RETIREMENT PLAN DISTRIBUTIONS AND ROLLOVERS

Quick Guide

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Introduction

Retirement planning is generally viewed as a three-step process.

- **Step 1** is the projection phase, where you determine how much to save for retirement.
- **Step 2** is the accumulation phase, where you save and invest for retirement. Depending on how much you've saved for retirement, you may still be in Step 2. Some people must still save even in retirement, so that retirement planning is an ongoing process.
- **Step 3** is the distribution phase, which is comprised of two interrelated parts:
  - Selecting a distribution option
  - Taxation of distribution options

Now that you're retiring, you probably thought the decision-making process was over. However, you now have to decide how you would like to withdraw money from your retirement plan(s). Some retirement plans have only one option. Other plans have several annuity options to choose from, as well as a lump-sum distribution option.

Which option is best for you depends on several factors, including your family situation and your ability to manage large sums of money. We'll discuss these options in this section. In many cases, the tax treatment of the retirement distribution does not have to be a controlling factor, because lump-sum distributions can be rolled over to an IRA within 60 days without tax consequences. But the tax consequences should be considered, and you must consider penalty taxes when making your distribution choice.

What Initiates a Distribution?

Certain events, including retirement, will permit or trigger your retirement funds to be distributed. When one of these events occurs, you must then make your choice (if one is available) as to the distribution method to be used. Events permitting or requiring a distribution must be specified in your qualified retirement plan document. Typical distribution events are:

- Retirement on or after attaining the plan's normal retirement age
- Financial hardship
- Death
- Attainment of normal retirement age
- Disability
- Attainment of age 70½, unless still employed. If you own more than 5% of the entity that sponsors the plan, you must begin taking minimum distributions at age 70½, even if you continue to work.

IMPORTANT NOTE: Distributions from a traditional IRA must begin at age 70½, even if you are still working.

- Other termination of employment, including early retirement
- Plan termination

Deciding on a Payout Option

The payout option you elect is probably one of the most important decisions you'll ever make. That's because your decision is irrevocable. Understanding your distribution options is crucial to your planning.

Retirement Plan Distribution Options

With a defined-benefit plan, your employer may give you a choice of a fixed monthly payout known as an annuity, a lump-sum distribution, or a combination of both. With a defined-contribution plan, you may be able to exercise these options:

- Annuitize your total investment and receive a fixed monthly income.
- Leave your money in the plan until you need it, or until the age that minimum distributions must begin (generally age 70½).
- Take it as a lump sum distribution and report it as taxable income in the current year, or defer taxes by either rolling it over to a traditional IRA, or by rolling it over to a new employer's plan within 60

days. You may be able to postpone distributions from your current employer's retirement plans if you are still employed, even if you are older than 70½. (This doesn't apply if you are a 5% owner; i.e., you own more than 5% of the company.) Distributions from a Roth IRA can be postponed beyond age 70½, whether you are employed or not.

SUGGESTION: If you have both a defined benefit plan and a defined contribution plan and don't need all the income at once, consider taking an annuity payout from your defined benefit plan and letting your money grow tax-deferred in the defined contribution plan.

Making the Decision: Annuity or Lump-Sum?

If retirement is five years or less away and you're eligible for a qualified retirement plan benefit, you should start evaluating which payout option might be best for you. While this decision doesn't become critical until retirement is staring you in the face, projecting which payout looks best can help you make necessary adjustments today. Should you save more for retirement or cut back on expenses? Will it be necessary for you to purchase additional life insurance? There are many small decisions along the way before making the big decision: *Should you take an annuity payout or a lump-sum distribution?*

IMPORTANT NOTE: You need to evaluate your alternatives. Understand that there is no single "right" answer. The optimal strategy is unique to each person because each of us has unique resources, circumstances, and goals.

Taxation of Distribution Options

Your choices of distribution of your retirement benefits generally include a lump-sum distribution, an annuity, or rollover to a traditional IRA or a new employer's qualified plan. Each of these distribution methods has different federal income tax requirements; an understanding of these will contribute to your decision of how to take your distribution.

You may want or need to take an early distribution of your retirement benefits, but you should be aware of the tax implications and possible penalties before you make this decision. Alternatively, you may want to defer your retirement plan distribution; you can do this for a time before minimum distribution requirements kick in.

If, after exploring these sections, you still have questions on the tax consequences of your distribution option choices, call your tax professional for assistance.

Lump-Sum Distributions

Some retirement plans offer only a lump-sum payout at retirement. In this case, is it better to pay taxes at distribution or defer taxes by rolling over the amount into a traditional IRA? A traditional IRA can serve as a place to continue the tax-deferred sheltering of money from your employer retirement plans. If you have your employer plan transfer the money directly into a traditional IRA, i.e., a direct rollover, no taxes are due until you begin to withdraw the money.

A lump-sum distribution is a distribution of all the money in your retirement plan in one large lump-sum. A payment qualifies as a lump-sum distribution if it meets the following requirements:

- The distribution is payable on account of death, attainment of age 59½, or separation from service.
- All the contributions and earnings in all your qualified retirement plans (i.e., pension, profit-sharing, or stock bonus plans) are paid out.
- The payment is made in one taxable year.

You will generally have three choices if you go this route:

1. You can roll all or part of it into a traditional IRA or Keogh or other qualified plan within 60 days and defer paying income tax.
2. You can convert a traditional IRA into a Roth IRA. You are required to pay tax on the deductible and pre-tax contributions and any earnings on the date of the conversion. The 10% early distribution penalty does not apply on the conversion.
3. You can decide to keep money and pay income tax on it.

Advantages and Disadvantages of a Lump-Sum Distribution

Advantages:

- You can roll the money into a traditional IRA within 60 days and continue to defer income taxes.
- You may convert the traditional IRA to a Roth IRA and enjoy tax-free growth and distributions (however there are potential taxes due from conversion).
- You have your money in hand and thus don't run the risk of dying prematurely and losing all of your future annuity payments.

Disadvantages:

- You have to actively manage your pension amount.
- There is a large up-front cash drain to pay income taxes on the entire distribution if it is not rolled over to a traditional IRA or other eligible plan.
- Depending on how the money is invested, future earnings on the amount distributed may be fully taxable.
- Distribution may be subject to the claims of creditors in the event of personal bankruptcy, even if rolled over to an IRA.

IMPORTANT NOTE: When you leave your job, one decision to make is whether the investment managers or investment opportunities through your employer pension plan are better than those available to you through an IRA rollover. Keep in mind that the investment management of your prior employer's pension plan may change, so monitor your investment performance to make sure your investments are still meeting your objectives.

Annuity Payouts

Your company may allow you to receive your qualified retirement plan monies as an annuity, in which a series of payments is made according to a predetermined schedule. If so, you may want to compare your company's annuity offer to the benefits you would receive by rolling over a lump-sum retirement distribution into a single premium immediate annuity you can get through an insurance company.

Assuming all of your retirement plan contributions were made with pre-tax dollars or your retirement plan is employer funded, each payment from your company annuity (or the insurance company annuity) would be taxable as ordinary income when received. If you made any after-tax contributions, a portion of each annuity payment would be tax-free.

Your financial professional can help you determine if an annuity payout is your best option.

Rollover into a Traditional IRA

If you don't need your retirement money in a hurry, rolling it over into a traditional IRA may make sense. Instead of putting the money into a bank account or other investment and paying tax on the earnings, you can defer taxes on both the contributions and the earnings if you put the money in a traditional IRA. By rolling funds into a traditional IRA, you generally will have more control over the timing of the distribution payments and the investment of the undistributed funds. You can invest the money in practically anything you want (there are a few restrictions, such as not being able to invest an IRA in collectibles), although we suggest you remain more conservative in your retirement years.

It is to your advantage to make it a direct rollover. This way, you don't have to get involved in the transfer and no income taxes will be withheld. If you are still working in retirement, you may have the option of rolling your qualified retirement plan money into the new employer's qualified plan.

IMPORTANT NOTE: If you receive the distribution (i.e., you don't do a direct rollover) and then decide to roll it over to a traditional IRA, you must complete the rollover generally within 60 days.

IMPORTANT NOTE: Since the federal government limits contributions to qualified plans, some employees also participate in nonqualified plans. Unlike qualified plans, money from a nonqualified plan generally cannot be rolled over into an IRA.

Advantages and Disadvantages of Rollover to a Traditional IRA

Advantages:

- No current taxes due at distribution if a direct rollover.
- Assets are invested in a tax-deferred environment.
- Opportunity to invest the cash that would otherwise go to taxes until ultimate distribution.
- You may convert the traditional IRA to a Roth IRA (however there are potential taxes due from conversion.)

Disadvantages:

- The tax rate on amounts distributed from the IRA may be higher depending on your tax bracket during distribution years.

IMPORTANT NOTE: The higher tax rate paid on IRA distributions may be fully offset by the tax deferral advantage of the IRA environment.

- Long-term gains on equity investments inside the IRA (normally taxed at a maximum rate of 15% outside the IRA for many taxpayers) are taxed at ordinary income tax rates (up to 35%) upon distribution.

Penalty Taxes Related to Distributions

20% Withholding

If you are receiving a distribution from a retirement account that is eligible to be rolled over and you don't transfer it directly (i.e., a direct rollover to a traditional IRA or other qualified plan), 20% will be withheld to pay for federal income taxes. This is the case even if you eventually roll the funds into a traditional IRA within 60 days of receiving the distribution.

IMPORTANT NOTE: If you don't do a direct rollover, but you do roll over the distribution within 60 days, you won't owe taxes on the amount you roll over. But watch out – you've received only 80% of your distribution (remember 20% was withheld) and thus, you are rolling over only 80%. So you have to come up with the other 20% that was withheld to pay taxes (generally within 60 days) or else, you will be taxed on the 20% you didn't roll over. As long as you roll over the entire retirement distribution, it won't be taxable. You can claim the 20% withholding on your federal income tax return.

SUGGESTION: Elect a direct transfer from your retirement plan to a traditional IRA or other qualified plan to avoid the withholding rule.

Early Distributions

You need to consider potential penalty taxes for early distributions and distributions of less than the required amount when making your distribution choice.

Most retirement accounts allow you to begin withdrawing money, without penalty, after age 59½. But, there is a 10% penalty tax on withdrawals made before age 59½ (if you don't roll it over) from any retirement account, unless the distribution is made under one of the limited circumstances allowed by law (see below); i.e., there is a penalty for taking your money too soon. Consult your tax professional if you are under age 59½ and you are considering taking any distributions from your retirement plans.

Some Exceptions to the 10% Early Withdrawal Penalty before Age 59½

The 10% penalty doesn't apply to these situations:

- Distributions made after you separate from service during or after the year in which you reach age 55. But beware: This rule doesn't apply to IRAs.
- Distributions that you roll over to another qualified plan, tax sheltered annuity, or IRA within 60 days.
- Distributions made due to disability or after the employee's death.
- Distributions for qualified medical expenses that exceed 10% (7.5% for age 65 or older) of adjusted gross income.
- Distributions after separation from service that are part of a scheduled series of substantially equal periodic payments. The separation from service requirement does not apply to IRAs.
- Distributions from an IRA to pay for qualified higher education expenses.
- Distributions from an IRA to qualified first-time homebuyers up to a $10,000 lifetime limit.

Mandatory Withdrawals

For many people, retirement plan balances will provide most of the financial support to funds cash flow needs in retirement and through life expectancy; therefore it is important to properly plan for and be aware of retirement account distribution requirements. There comes a point in your life when it is mandatory that you begin taking distributions from your retirement accounts. That magic age is 70½, when something called "required minimum distribution" (RMD) kicks in. In the case of IRA holders, it applies even when the person is still working. Those who participate in tax-qualified retirement plans, such as 401(k) plans, but continue to work, are not subject to the minimum distribution requirements (unless they own 5% or more of the employer, in which case they must take distributions) until retirement.

Minimum Distribution Requirements

Generally, you are required to take minimum annual RMDs from most of your qualified plans, including your 401(k), no later than April 1 of the year following the year in which you reach age 70½. The RMD requirement does not apply to Roth IRAs. Distributions for the following years must be made by December 31st of each year. You can postpone RMDs from your current employer's qualified plans, (but not from your traditional IRA) if you are still working, until after you retire at whatever age that may be. This doesn't mean you have to take all the money out at once. The RMD for each year generally equals the retirement plan account balance as of December 31 of the previous year divided by your applicable life expectancy, as defined by IRS life expectancy tables.

NOTE: In any year you can take more than the required minimum distribution.

IMPORTANT NOTE: If you fail to begin taking minimum distributions, you will be subject to a 50% penalty on the difference between the minimum distribution that was required to be made and the actual distribution that was made, one of the steepest penalties imposed by the IRS. Therefore, remember to begin taking the minimum required distributions, or you could stand to lose quite a bit of money.

403(b) Plans

Public employees and employees of not-for-profit organizations have other types of plans available to them which are similar to a 401(k), but are different when you take a closer look. 403(b) plans are available to employees of public educational organizations and tax-exempt organizations. Section 457 Plans are available to state or local government employees and employees of non-church tax-exempt organizations.

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403(b) plans, like 401(k) plans, allow you to make elective pre-tax contributions to the plan and to defer tax on income until retirement. Distributions from a 403(b) plan are taxed as ordinary income.

What makes a 401(k) plan different from a 403(b) plan?

The major differences between a 401(k) plan and a 403(b) plan are as follows:

- 403(b) plans have special increased contribution limits for employees who have completed 15 years of service with certain types of organizations. This feature is not available in a 401(k) plan. Other special contribution limits, not available in 401(k) plans, may be available for church employees.
- Your company's 401(k) plan may offer many different investment options. In contrast, 403(b) plan investments are limited to annuity contracts and mutual funds.
- Your 403(b) plan benefits that accrued prior to 1987 are not subject to the minimum distribution rules, assuming records have been maintained splitting out your pre-1987 benefits

403(b) Contribution Limits

The IRS places an annual dollar limit on your pre-tax contributions to a 403(b) plan. The limit is indexed for inflation, so that in future years, the dollar limit may be higher. This limit in 2016 is $18,000 (same in 2015), plus up to $6,000 (same in 2015) of catch-up contributions if you are at least age 50. In addition, if you have completed 15 years of service to qualified institutions and meet other conditions, you are eligible for additional Lifetime Catch-up contributions (contact your benefits administrator for details). All pre-tax contributions made to any 403(b), 401(k), SEP, or SIMPLE plan are counted towards these limits.

Overall Contribution Limits

The total annual contribution that can be made in 2016 to your 403(b) plan, as with a 401(k) plan, cannot exceed 100% of your compensation or $53,000 whichever is less (same in 2015).

If you are eligible to participate in a 403(b) plan, and require more detailed information, contact your benefits department. ♦