

## **Lump-Sum Distributions**

### **The Wrong Decision Could be Costly**

If you are retiring or changing careers it's time to decide what to do with the funds in your 401(k) or other type of employer-sponsored qualified retirement plan. Your decision on how to receive your qualified plan distribution does have real life consequences that can mean the difference between living a comfortable retirement or wondering if your savings will last. Naturally, you want to protect what you've accumulated during your years of hard work.

There are a number of options available. Unfortunately, your distribution could be subject to a variety of taxes and penalties. A brief explanation of several potential tax pitfalls appears on the reverse. Ideally, you would like to select an option that meets your retirement needs, minimizes the impact of taxes, and avoids penalties.

### **Direct Rollover**

One way to avoid the 20% mandatory withholding tax, as well as current income taxes, is to directly roll your entire distribution into another qualified employer plan or Individual Retirement Account (IRA). An IRA is a tax-deferred account that can be used to receive retirement benefits distributed from an employer-qualified plan. And, since all earnings continue to accumulate on a tax-deferred basis, your money will compound and accumulate more rapidly than money placed in an otherwise identical taxable account.

When considering an IRA, many individuals have been attracted to the benefits of a self-directed IRA. This type of IRA gives you the power and flexibility to shift your investments as your goals and economic conditions change. Investments in an IRA can include stocks, bonds, money-market funds, government securities, unit investment trusts and mutual funds.

If for some reason you have already received your lump-sum distribution, minus the 20% withholding tax, all may not be lost. You have 60 days from the date you received your payout to invest these funds into an IRA or qualified plan, along with an additional 20% of your own money to cover the amount withheld. When you file your income tax return, you will receive credit for the 20% withheld. But remember, you only have 60 days to do this. If you fail to act, your entire payout will be subject to state and federal income taxes, and its tax-deferred status will be lost forever.

To establish a direct rollover IRA, ask your former employer's plan administrator in writing to transfer the funds to the trustee of the new qualified plan or IRA. The plan administrator must provide you with the opportunity to make a direct rollover.

### **Transfer Funds to Your Employer's Plan**

Consolidating retirement assets into a single location makes it easier to manage your overall retirement planning strategy. You can transfer the funds directly to its 401(k) plan or other type of qualified employer plan, avoiding current income taxes and the 20% withholding tax.

### **Establish a Conduit IRA**

If there's a waiting period for participating in your employer's plan and you do not want to leave funds with your former employer, ask your former employer to transfer your retirement account to a conduit IRA. A conduit IRA is designed specifically for temporary rollovers, to keep them separate from any other IRA funds you possess. If you commingle your qualified plan distribution with regular IRA assets or contributions, you cannot roll any part of it into another employer's plan at a later date.

### **Keep Funds in Your Old Employer's Plan**

For account values of \$5,000 or more, you may want to keep funds in your employer's plan until you reach the plan's retirement age or age 62, whichever is later, if that is an option. Because of the nature of the plan, your funds will continue to accumulate tax-deferred and can later be moved to a new employer's qualified plan or an IRA without penalty. If you are over the plan's retirement age or age 62, your company may insist that you take a payout in order to decrease the plan's administrative costs. If this happens, you still have the option to make a direct rollover to an IRA. Ask your employer for additional information.

### **Periodic Withdrawals**

This option may be suitable if you need funds to supplement your retirement income. The 20% withholding rules do not apply if a distribution is part of a series of substantially equal periodic payments that are made at least once a year and will last for:

- Your lifetime, or
- Your lifetime and your beneficiary's lifetime, or
- A period of ten years or more.

Keep in mind that the funds you receive will be subject to current income taxes. If you choose the "10 years or more" payment option and you are under age 59 1/2, you may be subject to the 10% early withdrawal penalty. If you are already receiving fewer than 10 annual payments, 20% of what you expected in a given year (and in future years) will be withheld. To avoid this, instruct your plan administrator to transfer the payments directly into an IRA. You can then establish a payout schedule to avoid the mandatory withholding tax.

### **Lump Sum in Company Stock**

Some plans may allow you to take your lump-sum distribution in company stock. If your distribution consists of such stock, the mandatory 20% withholding tax will not apply. But keep in mind that you will need to pay regular income tax, and may also be subject to the 10% early withdrawal penalty if you are under age 59 1/2. One way to avoid this is to ask the plan trustee to sell the stock and put the proceeds into an IRA within 60 days from the time you receive your lump-sum distribution. By doing this, you will avoid current income taxes and the early withdrawal penalty.

### **Don't Lose Out — Get the Facts**

Whether it is time to enjoy your retirement or tackle a new career, be sure to carefully weigh your lump-sum distribution options. If you choose to take your distribution in one lump-sum, you will have immediate and unrestricted use of your money. That's the good news. The flip side is that depending on your age and the amount of your distribution, you may be subject to a number of taxes and penalties. In addition, you will have that much less of a retirement nest egg. Because of the tax ramifications of your decision, be sure to consult with your tax advisor before any decision is made.

### **Tax Pitfalls**

Here are several potential tax problems that could occur when you receive a lump-sum distribution:

- State and federal income taxes will take a "bite" out of your distribution. When you were making contributions to your 401(k), you most likely did so with pre-tax dollars. In addition, employer contributions to a qualified plan on your behalf were also tax deferred. Now, it is time to pay the piper. Upon distribution, you have to pay current income taxes on all pre-tax contributions and earnings.

- Arguably, the most devastating tax problem is the mandatory 20% federal income withholding tax that is applied to eligible rollover distributions. If you elect to receive a check directly from your employer, you will only receive 80% of your distribution. In essence, if you expect to receive a check for \$100,000, your employer will withhold 20%, or \$20,000, and send you a check for \$80,000.

If these taxes aren't bad enough, a 10% early withdrawal tax (also known as a premature distribution penalty) will be imposed on the entire distribution if you are under age 59½, unless the withdrawal is due to death or disability or taken in substantially equal periodic payments. Certain other exceptions may apply.