*When receiving a lump-sum distribution, the question of what to do with the assets can be complex. IRAs rollovers are often used, and it pays to understand how they work.*

# Rollover Options When Receiving Distributions From Employer Plans

By Michael E. Leonetti

Ever since individual retirement accounts (IRAs) were first introduced, people have used them as a shelter for lump-sum distributions from their employer retirement plans, since lump-sum distributions that are not rolled over are subject to tax and, if received before age 59½, a 10% early distribution penalty. Using IRAs for this purpose is on the increase now that more people are beginning to understand them.

While you may not have any other pension or retirement plan now, or you may believe you will remain covered under your current employer's plan until you retire and then take a monthly benefit check rather than a lump-sum distribution, it is still smart to have an idea of the IRA rollover option and how this works, since working lifetimes are lengthy and circumstances can change greatly.

The main difference between IRAs and qualified retirement plan proceeds, insofar as they relate to potential rollovers of lump-sum distributions, is that in general the tax treatment of a lump-sum distribution from an employer plan is more favorable than distributions from an IRA: A portion may be taxable as long-term capital gains, and some or all of it may be subject to a favorable averaging rule. However, the money rolled into an IRA from an employer plan will continue to pile up tax-sheltered earnings, and in time, this could more than offset the less favorable tax treatment given IRA distributions when you begin withdrawing money.

Complicating your choice when you are given a lump-sum distribution is the fact that you could roll your distribution into an IRA and use this as a "conduit" that could then be rolled back to your new employer plan at some later date—if the new employer will allow it. Thus, when you are given a lump-sum distribution, there are many important implications and decisions to be made. Additionally, you may have only 60 days in which to make these decisions, which could have a profound affect on your financial situation for many years to come.

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## Rollover Basics

***When Can Employer Rollovers Be Made?*** The first question most individuals have is: When can I receive a lump-sum distribution from my employer retirement plan that can be rolled over tax- and penalty-free into an IRA? Some of the situations include the following:

- If you leave your job for any reason, whether voluntary or because your services have been terminated;
- If your employer ends a pension plan or permanently stops making payments to a profit sharing or stock bonus plan and gives you your complete share;
- If you are age 59½ or older;
- If you die and your spouse is your beneficiary—in that event your spouse may roll your death benefits over from the plan into an IRA (with the exception of a death benefit exclusion, which will be explained later); or
- If you receive a distribution or under a domestic relations order—that is, if it is part of a divorce or separation settlement.

Ordinarily, rollovers into IRAs from a prior plan involve total distributions from the plan. But under some circumstances, you are now allowed to take partial distribution from your employer plan and roll it into an IRA.

***Self-Employment:*** If you stop being self-employed, you must still keep the money in a Keogh plan (or IRA) until age 59½, or pay the tax penalty if you take it out before then. However, if you are self-employed and become permanently disabled, even if under age 59½, you are allowed to take a lump-sum distribution of everything in your Keogh plan or IRA without a tax penalty. Of course, you would have to report the distribution as income and pay income tax on this.

***Employer Plan Rollovers and the 60-Day Rule:*** As with IRA-to-IRA rollovers, rollovers from an employer plan must be completed within 60 days of the date the assets are distributed to you.

If you are given the distribution because you were unexpectedly terminated from your job, you receive very little time to make what could well be the most important financial decision in your life. The sum in an employer plan distribution could be the largest you will ever handle and its disposition could have a great effect on your financial security and that of your beneficiaries.

During the time the assets are under your control after the distribution, and prior to being rolled over, you must take any money earned by those assets into your income for that year. The earnings on the money during that time, prior to roll over, should not be rolled over into an IRA later. You should contribute no more than the original distribution amount if you decide to complete the rollover.

You should also be aware that if you receive the lump-sum distribution, an employer is required to withhold 20% for income tax purposes. If you then decide to roll the assets into an IRA, you must roll over the entire distribution within the 60-day period, which means you must make up the 20% difference with other funds or that amount will be treated as a taxable distribution and possibly subject to the early withdrawal penalty (if you are under age 59½). [For more on this, see the Retirement Plans column in the August 1996 issue, "Straightforward Answers to Common Questions on Retirement Plan Rules," by Clark Blackman and Kevin McAuliffe.]

***Qualified Plan Rollovers Can Be Made at Any Time:*** An important difference between employer plan rollovers and IRA-to-IRA rollovers is that rollovers out of or into employer plans are not subject to the once-a-year rule—that is, they can be made at any time. Thus, if you lose your job and roll an employer plan distribution into an IRA, you could roll that money right back into another employer plan if you got a new job and the employer allowed the rollover. However, when assets are in your IRA, moves to another IRA would be covered by the IRA-to-IRA rules. If you move the assets to another IRA with a rollover, the move would be covered by the once-a-year rule. Trustee-to-trustee transfers, on the other hand, can be made at any time. Thus, if you had transferred the assets directly from one IRA trustee or custodian to another, you can move them as often as you wish. Trustee-to-trustee transfers also help avoid the withholding tax problem discussed above, since a direct transfer is not subject to withholding.

***To Keep the Roll Back Option—Don't Mix Assets:*** After you roll assets from an employer plan into an IRA, unless you have taken only a partial distribution from the plan, the law allows you to roll them back (along with any tax-sheltered earnings while they were in the IRA) to another employer plan at a later date. For some people, retaining this option would be a good idea. To retain this future option, however, you must not mix these former employer-plan assets with any other IRA assets. Thus, it is a good idea not to roll money or any other assets from an employer plan to an existing IRA if you wish to retain this option, even if the existing IRA only has a few dollars in it. Instead, you should set up a separate IRA for the assets being rolled over from the qualified plan, and then you should not make any additional IRA contributions to this account.

***You Need Not Roll All the Assets Over:*** When you receive a distribution from a qualified plan, you are not required to roll over all of it. If you wish, you may rollover part of the assets tax- and penalty-free, and spend the remainder (paying taxes and any penalty on this amount). Additionally, you may roll over the assets into more than one IRA account. These rules give you a lot of flexibility, particularly with a large employer plan distribution.

***Non-deductible Voluntary Contributions Should Not Be Rolled Over:*** Some employer plans allow employees to make voluntary contributions that you are not allowed to deduct from your income. Although the employer's plan shelters the earnings of those contributions from taxation, the contributions are made with aftertax dollars. If you roll employer plan assets into an IRA, you should not roll over any portion that consists of voluntary non-deductible contributions. Before completing the rollover, take those contributions out and keep the money. Your employer should give you a statement totaling your voluntary contributions. That money doesn't have to be added to your income since it has already been taxed.

***Rollover of Property Received in a Distribution:*** A rollover from an employer plan may also include property—most typically, stock in the employer's company. Unlike an IRA-to-IRA rollover where the exact property received must be rolled over, you are allowed to sell property received from an employer plan, and then roll the proceeds into an IRA. If you roll over the property or the proceeds from the property sale into an IRA, there would be no gain or loss to report on your return for that year. If you decide to sell property but do not roll over the entire proceeds, you would be taxed on the part you do not roll over.

***Rollover by a Surviving Spouse:*** A surviving spouse is allowed to roll over an employer's lump-sum distribution into an IRA of her or his own. This could happen either upon the employee's death or because of the termination of the employer's plan after the employee's death.

The surviving spouse may keep the IRA assets separate from other IRAs, commingle them with other IRA assets, or make additional contributions to them. However, assets received from an employer plan by a surviving spouse cannot be rolled into any other employer plan.

In some circumstances, the surviving spouse may be allowed to exclude up to $5,000 of a lump-sum distribution from income during the year of the distribution. This is called a death benefit exclusion, and no part of it can be rolled over into an IRA.

### Rollovers If You Are Still Working

You may find yourself receiving a lump-sum distribution of your entire share of an employer's qualified plan while you are still working. In this case, you may have a number of questions to ask yourself such as:

- Should you leave the money in the company plan (if possible) and allow it to grow there?
- Should you roll the entire employer plan distribution into an IRA?
- Should you take part of the money, pay taxes and penalties on it, and roll the remainder into an IRA?
- If you go ahead with a rollover, should you preserve the option to roll it back to some other employer plan by always keeping the assets separate from your other assets?

The answers to these questions may lie in your answers to other related questions. For example, whether you should leave the money in your company plan may depend largely on how you feel about the company, how well the company plan is doing (or might be expected to do in the future), and the options available under the company plan. Additionally, it may depend upon whether or not you have an immediate and pressing need for the money. It might also depend on whether you can roll the assets over to a plan with a new employer immediately—or that you will have to put them into an IRA conduit instead, possibly not knowing if you'll ever find another employer willing to accept them. A good general rule of thumb to follow is to consider leaving it in the employer plan for at least awhile until you have time to consider all of your alternatives.

As for rolling the entire distribution over, it may depend upon age. If you have many working years ahead and there is no immediate need for this money, it might be well-advised to roll the entire amount into an IRA even though you may risk losing favorable tax treatment given to employer plans if you take a lump-sum IRA distribution later. The tax-shelter earnings in your IRA could more than offset the difference.

If you have a pressing need for the money, such as where you have lost a job and have no other financial resources, you may need the distribution to live on, or you may decide that its best use would be to assure your child's education or to buy a home. Keep in mind, however, that in addition to incomes taxes, you will have to pay a 10% penalty for early distribution if you are not yet age 59½ (55 for certain employer plans), so make sure you balance your needs against the penalty.

### Rollovers When You Retire

A different set of factors come into play if you are given the opportunity to receive a lump-sum distribution from an employer plan when near or at retirement. In the past, individuals almost always received retirement benefits in the form of fixed monthly payments for the rest of their lives with some additional death benefits for the beneficiaries. This pattern has continued to change, particularly with the introduction of 401(k) plans, and the demand for lump-sum payments is becoming so insistent that nearly every pension plan offers this option even with defined-benefit plans. If you are given this option when you retire, you may have to make the following decisions:

- Should you roll your distribution into an IRA or keep it all?
- Should you take part of the distribution and roll over the other part?
- Should you take the lump-sum distribution or, if given the option, take regular monthly benefits for the rest of your life (this option is usually given for distributions from defined-benefit plans).

Again, many factors must be weighed.

Taxes aside, for many people the choice of keeping their distribution or rolling it over comes down to what you want to do rather than what a financial adviser thinks is best. It's not uncommon for people receiving a large distribution to prefer to pay the tax and use the remainder for luxuries that they could never afford before. In their minds, the pleasure the money buys them more than offsets the loss of additional retirement income.

On the other hand, if your goal is to build as big a retirement fund as you can, roll everything into an IRA and don't touch it until you have to. Allow the IRAs' tax-shelter leverage to work for you as long as possible. Obviously, the size of the IRA rollover has an impact on this decision, along with the mandatory distribution rules. Good tax advice will definitely be needed here. However, all things being equal, it is generally most beneficial to roll everything into an IRA and continue to shelter the earnings from taxation.

If you are offered a monthly payment option, one question to ask is whether or not you are the sort of person who spends everything you get. If so, you may want to give careful thought to the method of distribution. Unless you are assured of a retirement income from other sources, not taking the lump sum might be your better bet. And, you should ask yourself whether you are capable of investing a large sum yourself. If you are, would you worry a lot if you had to do so? And you need to consider how long you can reasonably be expected to live or to continue earning income if you are still earning or planning to continue in a different line of work. You should also consider what your other retirement income sources are and whether a spouse or other beneficiary will rely on your retirement income. Finally, what death benefits would your beneficiaries receive under the employer plan when you die?

[For a more extensive article discussing the tax implications and rules regarding distributions upon retirement, see "Distributions From Retirement Plans: A Look at the Options," by Clark Blackman and Kevin McAuliffe, in the April 1995 *AAII Journal*].

### If in Doubt, Roll It Over

If you are not sure what to do with a lump-sum company plan distribution when you receive it, roll it into an IRA. But, be sure to open a new IRA for these proceeds. At this point, do not commingle this money with money in an IRA that already exists. This way, you can preserve the IRA option while making up your mind. It may also give you time to concentrate on more important immediate matters, such as finding another job if you are given the distribution because you are unexpectedly terminated.

Of course, if you open an IRA while still unsure if you wish to keep it, select one that will allow you to withdraw the money later with little or no delay and without paying sponsor penalties or large termination fees.

Frankly, it might be prudent to tell the IRA sponsor what you are doing and obtain assurances that, if you wish, you can close out the IRA with a minimum of delay.

## Conclusion

When receiving a lump-sum distribution, the question of how to handle the rollover of these assets, whether to process a direct transfer or whether to take the rollover at all, can be a complex task and definitely an important one. With the complex tax rules involving these types of distributions, it would be wise to talk to a professional.

Often these dollars represent the largest single element of your net worth and you definitely want to avoid any mistakes here.

# Investor Web-Sightings

***Sites we've found on the World Wide Web that may be of interest to individual investors:***

**Chicago Stock Exchange**
http://www.chicagostockex.com
For each company on the Chicago Stock Exchange, this site gives its ticker symbol, investor contact, phone and fax numbers, Web address, company description, and name of specialist firm at Chicago Stock Exchange. You can click on the ticker symbol for a delayed quote and select current fundamental data. The site also contains links directly to the Web sites of listed companies.

**Life Insurance Analysis Center**
http://www.underwriter.com
Geared to helping you to learn about life insurance, analyze your own insurance needs, and obtain quotes on particular policies. The site presents a short introduction on the differences of basic insurance types and describes two methods for analyzing your needs: income replacement and needs fulfillment. The site takes you through the process used in each method, then offers quotes for specific insurance policies based on your answers to general questions about yourself and your health. You are not required to give your name or contact information in order to receive insurance policy quotes.

**Mutual Funds Interactive**
http://www.brill.com
This site contains profiles and interviews with close to 50 mutual fund portfolio managers. Feature articles and news on mutual funds are reported along with analyst recommendations. A mutual fund newsgroup is also accessible through this site. Basic introductory information about mutual funds and fund investing is excerpted from the book, "The Complete Idiot's Guide to Making Money with Mutual Funds." Links at this site provide mutual fund quotes, charts of prices, and toll-free numbers of mutual fund families. Other linked sites include NETworth, EDGAR filings and information on fund legislation and Canadian mutual funds.

**Securities and Exchange Commission (SEC)**
http://www.sec.gov/
Investors can read news digests and public statements released by the SEC, along with recent SEC enforcement actions and investor alerts. When appropriate, the public is invited to post opinions on SEC proposals. Under the section "What Every Investor Should Know," users can access a variety of readings on avoiding securities fraud and abuse and investing wisely. A search engine allows users to retrieve SEC news, enforcement actions, and reports on a particular subject of interest. A list of municipal securities information repositories and state information repositories is available, along with a directory of state securities regulators. A search engine and link to the EDGAR database of corporate information is also included, which holds SEC-required filings made by public corporations. Links to related sites include other government and educational Web sites, including White House, the Senate, the House of Representatives, the Library of Congress, and FedWorld.

**Standard & Poor's Equity Investor Services**
http://www.stockinfo.standardpoor.com/
This site provides information and statistics on the S&P indexes. It reports the previous day's closing value, and the current month and year-to-date total return of each index. Figures on the total market value, price-earnings ratio, and dividend yield for the indexes are found under a description of each index. A complete listing of companies that comprise the indexes can be found, as well as breakdowns by industry and exchange. Updates on stocks dropped or added to each index are also reported. You can order S&P reports and subscribe to other S&P on-line services for a fee.

***Web Address Corrections***

These sites were described in the April 1996 issue of the *AAII Journal*. Their corrected Web addresses are as follows:

**MIT Artificial Intelligence Lab's Stockmaster**
http://www.stockmaster.com

**Department of Finance—Ohio State University—The Financial Data Finder**
http://cob.ohio-state.edu/dept/fin/osudata.htm