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What to Do with Your Lump-Sum Distribution?

Thanks to the funds in your 401(k) or other type of employer-sponsored qualified retirement plan, if you are retiring or changing careers, you may receive a large chunk of money —possibly the biggest you've ever seen. That's why it's important that you do not overlook the need to "map out" a lump-sum distribution strategy to protect what you've accumulated. Ideally, it's best to choose a distribution option that meets your retirement needs, minimizes the impact of taxes, and avoids penalties.

Option #1
One possible option is to directly roll your entire distribution into another qualified employer plan or Individual Retirement Account (IRA). A direct rollover to an IRA will avoid income taxes, a 10% early withdrawal penalty, as well as the current mandatory 20% federal withholding tax that is imposed if you elect to receive a check directly from your employer. In an IRA, all earnings continue to accumulate on a tax-deferred basis, allowing your money to compound and accumulate quicker than money placed in an identical taxable account.

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.

Option #2
If your new employer accepts rollovers from another employer's plan, 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.

Option #3
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. Your funds will continue to accumulate tax-deferred and later can be moved to an employer's qualified plan or an IRA without penalty. If you are over the plan's retirement age or 62, your company may insist that you take a payout to decrease the plan's administrative costs. If this happens, you still have the option to make a direct rollover to an IRA.

Option #4
This option allows you to receive funds in a distribution that is part of a series of substantially equal periodic payments made at least once a year after separation from service and lasting for:

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

In such situations, the 20% withholding rules do not apply. For this reason, this option may be suitable if you need funds to supplement your retirement income. The funds you receive will be subject to current income taxes. If you choose to receive funds for a period of 10 years or more and you are under age 59 ½, you may be subject to the 10% early withdrawal penalty. If you are already receiving fewer than ten annual payments, 20% of what you expected in a given year (and in future years) will be withheld. To avoid this, you can instruct your plan administrator to transfer the payments directly into an IRA. You can then establish a payout schedule to avoid the 10% early withdrawal penalty tax.

Option #5
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. 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 ½. 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.

Tax Pitfalls
As you "map out" your distribution strategy, there are a number of potential tax pitfalls you should be aware of. Besides the 20% mandatory withholding tax, upon distribution you will have to pay current income taxes on all pre-tax contributions and earnings. And, a 10% early withdrawal tax (also known as a premature distribution penalty) will be imposed on the entire distribution if you are under age 59H, unless the withdrawal is due to death or disability or taken in substantially equal periodic payments. Certain other exceptions may apply.

Make an Informed Decision
Be sure to weigh your distribution options carefully. Your decision could mean the difference between a dream retirement or one where you struggle to meet basic needs. Because of its importance, be sure to consult with your professional advisors prior to making any decision. If you would like more information about insurance and other financial solutions, please contact **Jason M. Woodward, J.D.** today at financialattorney@gmail.com.