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Keep retirement money intact

If you expect to receive a distribution from your employer's pension, profit sharing or 401(k) plan, there is some important information you should know. Without understanding lump sum retirement plan distributions, you might have to hand a portion of your hard-earned retirement money in unnecessary taxes and penalties to the IRS.

Your employer is now required by law to automatically withhold 20 percent of the distribution unless you elect to roll over your distribution directly into an eligible retirement plan, such as a traditional individual retirement account (IRA) or a new employer's plan. The law impacts almost all distributions, including those due to termination of employment.

Distributions made payable to you

Generally, a plan distribution that is paid directly to you may be subject to the 20 percent tax withholding. This means that you would take home only 80 percent of your total plan distribution. The 20 percent withheld would be sent to the IRS and credited toward your federal income taxes. Furthermore, if you take a distribution before age 59 1/2, you may be subject to an additional 10 percent tax penalty for an early withdrawal.

After you receive your distribution, if you decide that you would like to roll it over, the following options are available:

- You may roll over the 80 percent that you received within 60 days. The remaining 20 percent would be considered taxable income.
- You may roll over 100 percent of the amount of the distribution within 60 days by coming up with the cash to replace the 20 percent withheld, which would be credited toward your current year's tax liability.

But it's easier to just avoid the 20 percent tax withholding by arranging for a direct rollover with your employer.

Avoiding the 20% withholding with a direct rollover

Rather than receive the distribution directly, you have the option to elect to have all or part of your eligible distribution rolled over from your company's retirement plan to a traditional IRA, or to your new employer's plan.

A rollover IRA, or conduit IRA, is established for the sole purpose of receiving an eligible distribution from a qualified plan. A rollover IRA is designed so that you can subsequently roll the money over into a new employer's qualified retirement plan. You can, of course, leave the money in the rollover IRA and continue to benefit from tax-deferred growth and the wide range of investment choices typically available.

If, however, you wish to maintain the option of being able to eventually roll the assets into a new employer's plan, you may not make additional IRA contributions to the rollover IRA. The rollover IRA must hold only those assets received from a former employer's qualified retirement plan as well as the gains and earnings on those assets. You would need to establish a separate IRA, commonly referred to as a contributory IRA, to make your annual contributions of up to $2,000.

If you decide to have your distribution rolled over to an IRA, be sure to contact the institution where your IRA will be established to obtain the necessary paperwork and instructions on forwarding the distribution. But keep in mind that you must instruct your company to make the check payable to the IRA custodian and not to you in order to avoid the withholding.

Direct rollover to another qualified retirement plan

If your new employer has a qualified retirement plan, ask the administrator of the plan whether rollover deposits are accepted. If they are, you have the additional choice to initiate a direct rollover to the plan by having your former employer's plan trustee transfer the funds directly to the new employer's plan trustee. If the plan does not accept rollover deposits, you can initiate a direct rollover to an IRA as described above.

Making your decision

The rules regarding distributions can be complex and contain many conditions and exceptions. To help you decide how to receive your distribution, your employer is required to give you a written notice which describes your options, including direct rollovers. Take the notice and any plan benefit statements you may have to your tax advisor so he or she can advise you before you take any distributions. Your financial advisor can help you review your retirement portfolio and implement strategies in accordance with your goals.