



Lump Sum Distributions

Regarding the issue of lump sum distributions, there are several points that you should be aware of when considering withdrawal of retirement funds. I have listed below some of the pitfalls and some tax-saving strategies that can be explored to maximize your after tax net from the withdrawal, using today's 2000 federal tax codes.

First, lump sum distributions from IRA's, Keogh plans, 401(k) plans, most company plans, and tax-sheltered annuities, made to persons under 59½, are subject to a 10% penalty (with some exceptions), and are also subject to income tax in the year of distribution. Your actual federal marginal tax rate on this distribution could be as high as 39.6% plus any state income tax that would be due. Because of these severe penalties, care must be taken to plan the best way to withdraw the money.

Some of the ways that you may be able to limit your tax liability on the distribution are:

Rollover distributions

When withdrawing money from any of the retirement plans listed above, you have a window of 60 days from the date of distribution to roll the money over into a new plan. This allows you to avoid the 10% premature distribution penalty, and continue to defer tax on the money.

There are several options available which suit different situations:

- 1) In the case of someone leaving one employer for another, your company plan must generally be distributed. In this case, the proceeds of the distribution can be rolled into the plan that you are covered under with your new employer (provided the plan accepts rollover contributions). This option allows you to continue to qualify for special tax averaging on the retirement plan upon final distribution.
- 2) If you haven't found a new job before the 60 day deadline for rollovers, you can set up a separate IRA account specifically for this distribution. Provided you don't co-mingle the original distribution funds with any other contributions, this "conduit" account will allow you to roll these funds later into another qualified plan and still retain special tax-averaging options on this money.
- 3) Roll all the money into an existing IRA account. If the money is co-mingled with other IRA funds, or if the money isn't rolled into a new qualified plan, you lose the option of special tax averaging, but still retain the tax deferred status on the account.
- 4) Do a partial rollover. If you need to use some of the money from the distribution, and you are unable to replace all of it before the 60 day deadline, you can still do a partial rollover. This strategy allows you to defer tax and avoid the 10% penalty on at least some of the distribution. Again, because of the severe tax implications, other avenues of borrowing should be exhausted before this option is considered.

However, the manner of the rollover is critical. In the case of lump sum distributions from a company plan, (vs. IRAs, Keoghs, SEPs), employers are required to subtract a 20% backup withholding tax from distributions paid directly to the employee (ie. you receive a check paid to you). This 20% tax is considered a taxable distribution to you, unless you make it up from other sources and roll it into the new plan. To avoid this problem, you can elect to have the whole distribution transferred directly to the new plan instead of to you.



Annuity Distributions

If you are under 59½ and elect to take the money from the plan, not as a lump sum, but as an annuity, you may be able to avoid the 10% premature distribution penalty. Under this arrangement, payments from the plan must be made at least once a year in a series of equal payments over your lifetime, or that of you and your beneficiary. The payments must continue for at least five years or until you reach 59½, whichever comes later. After this time limit has been met, you can elect to withdraw the balance any way you like, including a lump sum of the balance. Note that the payments received are subject to income tax in the year that they are received.

Because annuities require a projected life span, calculations to determine the amount of each payment must be done on an individual basis.

Hardship Cases

There are some circumstances where the 10% penalty may not be assessed on distributions from retirement plans. These are:

- 1) Distributions to support you in the case that you become permanently disabled.
- 2) Distributions made to settle a domestic relations court order— for example property settlements in a divorce.
- 3) Distributions made to pay for medical expenses exceeding 7.5% of your Adjusted Gross Income. (Note: this option does not apply to IRA accounts.)
- 4) Distribution for qualified educational expenses or purchase of a primary residence.

Special Averaging

If you are at least 59½ at the time you receive the distribution, you may be able to use a special "lump sum income averaging" method to save on taxes, although this option is being phased out over time. Averaging is a way of greatly reducing your income tax on the lump sum distribution under circumstances. With five-year averaging, you use current year tax rates, while with ten-year averaging, the taxes are calculated using 1986 tax rates. Both options may provide significant tax savings to many—but not all—people using this election. Again, it is important to plan how best to handle the distribution before it happens.