401(k) plan makes a distribution to a participant due to a separation from service and it is determined that a separation from service did not actually occur, the 401(k) plan may be disqualified under 401(a) and 401(k). Plan disqualification results in adverse tax consequences to the employees participating in the plan and to their employer.

Finally, a participant may be able to qualify for a distribution from a 401(k) plan without there having been a separation from service:

- **Distribution Upon Reaching Age 59 ½**. As discussed above, section 401(k)(2)(B)(i) of the Code permits (but does not require) certain 401(k) plans to allow a participant to take a distribution upon reaching age 59 ½ (even if the participant continues to work for the employer). [REDACTED] should ask the plan administrator whether her 401(k) plan permits her to receive a distribution from her 401(k) account due to the fact she has reached age 59 ½ (even if she does not separate from service because she returns to part-time employment with the employer). Alternatively, she may review a copy of the 401(k) plan document or its Summary Plan Description to determine if she may take a distribution under these circumstances.
- **Hardship Distribution**. Although nothing in her letter indicates she is experiencing a hardship, [REDACTED] may also want to explore whether her 401(k) plan allows distributions for a hardship (even if she has not experienced a "separation from service") and whether she meets the plan's requirements for receiving a hardship distribution. In general, subject to the terms of the plan document, a hardship distribution will only be made (if at all) for an immediate and heavy financial need of the employee and only to the extent necessary to satisfy that need.

I hope this information will help you to respond to [REDACTED]. If you have additional questions or need further information, please contact me at (202) 622-6090 or Sara Schumacher at (202) 622-6010.

Sincerely,

Michael J. Roach
Chief, Qualified Plans Branch 1
Office of Division Counsel/Associate
Chief Counsel (Tax Exempt &
Government Entities)