Retirement Plan Distributions — Handle with Care

When you change jobs or retire, you may be eligible to receive a distribution of the money you have accumulated in your employer's retirement plan. How you handle the distribution can have significant tax consequences.

Taking the Cash

Your retirement plan may provide for a cash distribution of your entire account balance upon termination of employment. Like many people, you may find this option appealing because the money will be yours to spend or invest as you see fit. But, before you decide to take the cash, consider your taxes.

When the money comes out of the plan, you'll have to pay income taxes on all previously tax-deferred amounts — quite possibly on the whole distribution. Adding the distribution income to your other taxable income for the year will likely put you in a higher tax bracket, and could result in a substantial tax liability.

The cost of withdrawal can be even greater if you are under age 59½. Then, a 10% penalty may be due on the taxable amount of your distribution — in addition to income taxes. Note, however, that distributions from a 401(k) or other qualified plan following separation from service with the employer are not subject to the 10% penalty if the separation occurs during or after the year you reach age 55.

Staying Sheltered

Between taxes and a possible penalty, the cost of taking a cash distribution is steep. Unless you really need all the money right away, you may be better off either leaving it in the plan (if you have that option) or rolling an eligible distribution over to another employer's plan or to an individual retirement account (IRA). You don't necessarily have to roll over the entire amount — partial rollovers are allowed. You have 60 days to complete the transaction. Future distributions would be taxed to you as ordinary income.

No Withholding on Direct Transfers

If you decide to roll over all or part of your distribution, it is usually best to arrange for a direct trustee-to-trustee transfer. Why? Your employer's plan must withhold 20% of any eligible rollover distribution paid to you as a prepayment of your federal income taxes, even if you intend to roll over the distribution to another plan or IRA. To accomplish a rollover of the whole distribution, you'd have to take money from another source to make up for the amount withheld. The plan does not have to withhold income taxes from a trustee-to-trustee transfer.

These tax rules can be tricky. Consult with a professional at our firm for planning assistance.