Retirement Plan Distribution Pitfalls

Article Highlights:

- Distribution Hazards
- Trustee-to-Trustee Transfers
- Rollovers
- Taxability
- Withholding Requirements
- Early Withdrawal Penalty

When an individual retires or leaves an employer's service, the individual will be required to take a distribution from the employer's retirement plan (if the employer had a plan). Depending on the employee's age and the plan's terms, a distribution may not be required immediately, but when it's time to take the distribution there are a number of tax pitfalls that can create some very big tax headaches for the employee. This article will explore those hazards and discuss how to avoid them.

First and foremost, if the employee does not transfer or roll the distribution over into another employer's qualified plan or an IRA, the entire taxable amount of the distribution will be included in the employee's taxed income for the year of the distribution. In addition, if the employee is under 59-1/2 years of age at the time of the distribution, the employee may also be subject to a 10% early withdrawal penalty on the taxable portion of the distribution.

There is also a major distinction between rolling over the distribution and having it directly transferred to another qualified plan or IRA account. A rollover is when the individual actually takes possession of the funds and then, within the statutory 60-day limit, deposits the funds into another qualified plan or IRA. As the name implies, a direct transfer is when the administrator (trustee) of the employer's plan transfers the funds directly to another qualified plan or an IRA in a trustee-to-trustee transfer for the departing employee.

Taking possession of the funds and subsequently rolling them over to another plan exposes the employee to a couple of substantial hazards. The first potential problem occurs when the employee fails to get the funds deposited into a new plan within the 60-day limit. In that case, the entire distribution will be taxable (except for the amount equal to the employee's after-tax contributions, if any) and the taxable amount may also be subject to the 10% early distribution penalty. The second hazard occurs because the employer is required by law to withhold 20% of the distribution for federal income taxes. Thus, when it comes time to roll the funds into another plan, the employee only has 80% of the funds needed to complete a tax-free rollover. If the employee does not have other funds to make up for the 20% withheld, 20% of the distribution will become taxable. Of course, the amount that was withheld is claimed as federal income tax withholding when the employee files his tax return for the year. However, depending on the employee's overall taxable income and tax bracket, the amount withheld from the retirement distribution may not be sufficient to cover all the tax liability on the non-rolled distribution, especially if the 10% penalty also applies.

On the other hand, when funds from the retirement plan are transferred trustee-to-trustee to another qualified plan or IRA, there is no withholding requirement, the employer can transfer the entire amount to the new plan, and the employee pays no tax on the transferred amount until it is withdrawn at some later date.

Pulling money from a retirement plan prior to retirement is never a good financial or tax move. Sometimes, however, a current financial need will make it necessary. The distribution will always be taxable (or partly taxable if the employee made post-tax contributions to the plan), but there are exceptions that may allow you to avoid all or part of the penalty. Please call for further details.

If you have already taken or anticipate taking a distribution in the near future and wish to discuss the tax issues that are related to the distribution, please give this office a call.