Your retirement payout: Choosing a destination

As if deciding when to retire isn't important and difficult enough, there's another decision that may sit side by side with it. Simply put, it's how to take maximum advantage of your distribution from your company's 401(k) or other retirement plans.

Plan-specific choices

Some of your options depend upon what your retirement plan will permit.

For instance, if your account balance is $5,000 or more, and you so wish, you can keep the money in the plan. Some plans allow you to purchase an annuity with your retirement money that will provide you with a regular source of income for your life (or the life of you and your spouse).

Taking the money in hand

Two other choices are generally the most popular among retiring plan participants. One is to take the money out of the plan, paying tax in the year that you receive it (and possibly a 10% additional penalty if you aren't at least age 55).

In almost all circumstances, if you choose to take your money in a "lump sum distribution," as it's termed, you will pay tax at ordinary income tax rates. Thus, for example, you will not be able to take advantage of the new, lower capital gain tax rate.

A very limited number of exceptions apply. For instance, if part of your payout consists of employer stock, the portion that represents its appreciated value will be eligible to be taxed as long-term capital gain.

Rolling over your money into an IRA

Your other choice is to continue to avoid all current tax and potential penalties by opening a Rollover IRA. It's a common decision—billions of dollars in employer-sponsored retirement plan assets are rolled over into IRAs every year.

There are specific rules as to what you may roll over into an IRA. The good news is that you are permitted to roll over the full amount of your plan payout or only a part of it, depending upon your needs.

However, you cannot roll over the following: amounts that represent a return of your after-tax contributions; a payment that is part of a series of payments that lasts for your life expectancy or ten or more years; or minimum distributions that you are required to withdraw from an IRA after you have reached age 70 1/2.

What's the minimum? IRS provides a table that will apply in almost all cases. Simply divide the account balance at the end of the previous tax year by the relevant factor in the table, and that's your minimum distribution. The table assumes that a beneficiary has been selected who is ten years younger than the IRA owner, an assumption that will be more favorable to the vast majority of taxpayers than the old rules. There is an exception, however. If the beneficiary is a spouse and more than ten years younger than the IRA owner, the table is not used—the couple's longer joint life expectancy is used instead.

How to avoid a tax trap

Taxes must be withheld from most company retirement plan payouts. That rule applies even when you decide to roll over your money into an IRA. You may avoid the mandatory 20% withholding by arranging for a direct transfer of your distribution from the plan to the Rollover IRA (a "trustee-to-trustee transfer").

What happens it you don't make such an arrangement? You'll receive your money with a 20% shortfall. But all is not lost. If you wish, you can establish a Rollover IRA for the full amount of your payout, adding back from your personal funds the amount withheld. However, you have to act quickly—you're only given 60 days from the time that you receive your distribution to place it in a Rollover IRA.

Plan in advance

In addition to all the decisions already discussed, here's another big one: how to invest your retirement plan payout.

Everyone's investment choices must be based upon his or her unique circumstances. We will be glad to meet with you to develop an investment strategy that is tailored to your specific needs and goals.

But keep in mind that advance planning is the best way to keep all of your options open. Be sure to call us well in advance of the time that you expect to receive your IRA distribution.

Any developments occurring after January 15, 2007, are not reflected in this article.