What You Ought to Know Before You Receive Your Retirement Distribution

Franklin Wealth Management

A Register Investment Advisor

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What You Ought to Know *Before* You Receive Your Retirement Distribution

What You **Don't** Know Could Cause You to Pay Excessive Taxes & Penalties!

If you're approaching retirement today, you'll soon be making some complex financial decisions. One of the most significant decisions you'll be making is how to take distributions of the funds that have built up in your company retirement plan. You've probably haven't decided on which method is right for you.

The information in this booklet reflects many changes in the tax laws that took effect since January 1, 2006. Most likely, you will have to make certain decisions on your retirement distribution **before** you leave your company, and you might make the wrong choice even **before** you receive your distribution. It's important you make the right decision based on your company retirement plan and your personal circumstances - otherwise, you could end up giving part of your retirement money away to pay excessive taxes and penalties.

Unfortunately, most people nearing retirement are not counseled properly with respect to this decision. The complexity of these plans has increased significantly over the years, and you have to be aware of the various pitfalls of each type of distribution.

This report is intended to give you the information and guidance you need to be able to talk with your financial advisor about the best retirement distribution option for you.

This report is not intended to be used as a substitute for expert advice. The publisher is not hereby rendering legal, accounting, tax or other professional advice. The services of competent professionals should be sought before applying the information provided here.

IMPORTANT NOTE: THE INFORMATION HERE MAY BE SUBJECT TO SIGNIFICANT CHANGE IN THE EVENT OF ANY AMENDMENT, CORRECTION, OR INTERPRETATION OF THE CURRENT TAX LAW ~ AND THERE IS A STRONG POSSIBILITY SOME LAWS MAY EVEN BE REPEALED!

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You may have retirement funds built up in a profit-sharing plan, a 401(k) plan, a pension plan, or ESOP. And, if you're like most people, deciding on a retirement distribution option is one of the biggest decisions you'll make in your lifetime; probably involving the largest financial asset you have.

One of the biggest problems with making such a decision is, once a decision is made, it's usually irrevocable and cannot be changed -- your decision will affect you for the rest of your life.

Improper decisions at this point in your life could be devastating. Therefore, it is extremely important that you seek qualified, competent counseling long **before** you receive your distribution, to ensure that you make the best financial decisions for your retirement future.

Many advisors, banks and brokerage firms are not familiar with tax laws and are only trying to sell investments. One of the most important concerns of retirement is the tax law. If someone suggests a specific investment, only time will tell whether or not this investment was the most appropriate. Therefore, an investment recommendation is a matter of "opinion.” However, when someone starts talking about the tax ramifications of a transaction, this is not a matter of "opinion," it is a matter of "fact."

Whatever you do, make sure you deal with someone who is **very** familiar with the tax laws governing retirement distributions.

What is a Lump-Sum Distribution?

You can usually elect to take your retirement benefit as lifetime income (such as an annuity), or as a lump-sum distribution.

A "lump-sum distribution" is the complete withdrawal of your account from your company retirement plan, also referred to as a "qualified plan". (Note: you do not need to take your distribution in the year you leave the company).

What Types of Lump-Sum Distributions Qualify for Special Tax Treatment?

A "lump-sum distribution" may be offered by the following retirement plans: 401(k) plans, profit-sharing plans, pension plans, ESOPs, stock savings plans, or Keoghs, but not IRAs.

However, only certain payments qualify as "lump-sum distributions" for tax purposes. These include payments made because of:

• Separation from service (voluntary or involuntary)

• Attainment of age 59 ½ (even if you're still working)

• Death

• Total disability

Retirement benefits that are taken out as an annuity (as a monthly benefit) **do not** qualify for "lump-sum distribution" treatment.

What are the Tax Effects of a "Lump-Sum Distribution"?

Your tax options will depend on your age, the length of time in the qualified plan, and the treatment used on previous lump-sum distributions. Generally, the various tax alternatives you have are as follows:

• Ordinary income taxes

• Long term capital gains

• Annuitization

• Direct IRA rollover

• IRA rollover

Plus, remember your employer might also allow you to keep your account in your current company retirement plan.

Tax-sheltered annuities, also known as 403 (b) plans, only have the ordinary income tax, annuitization, and IRA rollover/transfer options. However, their minimum distribution requirements can be different from other qualified plans and IRAs.

In addition to this, Simplified Employee Pensions (also known as SEPs) also have only the ordinary income tax, annuitization, and IRA rollover/transfer options.

You also may have a non-qualified plan, or a non-qualified deferred compensation plan. If this is the case, then your only election is either annuitization or ordinary income. Distributions from non-qualified plans are not eligible for IRA rollover or any form of averaging.

Under the Economic Growth and Tax Relief Reconciliation Act of 2001, however, Governmental Section 457 plans are eligible for an IRA rollover as long as the plan agrees to separately account for amounts that are rolled into it from eligible retirement plans other than Section 457 plans.

As you can see above, there are many different tax alternatives that you can choose from. The following will give you some guidelines and help you understand the differences in choosing these different distribution methods.

Mandatory 20% Federal Withholding

There is a mandatory 20% Federal withholding tax on "eligible rollover distributions" that are not directly "transferred" to another retirement plan. Although these distributions were always subject to withholding, it used to be very easy to avoid this by simply asking your employer not to withhold taxes.

Under the law, a 20% Federal withholding tax must be withheld from payments to you unless you either leave the funds with your former employer or make prior arrangements for a direct transfer to an IRA or other retirement plan. **If this is not done, 20% of the distribution will be deducted before you see any money.**

There are two ways in which to do a Direct IRA rollover. Both of these require filling out paperwork from your employer prior to receiving your distribution.

1. The first alternative is to request that the funds be electronically transferred to your IRA. This goes directly to your new IRA and you do not see any check. Generally, this is the recommended alternative for a Direct IRA rollover as it leaves less room for errors.

2. The second alternative is for you to instruct the employer to make the check payable to this new IRA. However, in this situation, the check is not mailed to you, but is made payable to the IRA custodian. It is imperative that the check **not** be made payable to you, but must be made payable solely to the IRA custodian. If the check is made payable, for example, to the retiree **and** the IRA custodian, there will still be a mandatory 20% withholding.

It is imperative to establish an IRA prior to filling out any paperwork to request your distribution from you plan.

This 20% withholding applies to all distributions from qualified plans, as discussed above, except for:

• Distributions from IRAs

• Pension benefits payable for 10 years or more, including pension benefits payable over the life expectancy of the retiree or a joint life expectancy

• Distributions from qualified plans when a total distribution is less than $200

• Age 70 ½ minimum distribution requirements

• IRA transfer to another IRA or qualified plan

• Distributions of your after-tax contributions to the plan (these are non-taxable when distributed to you. Under the 2001 Tax Act, distributions of your after-tax contributions to the plan are now eligible for rollover to another qualified plan or an IRA. Previously, you were not allowed to rollover these amounts). These after-tax contributions are eligible to be rolled into a Roth IRA in which principal and growth are for free. This is available only if you haven’t rolled over any other funds in the same tax year

• Distributions of excess 401(k) plan contributions

• Dividends on employer's stock

• Life insurance costs

• Taxable loans that are deemed distributions because they exceed the tax-free loan limits

• Non-spousal beneficiaries receiving a distribution

For all these distributions that are ineligible for rollover, you may elect to completely avoid tax withholding on form W-4P.

The 20% withholding rule also applies to eligible rollover distributions received by a surviving spouse, or by a spouse or former spouse receiving payments under a qualified domestic relations order (QDRO).

Non-spousal beneficiaries who receive a distribution after the death of a plan participant cannot make a rollover; therefore, the direct rollover option and the 20% withholding rule do not apply.

For 403(b) plans, also known as tax-sheltered annuities, there may be an exception of the 20% withholding, depending on what your plan allows. Please see your advisor for details.

There is a major difference between an IRA rollover and a Direct IRA rollover...

An IRA rollover is when a check is made payable to the **retiree**. The retiree then has 60 days in which to roll over these funds into an IRA. In this case, a 20% withholding will take place if the distribution came from a qualified plan.

A Direct IRA rollover, on the other hand, is when the check is made payable directly to the **IRA custodian.** No taxes are withheld in this circumstance.

Therefore, to avoid withholding, it would be best to do a Direct IRA rollover.

If the check is made payable to the retiree, then the retiree can roll over the 80% and get a partial refund of the taxes withheld. But if the retiree decides to roll over the entire (100%) of the distribution, he will have to come out of his own pocket with the additional 20% to complete the transaction and avoid paying any taxes (and possible penalties as well).

Since most people want to have all of their funds distributed into an IRA anyway, a Direct IRA rollover is best.

As you can see, making a decision before you receive your retirement distribution can be crucial to avoid paying taxes on your distribution.

There are, however, various advantages to this new tax law. In the past, a lump sum distribution from a qualified plan had to equal at least 50% of the total value of that qualified plan in order to be eligible for an IRA rollover. Under the new law, this 50% test is not required. For example, if you receive only 25% of your profit sharing plan, then this amount is eligible for an IRA rollover or a Direct IRA rollover. Under the old law, this would not be eligible for rollover and would be subject to ordinary income tax and possible penalties.

Another advantage of this new law is annuity payments (pension distributions), which are payable in a period certain of **less** than 10 years, are now eligible for an IRA rollover or an IRA transfer. In the past, any annuity payments were not eligible for an IRA rollover. However, it must be noted that in the event that the retiree is receiving a series of payments for **less** than 10 years, then there will be a mandatory 20% withholding unless these funds are directly transferred into an IRA.

If You Were Born On or After January 1, 1936...

If you were born on or after January 1, 1936, you only have four choices:

1. Pay ordinary income taxes and (most likely) a 10% early withdrawal penalty

2. Annuitize

3. IRA rollover

4. Direct IRA rollover

Other options are not available unless you were born prior to January 1, 1936.

The annuity option means you'll receive a stream of payments for a single or joint lifetime, or for a specified period of time. Usually, the size of your monthly check will depend on your age, gender, and how long the checks will be paid.

There are three advantages to taking an annuity distribution:

1. Guaranteed payments

2. Steady monthly income

3. No investment management required

However, there are several disadvantages:

1. No emergency fund (you can't get more money than the monthly fixed amount)

2. There's usually no hedge against inflation (no cost of living adjustments to the payments you receive)

3. No income tax flexibility (you can't let the income continue to accumulate tax-free if you don't need the money right away)

4. No special tax treatment (You must pay ordinary income taxes on the money you receive and you **cannot** roll over or transfer this to an IRA, assuming that the annuity is payable for at least 10 years or is paid over the life of the retiree. If the annuity is made payable over a period certain of **less** then 10 years, then the annuity payments are eligible for IRA rollover for IRA transfer; however, in this circumstance, the 20% withholding rule applies)

5. No money is paid to your surviving children or relatives (the payments usually end at the time of your death, or your surviving spouse's death)

In addition, you usually cannot change your mind after choosing an annuity distribution. Therefore, use extreme caution before choosing an annuity. In **most** circumstances, other alternatives offer greater benefits.

If you are **under** age 55 and receive a lump-sum distribution, then **usually** the best choice is to do an IRA rollover/transfer.

If you do not do a transfer/rollover, your overall taxes and penalties could exceed 50%!

Obviously, each individual is different with respect to goals and circumstances, and you should address your own circumstances with your advisor before making a final decision. We will talk more about IRA rollovers/transfers later on.

"Should I Do a Rollover/Transfer or Should I Pay Taxes?"

Obviously, this will depend on whether or not you currently need the money. **As a general rule, your lump-sum distribution should usually be transferred into an IRA** unless you have a specific and immediate need for the money. However, as mentioned earlier, there are many exceptions to this rule and the tax consequences of taking money out of an IRA are extremely complicated.

Also take into consideration your current state income tax, as this can have a bearing on the decision you should make.

Another factor that you must take into account is the state income tax **after** retirement. Obviously, if the new state that you are moving to has lower tax, this can impact your decision on when to take your benefits from your current retirement plan.

Considering Net Unrealized Appreciation

Before you decide to rollover your lump sum distribution to an IRA, you should carefully consider taking advantage of your net unrealized appreciation (NUA). Employer securities in a qualified plan are, in part, eligible for special net unrealized appreciation treatment upon distribution from a Qualified Plan as part of a lump sum distribution. The NUA rule states that only the employee’s basis in the securities is taxable at ordinary income tax rates. The NUA portion at the time of distribution from the qualified plan is taxable at the long-term capital gains tax rate only when the distributed stock is sold. Any subsequent appreciation between the distribution date of the stock and the sale is taxed depending how long the stock is held.

From purely a tax perspective, a lump-sum distribution obtaining NUA treatment is clearly superior to a 100% rollover to an IRA. However, the lump-sum treatment is not without its drawbacks. For instance, income tax is paid at the initial distribution. Only upon sale of the security is the capital gain realized. Thus, if a taxpayer intends to defer capital gain tax, the taxpayer will likely continue to hold the employer securities outside of the plan for some time period. Unfortunately, this may result in realization of risks inherent with a non-diversified portfolio.

If you roll 100% of the employer securities to an IRA, this would not be an issue, as an IRA can be diversified in a tax-deferred environment. However, if the rollover occurs to an IRA, the taxpayer foregoes NUA treatment. Thus, you are left with a dilemma. If a lump sum payment occurs, NUA treatment results; however no diversification. If you elect a 100% rollover to an IRA, diversification occurs; however NUA treatment is lost. You should carefully discuss this issue with your financial and tax advisor to determine the best course of action.

10% Penalty

As if the previously described tax matters aren't enough to be concerned about, you must also be concerned about the Federal 10% early withdrawal penalty. The State of California also imposes a 2.5 % penalty. Other states may vary.

Distributions from qualified retirement plans and IRA accounts may be subject to a 10% early withdrawal penalty if you are younger than age 59 ½. However, this penalty will not apply in the following situations:

• Attainment of age 55 **and** separation from service (applicable for employer distributions, but not distributions, but not distributions from IRAs)

• Distributions used to pay certain medical expenses

• Death

• Total disability

• IRA rollover/transfer

• Rolling over/transferring the distribution into another qualified plan

• Divorce settlements paid to a spouse pursuant to a Qualified Domestic Relations Order

• Annuitization (described earlier)

• Taking distributions of "substantially equal payments"

• Distributions from IRAs up to $10,000 for first-time homebuyers (effective January 1, 1998)

• Distributions from IRAs for higher education expenses (effective January 1, 1998)

• Distributions due to an IRS levy.

Obviously, the most commonly used method is the IRA rollover/transfer. However, we have been getting more and more inquires with respect to taking money out of an IRA before age 59 ½ and avoiding payment of the 10% additional tax. Usually, the most recommended way is the "substantially equal payments" method. In order to utilize this option, you must pick one of three alternate calculation schedules. The schedule chosen and the resulting amount of the "substantially equal payments" have to remain in force for at least five years or until you reach the age of 59 ½, whichever is longer.

For example, if a retiree initiated a payment schedule at age 58, it must stay in effect until age 63. If another retiree wished to start at age 50, then he must continue this until age 59 ½. If the test is failed, the 10% penalty will apply retroactively to the first year in which the distributions started.

It is imperative to recognize that the "substantially equal payments" method can also apply from a qualified plan, assuming you have terminated employment. However, it is important to remember that if you do take substantially equal payments from a qualified plan, rather than from an IRA, there will most likely be a 20% Federal withholding tax on these substantially equal payments, since these distributions are usually less then 10 years and these distributions come from a qualified plan. The 20% withholding will not apply if it comes from an IRA. Obviously, distributions from any IRA or qualified plan will be usually subject to taxation.

Therefore, in the event that the retiree would like to utilize the substantially equal payments, it is best to first take a lump-sum distribution and transfer it to an IRA, and then start taking out the substantially equal payments from the IRA.

It is very important to review these alternatives and care must be taken to make sure which choice is made before it is initiated. Fairly sophisticated calculations must be made. These can be done properly only if your advisor has a thorough understanding of the applicable tax laws.

Miscellaneous Changes to Retirement Accounts Created By the Taxpayer Relief Act of 1997

There are many other changes with respect to retirement accounts that were created by the Taxpayer Relief Act of 1997. Let us address a few of these issues.

First of all, a new IRA has been established called the Roth IRA which is a non-deductible IRA from which withdrawals may be made tax-free. Retirees may want to consider converting or rolling over some of their "old" taxable IRAs to the Roth IRA, so they can receive tax-free retirement income. There are a number of different, complicated rules regarding this Roth IRA.

The Taxpayer Relief Act of 1997 also introduces additional provisions for current IRAs. For example, effective January 1, 1998, the act eases the income limitation of those eligible to make deductible IRA contributions. Please see your tax advisor for details.

There is also a non-deductible "Education IRA" which can be established to pay qualified higher education expenses of a designated beneficiary. Although there is no income tax deduction for contributions to this IRA, there is a contribution limit of $2,000 annually. These contributions may be made regardless whether the beneficiary has any gross income. However, the contributions may not be made after the beneficiary reaches 18. The Education IRA became effective January 1, 1998.

There used to be an additional 15% excise tax if you took a large distribution from your retirement accounts or had a sizeable amount in your retirement accounts when you passed away. The Taxpayer Relief Act of 1997 repealed this excise tax effective January 1, 1997.

Common Questions & Answers

If you're like most people, you'll probably want to roll over or transfer your lump-sum distribution into an IRA. Although this sounds easy, we always get a lot of questions from people regarding IRA rollovers and transfers. We're going to answer the most common questions here.

Q1. Can I roll over or transfer the full amount of my distribution?

A. Generally yes. Prior to 2002, if after-tax contributions were made to your plan, these amounts were not eligible for an IRA rollover. Under the 2001 Tax Act, however, you are permitted to roll over the non-taxable portion of an eligible rollover distribution, but only to the extent that the non-taxable portion is rolled over to an IRA or, under specific conditions, a defined contribution plan. Also under the 2001 Tax Act, you are allowed to roll over to another qualified plan such non-taxable portion of an eligible rollover distribution only if the rollover is executed in a direct trustee-to-trustee transfer, the plan that the rollover is transferred into is a defined contribution plan and the plan that the rollover is transferred into agrees to separately account for amounts transferred, including a separate accounting for the portion of the distribution which is includible in income and the portion which is not includible in income. You may want to rollover after tax portion to a Roth IRA, but this can’t be done in the same year as a Traditional IRA rollover.

Q2. How long do I have before I must roll over my distribution into an IRA?

A. You normally have 60 days from the date of receipt of the distribution to roll over the proceeds. However, receipt can be a questionable area with respect to the IRS. It is usually recommended that you roll over the proceeds within 60 days of the date of the check or stock certificate. If you go beyond the 60 day deadline, the IRS now allows a late rollover under limited circumstances, such as death and an error on the part of the financial institution. If you missed this deadline, you should contact your advisor to determine if relief is available to you.

Q3. How long do I have before I must transfer my distribution into an IRA?

A. Most qualified plans allow retirees to leave their monies in their plan at work at least until age 65 and usually until age 70½. However, if you request a transfer, then the plan has to transfer the funds at least within the same time period that they would have in order to send you a check made payable to the retiree.

Assuming that the retirement plan administrator does not send a check payable to the IRA custodian, but sends the check to the retiree, the law does not state how long the retiree has before he sends this check to the IRA custodian.

Obviously, there would be no time limit on any distributions electronically transferred directly to the IRA. The 20% withholding will not apply if it comes from an IRA. However, distributions from any IRA or qualified plan will be usually subject to taxation.

In the event that the retiree would like to utilize the substantially equal payments, it is best to first take a lump-sum distribution and transfer it to an IRA, and then start taking out the substantially equal payments from the IRA.

It is very important to review these alternatives and care must be taken to make sure which choice is made before it is initiated. Fairly sophisticated calculations must be made -- these can be done properly only if your advisor has a thorough understanding of the applicable tax laws.

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First of all, a new IRA was established called the Roth IRA which is a non-deductible IRA from which withdrawals may be made tax-free. Retirees may want to consider converting or rolling over some of their "old" taxable IRAs to the Roth IRA, so they can receive tax-free retirement income. There are a number of different, complicated rules regarding this Roth IRA. If you would like to get more information regarding this Roth IRA, please visit with the advisor who provided you with this book.

The Taxpayer Relief Act of 1997 also introduced additional provisions for current IRAs. For example, effective January 1, 1998, the act eases the income limitation of those eligible to make deductible IRA contributions. Please see your tax advisor for details.

Miscellaneous Changes to Retirement Accounts Created by the Economic Growth and Tax Relief Reconciliation Act of 2001 (The 2001 Act)

As previously mentioned, there is a non-deductible "Education IRA" which can be established to pay qualified higher education expenses of a designated beneficiary. Although there is no income tax deduction for contributions to this IRA, beginning in 2002 contributions of up to $2,000 (previously the limit was $500) may be made to an Education IRA subject to income limitations. These contributions may be made regardless whether the beneficiary has any gross income. However, the contributions may not be made after the beneficiary reaches age 18. This age limitation will not apply to any designated beneficiary with special needs as defined under IRS regulations.

Many limits on contributions to qualified plans and IRAs were increased. For example, the limit on IRA contributions increased from a maximum of $5,000 to a maximum of $5,500 for 2013. In addition, individuals 50 or over are allowed an additional "catch-up" contribution of $1,000 to a number of plans.

There used to be an additional 15% excise tax if you took a large distribution from your retirement accounts or had a sizeable amount in your retirement accounts when you passed away. The Taxpayer Relief Act of 1997 repealed this excise tax effective January 1, 1997.

Q4. If I want to do an IRA rollover/transfer, do I have to rollover/transfer everything?

A. No. You have a number of different options. You may request that the retirement plan administrator do a direct transfer of part of your retirement plan to an IRA and send the balance to you. Obviously, the amount that is made payable to you, and not directly transferred to an IRA or other qualified plan (with the exception of after-tax contributions), will be subject to the 20% Federal withholding and possible penalties. Again, this difference is <u>not</u> eligible for 10 year averaging. It is also important to note that a qualified plan is <u>not</u> required to issue more than one check.

Q5. What are my options if I receive my lump-sum distribution in the form of stock?

A. This is a very tricky area of the law. If you have a stock savings plan at work, then you must also tell the employer whether or not you want to do a direct transfer of the stock or whether you would like the stock to be in your name.

In the event that the stock certificate is issued in your name, rather than the IRA custodian's, this will also be subject to the 20% withholding rule; however, the law provides that the maximum amount to be withheld <u>must not</u> exceed the sum of the cash received in the total distribution.

You must also remember that in order to avoid paying taxes on this distribution, then within the 60-day period either the securities must be sold and the proceeds rolled over into an IRA, or the <u>actual</u> securities must be rolled over/transferred into an IRA.

Q6. But what if I don't want to sell the stock and my bank says that I can't roll over/transfer the shares into an IRA?

A. This is a situation where we normally recommend that you open what is called a "self-directed IRA". Most banks do not have true self-directed IRAs and are not familiar with the intricate tax laws with respect to how to roll over/transfer stock. Even if you don't want to sell the shares, then the shares themselves must be rolled over/transferred into an IRA to avoid paying taxes. If you keep the shares outside of your IRA, you'll be taxed even if you do not sell them!

You may keep the shares in you IRA as long as you wish. Then, you can sell the stock when you feel the time is right.

Be careful about your selection of the trustee or custodian who will receive the rollover/transfer to your "self-directed IRA".

Q7. Can I roll over/transfer my money into an existing IRA?

A. Yes, and under the 2001 Tax Act, doing so will not prevent you from transferring your rollover IRA into a new employer's qualified plan should you wish to do so. Under the 2001 Tax Act, if you receive an otherwise taxable distribution from your IRA, you may, within 60 days, roll it over into a qualified plan, a tax-sheltered annuity or to another IRA.

Q8. Can I just leave my retirement account at my current employer?

A. This will depend on the rules that your employer currently has for its existing plan. However, in the event that you have a substantial number of stock shares in your account, it is highly recommended that you take the distribution from your employer's plan and roll over/transfer it into your IRA. When and if it comes time to sell the shares, you can accomplish the sale much more quickly -- at the price you want -- than if the stock is left to your employer's plan to take care of. In addition, your own IRA will allow you more investment diversification and less risk than keeping a sizable portion of your retirement funds all in one investment.

In addition to this, most retirement plans at work require your beneficiaries to take out the entire distribution within a short period of time after you pass away. This is okay if the spouse is the primary beneficiary. He or she could take this distribution and roll it over into an IRA. On the other hand, if it is a non-spouse beneficiary, such as a child, then the distribution would normally have to be paid out all in one year! This could subject the beneficiaries to significant income taxes that could have been deferred over their lifetime.

A much better alternative would be to take the lump sum distribution from the retirement plan at work and directly roll this over into your IRA. In this scenario, the non-spouse beneficiaries would be able to establish an "Inherited IRA" in the event you should pass away. They could then make an election and take out the money from this IRA over their lifetimes. Beneficiaries pay income taxes as they receive the money. If they are only required to take out a certain minimum amount of money, they will still be able to defer the remaining funds into your IRA and let the IRA still accumulate, tax deferred, just the way you have been doing over your lifetime.

Therefore, based upon these rules and the restrictions inside of most retirement plans at work, we highly recommend that you usually take out the funds immediately after you retire and roll them over into an IRA.

Q9. If I decide on an IRA rollover/transfer, must my distributions be rolled over into one investment?

A. No. As described earlier, a self-directed IRA (or a number of self-directed IRAs) can be opened. And it's recommended that you diversify your investment into a number of different alternatives in order to reduce your risk and maximize your return. If your investment advisor insists on placing your entire distribution in one type of investment (all in one CD or one mutual fund), you should consider getting another investment advisor.

Q10. If I'm still working, do I have to quit my job in order to receive a lump-sum distribution?

A. This will depend upon a number of factors. Although job termination is the most likely reason for receiving a lump-sum, there is always a possibility that your retirement plan may be terminated or you may become disabled. In addition, some companies will allow you to receive your lump-sum distribution at age 59½, even if you're still employed.

However, tax law requires that if you receive your distribution from your plan and you are under age 59½ and you have <u>not</u> separated from service, then there will be a 10% penalty on this distribution if it is not rolled over/transferred into an IRA. If your company is taken over by another employer, then this is usually <u>not</u> considered a "separation from service". It's best to consult with your plan administrator to determine your options.

Q11. If I go to work for someone else who has another qualified retirement plan, can I roll over/transfer my lump-sum distribution into their plan?

A. This will depend on your new employer. Some employers will allow you to roll over/transfer the proceeds from your qualified plan into their qualified plan. The IRS will allow this, and you may retain your ability to use 10 year averaging and the possibility to take out loans from this existing plan. However, it is important to determine the investment options this new qualified plan offers before you decide whether or not it would be wise to roll over/transfer your money into their plan.

For example, if your new employer's plan is 100% invested in its own company stock, analyze their stock before deciding whether or not it would be your best option to place all of your retirement funds into one investment. In addition to this, you usually have more control of your investments in your IRA rather than in your employer's plan. In most circumstances, the smartest move is to roll over/transfer it into your own IRA, rather than rolling/transferring it into the new company's plan.

Q12. When do I have to start taking out withdrawals from my IRA? And can I roll over/transfer my retirement plan to an IRA even after I have reached age 70½?

A. Sometimes people get confused about these two issues. First, there is a 50% penalty for failing to properly start your IRA withdrawals by April 1 of the year following the year you turn 70½. Second, you can roll over/transfer your distribution to an IRA even if it is received after age 70½ but remember, certain minimum distributions must be made to you each year or you will face the 50% penalty on the amount that you should have taken out. This is an extremely complicated area and you should see a qualified advisor before making a rollover/transfer after age 70½.

An individual does not have to start taking money from his retirement plan at work, in the event that he is still working and he and his family do not own 5% or more of the company that he is employed with. **THIS CHANGE WILL NOT APPLY TO DISTRIBUTIONS FROM IRAs.** This only applies to distributions from qualified retirement plans at the company that the employee is still employed with. However, your employer is not required to comply with these rules. Many companies do not want the "hassle" and liability of this provision and may still require you to take out your minimum distribution even if you are still working. Please check with your employer to make sure that you know what their rules are.

Q13. I currently have a large IRA. Are there any planning techniques that I can utilize in order to minimize the income tax and penalties?

A. Yes, there are. However, before we answer your question, you should also be aware that there may be estate (death) taxes on distributions as well.

Upon your death, in the event that an IRA beneficiary is the surviving spouse, then no income tax or estate (death) tax is due, assuming the proceeds are rolled over/ transferred to his or her own IRA. However, in the event that the beneficiary is other than a spouse, then not only is the income tax due (see question 23), but the distribution may also be estate taxed. In fact, if one is not careful, the total tax paid because of this "double taxation" could exceed well over 70% of the IRA distribution!

One of the best means to reduce this overall tax is to "prepay" the tax by taking partial distributions from the IRA before age 70½, paying taxes on that distribution and purchasing a "second to die" life insurance policy which will cover this double tax when the surviving spouse dies. Again, there is no income tax or estate tax that is payable when the first spouse passes away, assuming that the beneficiary is the surviving spouse and rolls/transfers the IRA over to his or her own IRA. All of these taxes will be due and payable when the second spouse passes away.

Remember -- under current law non-spouse beneficiaries cannot roll over/transfer these funds into their own IRAs. By purchasing a life insurance policy which pays off when the second spouse dies, you effectively pay the overall tax at a very significant discount. Obviously, this result will depend on your and your spouse's health and age. See your advisor to "run the numbers" to make sure this makes sense in your particular situation. Also, be sure to get the owners and beneficiaries of the policy correct.

Q14. When is an IRA rollover/transfer the best choice?

A. This will depend upon the situation. However, the IRA rollover/transfer option is usually the best alternative, if you have a large distribution, you should have other emergency funds available, and you may be subject to the 10% early withdrawal penalty.

An additional advantage, of course, is the tax-deferred status you get in an IRA.

Q15. I'm required by my employer to fill out paperwork before my retirement. Are there things I should know before I complete this paperwork?

A. If there are annuity options available, it is imperative that you contact your advisor to go over your different alternatives and determine which one is the best for you. Once you make these elections, they are usually irreversible and cannot be changed. Therefore, it is extremely important that you consult with your advisor before making your selection.

In addition, you may also have the alternative of taking your retirement distribution in the form of a lump-sum distribution instead of an annuity. Again, it is very important to review all the different facts before making this election.

In most cases, it is <u>usually</u> recommended to take the lump-sum distribution instead of the annuity. The reasons for this were described earlier in this report.

It is also important to determine whether or not to elect a direct rollover or have the check made payable directly to you or a combination of both. Your employer will have the forms available for you to properly fill out.

In the event you want to do a Direct IRA rollover, then it is imperative to open an IRA first in order to make sure that the transfer is done correctly. This usually requires meeting with your advisor and filling out the proper routing numbers so that the funds are transferred correctly. Failure to do so could result in many problems, including the possibility of having your funds transferred incorrectly into some other person's account.

In the event that you want to have the check made payable to you, it is important to note that there will be the mandatory 20% withholding on the distribution. This also applies to any outstanding loans.

Let me give you an example ... Let's assume that Bill is terminating employment from XYZ corporation and has $100,000 in his company retirement plan (assume there are no after-tax contributions). Inadvertently, Bill fails to do a direct IRA rollover and instead requested his lump-sum distribution made payable to himself. A few weeks later, he receives a check for only $80,000. What happened to the other $20,000? The employer sent it to the IRS and this cannot be reversed. Bill must now come up with an additional $20,000 out-of-pocket in order to roll over the full amount of $100,000!

What happens if he doesn't have that additional $20,000? In that case, if he only rolls over $80,000, then the $20,000 that was not rolled over will be subject to income tax. Obviously, he will most likely get a tax refund next April, since the tax on this $20,000 is less than $20,000. Please note that the IRS will not give you any interest on this refund.

Remember -- you must roll over 100% of the taxable distribution within 60 days to avoid taxes and penalties. Obviously, Bill could also be subject to a 10% penalty, depending on his age.

Q16. I just received my lump-sum distribution which consisted of $50,000 worth of stocks. All of this is taxable and I want to roll over everything into my IRA. However, I would like to keep the stocks outside of my IRA and I want to take $50,000 cash that I have on the side and put it in my IRA. Can I do this?

A. No. If you do this, the $50,000 distribution of stocks is taxable. It's imperative that the actual stocks, or the stock sale proceeds (assuming the stock was sold), must be rolled over into your IRA within the 60-day rollover period. You cannot keep the actual stock and roll over a like amount from your separate funds. Incidentally, if you do this, you will pay taxes on the $50,000 worth of stock you kept plus a penalty or rolling over the $50,000 of your own funds -- this is considered an "excess contribution" and is not allowed.

Q17. I just received some shares of stock, all of which is taxable, and I don't want to keep them. The stock was valued at $100,000 when I received it, but it's now worth $110,000.If I sell these shares within the 60-day time period, do I have to roll over the full $110,000 or do I only have to roll over $100,000?

A. You should roll over the full $110,000. If you only roll over $100,000, then the remaining$10,000 will be currently taxable to you.

Q18. I just received some shares of stock, all of which is taxable, from my qualified plan. They were worth $100,000 at the date of distribution but the value has gone down since the date of distribution and is currently worth only $90,000. If I sold the shares within the 60-day time period, must I still roll over the $100,000 in order to avoid any taxes on this distribution?

A. No. You can only roll over $90,000. As long as you roll over the actual amount received from the sale of the securities distributed from the taxable portion of the qualified plan, this will satisfy the IRA rollover requirements.

It is important to note that, most of the time, the actual price of the securities sold will be different from the fair market value of the securities when they were issued from the qualified plan. This is due to the fact that the market will most likely have fluctuated between the date the stock was issued and the date the stock was sold.

Also note that the sale of the securities and the rollover of the proceeds must be done within the 60-day period, as described earlier.

Q19. I am getting quite confused about all of this paperwork and the complexities of the tax laws. I currently have a stock savings plan at work and I would like to transfer everything into my IRA at the credit union. Can I do this?

A. In most cases, no. Be very careful when you attempt this, because you will usually receive a cash distribution and stock certificates from your stock savings plan.

In order to avoid the mandatory 20% withholding, you must have the check payable to the IRA custodian and you must also have the stock certificates issued in the IRA custodian's name.

Most IRA custodians will not accept stock certificates. Therefore, it is imperative that you ask the IRA custodian whether or not they do accept stock. Make sure that whatever IRA custodian you choose will accept stock certificates.

Again, this is a major reason why a self-directed IRA is usually the best choice. Not getting this information correct initially could cause you many problems down the road after you receive your certificate. Again, please see your advisor before you fill out any paperwork.

Q20. I am looking at my distribution form that came with my check and stock. It shows that there is an amount called "taxable income". Must I roll over/transfer only the portion of this distribution identified as "taxable income" to avoid paying any tax?

A. In most cases, you must roll over the entire distribution. This is a very confusing area since, in the event that you receive any stock certificates, there are often two components of value stated on your distribution form -- "net unrealized appreciation" and "taxable income". The "taxable income" is how much you would have to pay taxes on if you decided to keep the shares immediately and not roll them over into your IRA.

If you do not want to do an IRA rollover, the "net unrealized appreciation" of the stock (this represents the increase in value of the stock since it was contributed to the plan) is not currently taxable. However, note that if you sell the shares down the road, you will most likely have a capital gains tax too, because you have not yet paid for the "net unrealized appreciation" of the stock shares.

If you do receive shares of stock as part of your distribution, see a ***qualified advisor*** in order for you to understand all the options you have. This is especially true if some of the shares were purchased with after-tax dollars.

CRITICAL MISTAKES ARE TOO
OFTEN MADE WHEN ROLLING OVER
STOCK SHARES.

Remember, this is usually the first time that you have received such a distribution. There are many penalties and misfortunes you could face if you're not careful.

Q21. I am now age 70½ and have many different IRA accounts. Do I have to take the minimum distribution from each IRA?

A. No. The totals of each of the IRAs should be lumped together to determine the minimum distribution requirement. Depending on which formula you use, you'll arrive at the amount you must take out to avoid the 50% excise tax penalty. This amount can be withdrawn from one or more of your IRAs and does not need to be withdrawn proportionately from each one.

It's important to note that some financial institutions may require you to withdraw your distribution from their IRA, based on their internal policies. It's usually best, however, to take the distribution from the IRA that is earning the lowest interest. That way, the IRAs that are earning more interest can continue to compound that interest, tax-free. You could also consolidate your IRAs into one self-directed IRA. This will minimize paperwork and problems associated with an audit, should the IRS question your calculations.

In addition to this, you may also have what is called a "Roth IRA". The minimum distribution requirements do not apply to a Roth IRA. In other words, no distributions are required to be taken from your Roth IRA until your death. For more information regarding the Roth IRA, you should discuss your situation with the advisor that provided you this book.

Q22. What happens to my IRA if I die?

A. This will depend on who you name as the beneficiary of your IRA. The beneficiary receives your account upon your death and then has various options. Normally, the beneficiary is your surviving spouse. If this is the case, your spouse may roll over the benefits into his or her own IRA and continue to defer taxes until he or she reaches age 70½.In the event that a non-spouse is the beneficiary and minimum distributions have not started, then the beneficiary must take out the entire balance by December 31 of the fifth year following your death, or take the distributions as an annuity over his or her own life expectancy.

One of the other options that many advisors and custodians are not aware of is the election to have an Inherited IRA, which will allow the non-spouse beneficiaries to take out the distributions from your IRA over their lifetimes! This is another excellent example of the issue of making sure that your advisor is familiar with all of the tax options and does not merely give you or your survivors the "standard" alternatives. The distribution differential is enormous.

Let me give you an example.

Let us assume that you have an IRA valued at $100,000 and that your beneficiary is your son, who is 30 years old. If he makes no special election, then most custodians will pay you out the $100,000 all in one year, which will be taxable to your son all in only one year. Do you think this will push him into the higher income tax brackets? Of course! Do you think that he would need all of this money, all in only one year? Probably not. However, this is how it works.

In the event that he would make the proper elections for this Inherited IRA, his minimum distribution would be about $2,000! The remaining $98,000 could still remain to accumulate tax-deferred and he would merely have to take out a minimum distribution each year in order to satisfy this requirement. Obviously, he could take out more in the event that he needed more money. Otherwise, the IRS says that he is only required to remove a certain minimum distribution, similar to the formula you would have to use in the event you turned age 70½. Please make sure that you discuss this in detail with your advisor.

If you die after distributions have begun, the remaining balance must be distributed based on either your life expectancy or that of your beneficiary.

It is important to know that non-spousal beneficiaries may <u>not</u> roll over any part of the IRA into their own IRA accounts.

There are many different decisions and elections that one must make when someone passes away. Unfortunately, this is beyond the scope of this book, therefore I recommend that you set up an appointment with your advisor to discuss this situation to gather more knowledge.

Q23. After I set up my initial IRA rollover, how often can I roll it over to other IRA accounts (such as if I want to invest in something else)?

A. IRA rollovers may only be made once per year, tax-free, but that is <u>per</u> IRA. For example, if you have five different IRA accounts, you may elect to roll over each of these IRAs into different IRAs or to consolidate them into one IRA.

We recommend opening one self-directed IRA, which will allow you to make new investments without always having to do rollovers.

Another alternative is what is known as a trustee-to-trustee transfer. A trustee-to-trustee transfer is merely a transfer directly from one IRA trustee to another IRA trustee. It does not go into the retiree's hands, but is merely transferred from one institution to another, so it isn't subject to tax. Trustee-to-trustee transfers are unlimited and they avoid many of the tax- related problems of moving IRA funds to new investments. However, trustee-to-trustee transfers require a great deal of paperwork and often involve significant time delays.

Q24. What types of investments are appropriate for my IRA?

A. This is obviously a very important question. Making the proper investment choices is just as important as how to roll over your IRA. Watch out for advisors who pressure you to make your investment decisions within the 60-day rollover period -- you only need to roll over/transfer your IRA within that time. We usually recommend opening a self-directed IRA and placing the money into a money market fund until you have time to evaluate your investment options carefully.

Please note that it is important to avoid advisors who are limited to only one type of investment or company. For example, many banks only authorize investing in CDs and don't even offer the option of a true, self-directed IRA (what they call a self-directed IRA often allows you only two choices -- a CD or their money market fund!). Many investment companies do offer you a choice of investments, but only in their own mutual funds. Diversification is extremely important and it's wise not to "place all of your eggs in one basket".

Many IRA investments include sales charges, fees, and other restrictions. It is best to "shop and compare" to determine which type of investments are appropriate for you in your personal situation. Whether or not you'll need to start withdrawing funds soon is a major consideration. You must evaluate your tax situation and your income and investment assets outside your IRA as well.

Q25. Is there any way I can get a check from my retirement plan made payable to me and avoid the withholding tax?

A. No. In fact, even hardship distributions from retirement plans are subject to the 20% withholding. The only exception is if the distribution is less than $200, and no other distributions are expected to be received.

Q26. I received a $100,000 distribution from my retirement plan on December 30, 2012. I would like to only roll over $70,000 within the 60-day time period, which will be during 2013. $30,000 will be taxable, but I want this $30,000 taxable on my 2013 tax return, since my income will be lower in 2013. Can I do this?

A. No. Since the distribution came during 2012, any amount not rolled over within the 60-day time period will be taxable on your 2012 tax return.

In addition, it is important to note that when you do your IRA rollover in 2013, you must instruct the IRA custodian that this is for a 2012 distribution from a qualified plan. If you do not inform the IRA custodian of these facts, then the IRA custodian will show that the rollover they received in 2013 was for a 2013 distribution. Then, within a couple of years, you will most likely receive a letter from the IRS requesting information on this transaction, which could cause you additional fees, and a possible audit. Be careful to avoid this.

Q27. I retired six years ago with a 15-year period certain annuity from my pension plan. I now have nine years left. I'm currently in a high tax bracket and don't need this income. Can I roll over/transfer my monthly checks that I receive from my pension into an IRA, now that there is less than 10 years left for me to receive these payments?

A. No. In order to qualify for these payments to be rolled over into an IRA, the annuity must have been payable to you in a period of less than 10 years at the time you started receiving your pension. Since yours was originally a 15-year period certain, then these annuity payments do not qualify for an IRA rollover. It is also important to note that there is no mandatory 20% Federal withholding on your pension payments in this example. However, pension payments will still be subject to ordinary income tax.

Q28. You have talked about the mandatory 20% Federal withholding tax on distributions made payable directly to a retiree. Are there any mandatory State withholding taxes?

A. As of the date of this publication, there is no mandatory State withholding tax in the State of Tennessee. However, it is the author's opinion that this could change in the near future. Other states, as always, will vary. Be sure to find out what your state requires as an additional precaution.

Conclusion

It should be obvious from this report, that lump-sum distributions and IRA rollovers/transfers involve a number of complex issues and decisions. Also, keep in mind that your overall retirement planning involves not only your IRA rollover/transfer decision, but many other significant choices that will affect your future. **Therefore, it's important that you seek educated, qualified counseling *before* you make any decisions**. And it's imperative that you get involved in the planning process as much as possible in order to understand which options are the most appropriate for you.

We also encourage you to involve your spouse in your decisions, since it's important for him or her to understand what choices you're making. In fact, under federal law, it's often necessary for your spouse to actually sign a consent form to approve what you are attempting to do.

In closing, we should point out that you may want to take a look at IRS Publication 575, "Pension and Annuity Income." However, we warn you that, after reading this IRS booklet, you may become even more confused! This IRS booklet does provide technical details on some of the most complex parts of the tax code, but it does not address, in plain English, the common questions most taxpayers have. Hopefully, this report will help you bridge that gap.

If you still have unanswered questions, or you require assistance in weighing your options, give us a call.

Happy Retirement!

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