

For years, you've been trying to shelter your retirement savings from federal income tax. You've even found the perfect IRA to carry your nest egg tax-deferred into the 21st century. However, legislative changes that went into effect at the beginning of 1993 will complicate your planning.

The good news in these changes is that you've got more command over the investment of your savings than ever before. The bad news is that if you're not careful, some of that nest egg may find itself subject to current, rather than future taxation.

THE CATALYST: LEGISLATIVE CHANGES

Deep in the heart of last July's Unemployment Compensation Amendments Act were enhancements to two old friends of distributions from company-sponsored savings plans: rollovers and federal income tax withholding.

A rollover — the transfer of taxable money from one retirement savings vehicle (e.g., your company's 401(k) plan) to another (e.g., your next job's retirement plan or an IRA) — maintains the deferral of all tax consequences on the amount being transferred. At the beginning of 1993, rollovers were made far more available than ever before. Except when paid in annuities, almost any taxable money you receive from an IRS-qualified pension and savings plan can be rolled over to another qualified

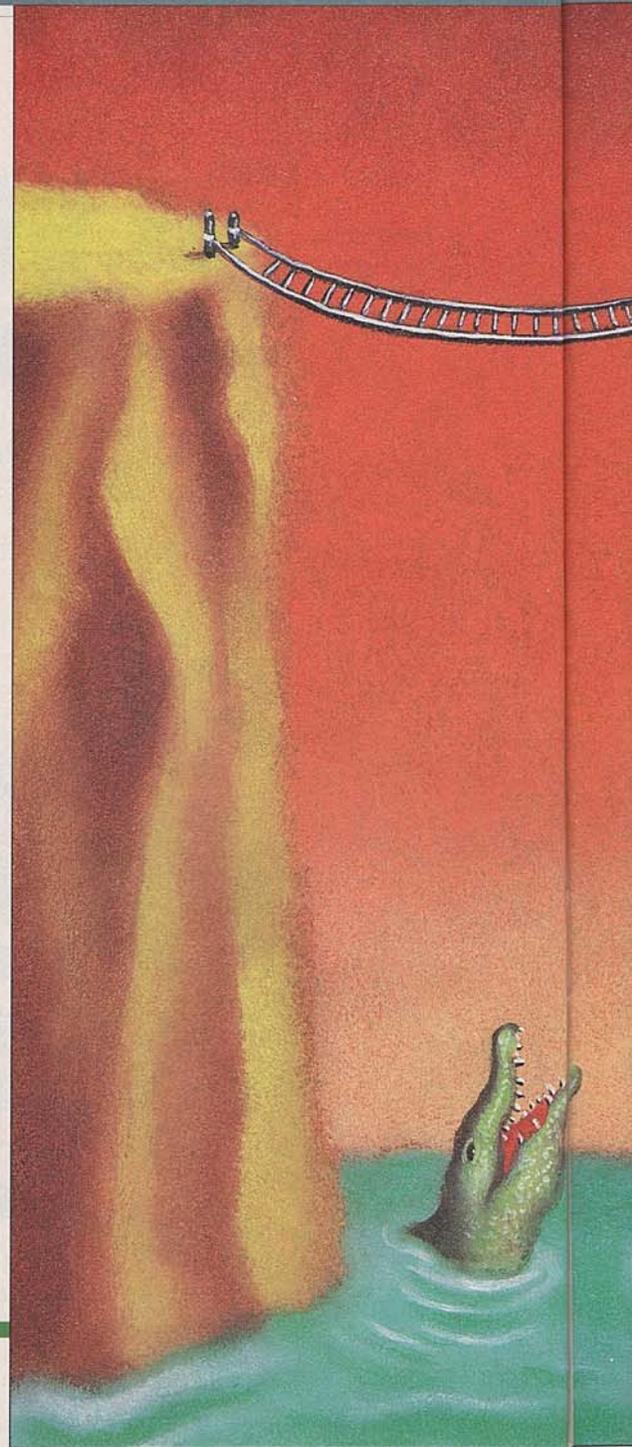
plan or IRA, even if you're still employed by the company sponsoring the plan that's holding your money.

From these plans, as from everywhere else, withholding is the IRS' way of saying, "we need an advance" on the tax you'd otherwise be paying next April 15th. This year, withholding became mandatory, and at a 20% rate, from virtually all payments that are not being *directly* rolled over, except for annuities. Rollovers only are "direct" when the money is either forwarded by your plan directly to the receiving plan or IRA, or given to you in a check made payable to the receiving plan or IRA.

QUALIFIED PLANS VS. IRAS

If rollovers and withholding were the only two considerations, tax strategy would be easy: (i) whenever you're attracted by an IRA's investment mix, even while you're employed, just roll over any taxable money you can get out of your company's 401(k) plan, and (ii) unless you *really* need your 401(k) money when you leave your job, either leave it in the plan, or roll it on over to avoid the withholding. But, in reality, there are a lot of subtle reasons to look before you leap into rollovers.

Company-sponsored retirement plans offer unique opportunities not found in IRAs, such as loans, tax-saving forward averaging and capital gains treatment, and protection from creditors in the event of bankruptcy. Depending on the magnitude of your



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savings and other current and future taxable income, the flexibility and reduced tax rates from these opportunities can be worth thousands, maybe tens of thousands of dollars in tax savings to you.

Are these things to just give away? Probably not, but if you gain something back by rolling over, like a great investment opportunity, then maybe you're making a fair trade for yourself. Here are some things to consider.

CONSIDERATIONS BEFORE ROLLING OVER

The concept of rollovers is not new. People have rolled over and sheltered the taxable portion of their lump sum distributions, within 60 days of receipt, for years. But that was when federal income tax withholding was optional.

Now, withholding is taken automatically unless the amount is *directly* rolled over. As a result, this means you're being paid only 80% of the money you thought you had 60 days to completely shelter. You still have the 60 days to complete a rollover, but you have to look elsewhere (e.g., other personal savings, a bridge loan, etc.) for the missing 20% to roll over. Otherwise, the 20% withheld is deemed additional taxable income to you. Clearly, you've got to make your rollover decision sooner than you had to under the old rules (i.e., *before* you receive your money). The old 60-day

rollover sure doesn't shelter everything it used to.

If sheltering is the key, direct rollovers accomplish what you're really trying to do: not pay any tax now, at least not on your retirement savings. And if you don't want to pay any tax now, it's likely you wouldn't want any withholding taken now either, especially when it would just be refunded to you after you file your tax return.

On the other hand, maybe just leaving your money in your company's plan is the best thing after all. You might not be thrilled with its investment options, but that sexy IRA across the street has to make up in earnings what you'd be losing in tax savings from your plan's forward averaging or capital gains treatment. There is no absolute answer to this, other than an old familiar suggestion: be sure to contact your personal tax advisor before hastily responding to the lure of an IRA or another qualified plan.

And, be sensitive to how your company's plan lets you draw on the taxable money you want to roll over. Plans often dictate that when you've elected to withdraw, some or all of your tax-free money (i.e., contributions you've made to the plan on an after-tax basis) is distributed *before* the bulk of your taxable, rollover-eligible money. By law, the tax-free money can't be rolled over at all. So, by withdrawing enough to fuel your rollover, you'd be

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left holding the tax-free money, with less chance to earn tax-deferred income on it.

DIRECT ROLLOVERS FROM ONE PLAN TO ANOTHER

Company-sponsored plans don't automatically provide favorable tax treatment (e.g., forward averaging and capital gains). You must participate in these plans during at least five years before the year in which you receive your payment. After a direct rollover, your years of participation in the sending plan don't count toward the five you'll need in the receiving plan. And, if you only roll over a portion of your account, the remainder in that plan (including future contributions and investment earnings) can *not* receive forward averaging or capital gains treatment when it is ultimately paid to you.

In fact, by rolling over, you're not only trading in preferential tax treatment for the next plan's investment options, but also for the next plan's withdrawal and loan provisions. The simplicity of the rollover process — some plans make it very easy to steer payments to another plan or IRA — shouldn't distract you from investigating the receiving plan's in-service distribution options. If loans or non-hardship withdrawals aren't available to "rollover accounts" in the new plan, your future access to this money could be more restricted than if it had remained in the sending plan all along.

HOW MANDATORY IS THE MANDATORY WITHHOLDING?

IRAs have always been long-term savings vehicles. Now, they can be effective in the short term, as well. If you're entitled to a sizeable payment from your com-

pany's profit-sharing plan and you want to minimize immediate federal income tax withholding, consider that withholding is only mandatory from company-sponsored plans, not IRAs.

This distinction leads us to the "IRA two-step," a convenient little jig that gets you your money without a 20% bite taken out.

Step one: elect your distribution to be *directly* rolled over (remember, the conventional 60-day rollover won't do) into any liquid IRA investment.

Step two: close out the account as soon as you like and, subject to any restrictions imposed by the IRA sponsor, take your money. IRAs require a 10% premature distribution penalty, just like qualified plans (almost), but there's no 20% withholding.

If you like the two-step, beware the "almost." The 10% penalty — an extra tax not just extra withholding — remains effective until different ages between qualified plans and IRAs. If you're receiving a distribution from your company's 401(k) plan because you stopped working there during or after the year you reach age 55, you should defer receiving your payment from the IRA until after age 59 1/2.

Otherwise, you may walk right back into an additional 10% tax that you had outlasted in the profit-sharing plan.

Of course, without withholding, you'll likely owe tax next April 15th and, perhaps, quarterly estimated taxes beforehand.

BEWARE OF STATE TAXES

While federal income tax withholding is increasingly visible in retirement plan distributions, state tax issues remain conspicuously silent. State withholding procedures across company-sponsored plans are much less prevalent, yet state taxes ultimately need to be paid. In fact, a number of states'

withholding formulas are tied to federal withholding, so it could be interpreted that they, too, have crossed the line from optional to mandatory.

Play it safe. When receiving a taxable payment from any plan, be aware of its state withholding policy and your state's requirements for periodic estimated tax payments, if any. A sizeable payment from your 401(k) plan could mean a sizeable obligation to your home state. Don't wait until April 15th to find out.

IF WITHHOLDING IS A PROBLEM, CAN LOANS AND COMPANY STOCK HELP?

Within company-sponsored plans, federal withholding has always found an obstacle: employer securities. By law, shares of company stock count towards what's taxable, but they do not have to be sold just to provide cash for federal withholding. When the taxable portion of your payment consists of company stock, it will be at least partially taxable if you don't roll over the shares. But if there's not enough cash in your payment, the IRS has no source for its withholding. It appears that investing in company stock, even briefly, can be a clever way to push back Uncle Sam to next April 15th. But again, beware of the IRS' quarterly estimated tax requirements.

Under the new withholding rules, taking a loan from a qualified plan is similar to investing in company stock. An outstanding loan balance is likely to become taxable to you when the rest of your account becomes payable, but if your account has nothing else from which the IRS can withhold, here too, you'll receive your payment withholding-free.

With all the nuances in the tax law surrounding qualified plans and IRAs, the new rules certainly add some spice to financial decision-making. Only you can decide which are the best moves in keeping with your overall tax and investment strategy, both short-term and long-term.

Just watch out for the traps. ◀

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