

## What to Do With Your Company-Sponsored Retirement Plan

**Overview:** As more members of the baby boomer generation enter retirement, tremendous amounts of wealth are being transferred in the form of retirement plans. The following discusses options investors should consider regarding their retirement plans.

### Introduction

The baby boomer generation describes the population born between 1946 and 1964, estimated to be about 80 million individuals. A July 2006 report by the Government Accountability Office stated that the wealthiest 10 percent of boomers averages \$1.2 million in retirement accounts and makes up more than two-thirds of the estimated \$7.6 trillion of retirement savings. As these individuals enter retirement, the result is potentially the largest transfer of wealth from company plans to individually controlled accounts in history.

### Options

For individuals leaving their jobs, there are three basic options for how to handle the assets in their company-sponsored retirement plans:

- ▲ Keep the funds in a company-sponsored retirement plan, either with the previous employer or with a new employer if switching jobs.
- ▲ Roll over the funds to an IRA.
- ▲ Withdraw the funds in a lump-sum distribution.

It is important to understand the advantages and disadvantages of each before choosing an option.

### **Option 1: Leaving the Money in a Company-Sponsored Plan**

Some of the advantages of keeping assets in a company-sponsored retirement plan (whether it is left in an old plan or transferred to a new plan) include continued tax-deferred growth without penalties and the fact that participants can borrow against the funds. Also, some plans do not require participants to take distributions after they reach age 70½ as long as they continue to work, thus allowing for longer periods of tax-deferred growth.

A significant disadvantage to leaving the funds in a plan is that individuals give up control and flexibility. For example:

- ▲ Investment choices are often limited to those selected by the employer plan.
- ▲ For some plans, participants over a set retirement age may be forced to start taking distributions according to guidelines mandated by the plan.

- ▲ Many plans do not allow the stretch options that IRA rules permit. Stretching an IRA involves the account passing to a beneficiary after the account holder's death and the beneficiary taking distributions from the IRA based on his or her life expectancy.
- ▲ The guidelines of the plan are subject to change.

One of the major benefits of leaving assets in a company-sponsored retirement plan used to be that they would be protected from bankruptcy proceedings, while IRAs would not. However, the U.S. Supreme Court ruled in April 2005 that IRAs can also receive the same federal creditor protection in bankruptcy proceedings as qualified plans.

### **Option 2: Rolling Funds Into an IRA**

A retirement plan rollover allows for continued tax-deferred growth and more control and flexibility over retirement funds when leaving a job. There are two types of rollovers:

- ▲ A **direct rollover** occurs when assets transfer from an employer-sponsored plan directly into a rollover IRA.
- ▲ An **indirect rollover** is when the employer-sponsored plan issues a check payable to the former participant, who distributes the money to an IRA within 60 days.

It should be noted that choosing an indirect rollover involves the chance that the check is not deposited within an IRA during the 60-day window. Investors who miss that window may be subject to mandatory state or federal withholding taxes as well as a 10 percent penalty.

Benefits of a rollover to an IRA include:

- ▲ Investors have numerous investment options, allowing them to customize their investment choices to meet their personal needs and risk tolerance.
- ▲ The assets will continue to grow tax-deferred.
- ▲ Consolidating several employer-sponsored plans into one IRA makes management simpler and easier. For example, each plan will have its own distribution requirements and withdrawal options.
- ▲ Investors who re-enter the workforce can roll the funds back into a new company's plan.
- ▲ IRAs may offer individuals and their beneficiaries more flexible and tax-favored distribution options than a retirement plan.

### **Option 3: Taking a Lump-Sum Distribution**

The lump-sum distribution option may be enticing because it gives individuals instant access to the cash in their retirement plan and gives them the most flexibility with how to use it. For example, it may be an easy solution for paying off debt, covering expenses between jobs or making a much needed (or wanted) purchase.

For individuals with a large percentage of company stock in their retirement plan, the IRS gives them a special tax break for taking a lump-sum distribution of this stock. Called the Net Unrealized Appreciation (NUA) rule, individuals are allowed to pay ordinary income tax on the original cost of the stock rather than its fair market value at the time of withdrawal. Once the stock is sold, the individual pays taxes at the 15 percent capital gains rate on this appreciation only. If the stock were instead rolled into an IRA, this tax break would be lost, and the value would be subject to ordinary income tax rates when IRA funds are distributed.

However, the costs for choosing the lump-sum option are perhaps the steepest of any of the options. For example:

- ▲ The plan may require a 20 percent mandatory withholding for federal income taxes from the distribution. In addition, the federal tax liability could be greater as the distribution may significantly increase taxable income in the year taken.
- ▲ A 10 percent distribution penalty will be added to the taxes for participants under age 59½.
- ▲ The distribution will result in the loss of tax-deferred growth of the assets.

Thus, if there is no immediate urgent need for the cash and the NUA rule does not apply, there is little reason for taking a lump-sum distribution out of the tax-deferred environment and subjecting the funds to taxes and potential penalties.

### **Summary**

The rise of account-based defined contribution plans (not to mention the uncertainties about Social Security) makes retirement security more dependent on individual saving and rates of return.

As a result, investors may need to become more educated about financial issues, both in accumulating sufficient assets and in learning to draw them down effectively. Part of that could involve investors seeking help from their investment advisor regarding their retirement plans.

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