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Laid off? Don't compound your woes with pension miscue

Direct rollover of 401(k) into an IRA might be best option, if plan allows it

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Losing your job because of the economic downturn is stressful enough. Imagine making an avoidable financial mistake on top of it, and you have reason enough to read on.

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Have you lost your job due to the economic crisis? Did you quit or change jobs? Are you wondering now what to do with your retirement account? Cashing it out could be a big mistake. You could be hit with a 10 percent penalty for making an early withdrawal and taxed on the amount cashed out, since the IRS normally would consider this a taxable distribution.

But this isn't the only mistake that could cost you in penalties and taxes. Another is doing 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 for your retirement funds in your name. You have 60 days to deposit those funds into an IRA or other qualified retirement plan.

Miss that deadline, and the IRS could consider it a distribution and tax you at your ordinary income tax rate.

It also could slap you with a 10 percent early-withdrawal penalty if you are younger than 59 1/2 years old. Even if you are planning to do an indirect rollover into an IRA, your former employer normally is required to withhold 20 percent of the distribution for taxes.

You could get that sum refunded when you file your income tax return—if you meet the 60-day rollover deadline and you come up with the 20 percent of your money your former employer withheld.

Here's an example: Say you have $100,000 in your 401(k) with your former employer and plan to do an indirect rollover to an IRA. By law, your former employer must withhold $20,000 for tax purposes. You now hold a check made out to you for $80,000. You have 60 days to roll over the $80,000, but you still need to come up with $20,000 of your own money and put it in your rollover account to replace the amount your employer withheld.

If you don't have that kind of money lying around and you roll over just the $80,000, you are taxed on the $20,000 because it's considered a distribution. In addition, you could expect to pay a $2,000 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 (also known as a trustee-to-trustee transfer). Set up an IRA account with a new custodian and have the 401(k) funds from your former employer transferred directly to the new custodian.

You never see the check, so you won't be tempted to spend any of it, and there is no requirement to withhold 20 percent for income taxes. The entire $100,000 is transferred. Even if you need some money to pay unexpected expenses, it still might be better to do the direct rollover first, because once the money is transferred, you can withdraw what's needed. You still probably will pay taxes, and possibly the 10 percent penalty on the amount withdrawn, but you don't need to worry about coming up with your own money. There is no requirement for your employer to withhold the 20 percent.

> If your plan won't allow a direct rollover, you still have an alternative.

Additionally, you can do as many direct rollovers per year as is needed. You can do an indirect rollover only once in a 12-month period.

As strange as it seems, some company plans won't allow a direct rollover. If that's true in your case, there is an alternative. Set up your IRA with the new custodian and have your former employer make the check out to your "new custodian for-the-benefit (FBO) of you." This way you don't have immediate access to the funds because the check isn't issued in your name. The check, as in the example above, is made out for the entire $100,000, since the 20 percent isn't required to be withheld for tax purposes. Simply deposit the check with your new custodian into your newly established IRA, and all the tax and penalty hassle should be eliminated.

As I mentioned earlier, it's normally better to transfer funds from your 401(k) to an IRA. There is, however, an exception.

If you are leaving your job for any reason—laid off, job change, or taking early retirement, and you are at least 55 years old and need the money, it might be better to leave the funds in the 401(k).

Here's why: Normally, you would be allowed to withdraw the funds as needed from your 401(k) without paying the 10 percent early-withdrawal penalty. You still will be required to pay taxes on the withdrawal, but at least you won't be hit with the penalty. The IRS allows this exception only in company plans; it doesn't apply to IRAs.

If you are nearing 55 years old, are considering leaving your present employer and need the money, it might be better to hold off, if at all possible, until you reach age 55. This way you might be able to take advantage of the exception. But if you are much younger than 55, a direct transfer to an IRA might be the best. Check your company's summary plan document (SPD) to make sure this 55-year-old exception is allowed, and call your financial adviser. Let him or her walk you through the alternatives and help you choose the best route for your situation.

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