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Laid Off? Pay Attention to Your Pension!

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Are you one of the unfortunate workers that lost a job due to the economic crisis (or quit, or changed jobs?) and are wondering what to do with your retirement account?

Cashing it out would be a big mistake. You could be hit with a 10% penalty for early withdraw, plus you could be taxed on the amount cashed out since the IRS considers it a taxable distribution. But there are other mistakes that could cost you money in penalty and taxes. One of them is to do an ***indirect rollover*** of your 401(k) (or other qualified retirement plan) into an IRA. An indirect rollover is when your former employer issues a check in your name for your retirement funds. You then have 60 days to deposit those funds into an IRA. If you fail to meet this deadline, the IRS will consider it a distribution, and you will be taxed on the distribution amount at your ordinary income tax rate. You could also be slapped with a 10% early-withdrawal penalty on the distribution if you are younger than 59 1/2 years old. What is worse is your former employer is required to withhold 20% of the distribution for tax purposes. This could be refunded when you file your income tax return—if you meet the 60-day rollover deadline ***and*** you come up with 20% of the money your former employer withheld. Here's an example: Say you have a $100,000 in your 401(k) with your former employer, and you are planning to do an indirect rollover to an IRA. By law your former employer must withhold $20,000 for tax purposes. You now have a check made out to you for $80,000. You have 60 days to rollover the $80,000 plus $20,000 of your own money. If you don't have that kind of money lying around and you only rollover the $80,000, you will be taxed on the $20,000, since this is considered a distribution. You could also be hit with the 10% penalty for early withdrawal if you are younger than 59 1/2 years old.

It is easy to avoid all of this: do a ***direct rollover*** (trustee-to-trustee transfer). Set up an IRA account with the new custodian and have your 401 (k) (from your former employer) transferred directly to the new custodian. You never see the check so you will not be tempted to spend any of it. Plus, there is no requirement to withhold 20% for income taxes; the entire $100,000 is transferred. Even if you need some money to pay unexpected expenses, it's still better to do the direct rollover first. Once the money is transferred, you can withdraw what's needed. You will still pay taxes, and possibly the 10% penalty on the amount withdrawn, but you don't need to worry about coming up with your own money because there is no requirement to withhold 20% for taxes. Additionally, you can do as many direct rollovers per year as needed. For indirect rollovers, only one per 12-month period is allowed.

Direct rollovers are easily done and can be facilitated by your financial advisor. Give him or her a call if you are planning to transfer a qualified retirement plan into an IRA.