

“THE LAW OF THE PLAN IS THE LAW OF THE LAND”

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By Andy Ives, CFP®, AIF®
IRA Analyst

When it comes to the rules governing specific workplace retirement plans like a 401(k), there are the foundational rules dictated by law, and there are “in-house rules” put into place by the plan itself. Plans can choose to be far more restrictive than what the law allows. For example, while loans are permitted to be taken from a 401(k), a specific plan can be designed to refuse all loan requests. Workplace plans can implement all sorts of restrictions that plan participants may not be aware of...until it comes time to access their funds. Plans are perfectly within their rights to do so, and any complaints will fall on deaf ears. When it comes to plan design, we like to say, “the law of the plan is the law of the land.”

In one egregious scenario, a small (20-employee) blue-collar business installed a 401(k) plan for its employees. The problem was that the business owner appeared to suffer from some level of paranoia. He was so concerned that an employee would quit and use his 401(k) funds to start a competing business that he designed the 401(k) to be incredibly restrictive when it came to withdrawals. In fact, participants could not access a penny of their retirement money – even if they separated from service – until age 65 or death.

Recently, I was contacted by a member of Ed Slott’s Elite IRA Advisor GroupSM whose successful client was preparing to retire early, at age 56, from a large medical company (approximately 300,000 employees). The client had a significant balance in her 401(k). The idea was for the client to delay a rollover of the 401(k) to her IRA until she was 59½. Until then, she would take periodic distributions from the 401(k) to cover whatever expenses she had.

On its surface, this seemed like a wise planning strategy. The advisor had done his homework and was aware of the “age 55 exception” to the 10% early withdrawal penalty. When a person leaves her job in the year she turns age 55 or older, she can take penalty-free withdrawals from the 401(k) held at that business. The age 55 exception is written into the tax law and is claimed on a taxpayer’s federal return using Form 5329. The advisor in this case also knew the age 55 exception applies to plan withdrawals only. It does not apply to distributions from an IRA, hence the need to leave the 401(k) assets where they were for a few years.

The advisor and his client contacted the 401(k) provider to explain their intentions...and their best-laid plans fell apart.

In fact, the plan design of this large 401(k) did not allow for partial withdrawals before age 59½. For anyone in the age 55 to 59½ range, the plan contained an all-or-nothing withdrawal rule. Essentially, this 401(k) legislated out the age 55 exception. Ultimately, it appeared the plan was intentionally structured this way to discourage early retirement among highly skilled employees who would otherwise be most likely to separate from service. Most of these employees have no idea how much the plan rules disadvantage them, and the plan is within its rights to do so.

It would be wise to get a handle on what your plan does and does not allow before it is too late. After all, the law of the plan is the law of the land.

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