Fiscal Fitness

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A Common IRA Mistake: The Indirect Rollover

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Are you planning to change jobs? Have you recently made a switch to a new company? A common IRA mistake 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 a portion of 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 makes an indirect rollover even worse is that 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 met the 60 day rollover deadline ***and*** you came up with 20% of your own money the former employer had withheld. Here's an example. Say you have a $100,000 in your 401(k) with your former employer. 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. In addition, you could be hit with the 10% penalty for early withdrawal if you are younger than 59 1/2 years old.

There is a very easy way to avoid all of this: do a ***direct rollover*** (trustee-to-trustee transfer). For a direct rollover, set up an IRA account with the new custodian and have your 401(k) (with your former employer) transferred directly to the new custodian. You never see the check, so you will not be tempted to spend any of your retirement money. 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 You will still pay taxes, and possibly the 10% penalty on the amount withdrawn, but you don't need to worry about coming up with your own money because there is no requirement to withhold 20% for taxes.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 very 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.

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