401(k) and Pension Rollovers

by Gary Case

Whether you are retiring or merely switching jobs, one of the most important decisions you will face is what to do with your retirement account balance. In the event you are retiring, it may be wise for you to consider that as interest rates rise, distributions from pension (defined benefit) plans will likely shrink. This means that you may want to consider retiring sooner rather than later if you want a larger rollover check. It pays to check with your employer or advisor to help determine whether interest rate movements affect your distribution amount.

Generally, you will probably want to rule out the option of personally taking the distribution from a qualified plan. In addition to being taxable at your highest personal income tax rate, constructively receiving money from a retirement account often subjects all of that money to an additional 10% IRS penalty. When you take a distribution from an employer-sponsored account, the employer must withhold 20% of your distribution and deposit it with the IRS against any taxes due on the distribution. You may be able to get the withholding returned, but not until you file taxes for the year in which the withholding was deposited.

Another problem associated with personally receiving proceeds from your account occurs when you decide to roll over the money received into another retirement account. 20% of your distribution is withheld, but your tax liability is on 100% of your account value. This leaves you having to come up with the additional 20% to accomplish a complete rollover, or be faced with tax and most likely penalty due on the amount withheld from your distribution! Ouch!

One potential advantage to leaving funds on deposit with your former employer could be that you may be able to access your retirement funds prior to reaching age 59 ½. This option is governed by the plan document associated with your account. Your employer's administrator should be able to supply you with information accessing money from the plan without penalty.

A disadvantage to leaving money in a former employer's plan is most employers require full distribution of an account balance to non-spouse beneficiaries at an account owner's death. This can be an expensive tax event, causing all taxes due on an account to be payable in one year rather than spread out of several years (or even over the lifetime of the beneficiary).

In many instances, you may wish to consider moving your retirement account either to an IRA or to your new employer's plan (if one exists and accepts rollover contributions). Generally, more investment options exist in an IRA versus an employer-sponsored plan. When properly executed, such rollovers should not cause any adverse tax consequences.

If your 401(k) plan contains a significant amount of company stock that you acquired at a relatively cheap price, you may with to take a direct distribution of that stock and pay at capital gains rather than ordinary income tax rates. You should consult your advisor prior to executing this option.

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