

# FINANCIALink®

Your Money Management Newsletter

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 Title

## IRA Rollovers: *Helping Retirement Savers Defer Taxes, Avoid Penalties*

If you participate in an employer-sponsored retirement plan, you may have concluded that you don't need a traditional IRA. Many people see the IRA as unnecessary because they don't exhaust the contribution limits on their employer plans. But don't be fooled into thinking that an IRA can't help you reach your retirement saving goals. Chances are actually pretty good that there's at least one IRA rollover in your future.

An IRA rollover is a method of transferring assets to a traditional IRA from an employer-sponsored retirement plan, such as a 401(k) or a 403(b), or from another IRA. Rollovers are commonly used by workers who are changing jobs or retiring and want to move their assets out of a former employer's plan. Rollovers can also be used to consolidate retirement assets or change financial institutions. A correctly executed IRA rollover preserves the tax-deferred status of qualified retirement savings and helps avoid tax penalties.

IRA rollovers are so popular that they account for about \$96 of every \$100 flowing into traditional IRAs (IRA contributions account for the remaining inflows).<sup>1</sup> Many investors recognize the advantages that IRAs have to offer.

**Some employer-sponsored retirement accounts have limited investment choices.** When you participate in an employer's plan, your investment options are limited to those offered by the plan itself. Some plans may have high fees. Once you leave the employer, an IRA may provide you with more freedom to choose the investments that make sense for your financial goals. Not only is the universe of investment options in an IRA much larger, but an IRA can include individual securities and alternative investments.

### BY THE NUMBERS

**41.4%**  
 U.S. households who owned some type of IRA in 2010

**26.9%**  
 Percentage of U.S. retirement wealth held in IRAs in 2010

**4.1%**  
 Percentage of traditional IRA inflows due to contributions in 2008

Source: Investment Company Institute, 2010–2011 (most recent data available)

**Retirement assets scattered across a number of accounts may be difficult to manage.** By consolidating your assets into a single IRA, you may have a clearer picture of your portfolio's assets and allocations, which could help you more easily make adjustments as your needs and circumstances evolve. This is especially important for people age 70½ and older who are required to take minimum annual distributions based on their age and the total assets they hold in tax-deferred retirement accounts.

**IRAs have provisions for qualified penalty-free withdrawals before age 59½.** First-time homebuyers (including buyers who haven't owned a home in the previous two years) may be able to withdraw up to \$10,000 (lifetime limit) toward the purchase of a home. IRA funds can be withdrawn to pay qualified higher-education expenses for IRA owners and their spouses, children, and grandchildren. An IRA can even be used to pay unreimbursed medical expenses in excess of 7.5% of adjusted gross income.<sup>2</sup>

Penalty-free IRA withdrawals are also allowed for owners who become permanently disabled and for IRA beneficiaries; however,

spouses who inherit an IRA and elect to treat it as their own may be subject to the penalty on distributions before age 59½.

Although these early-withdrawal exceptions may avoid the 10% federal income tax penalty, all distributions from traditional IRAs are subject to ordinary income taxes.

### **THE TYRANNY OF MISTAKES**

An IRA rollover is simple in theory, but the details can be complicated. Failure to abide by the rules can result in tax penalties and unintended tax consequences. This makes it a good idea to fully understand your options before you initiate a rollover.

When you opt for a *direct (trustee to trustee) rollover*, the assets are transferred directly from your existing account to the new IRA. The details are handled by the financial institutions involved, which helps reduce the potential for error because you are never in possession of the funds.

When you execute an *indirect rollover* from an employer-sponsored retirement plan to an IRA, only 80% of the lump-sum distribution will be distributed to you. The remaining 20% is withheld to help cover taxes.

You have 60 days to deposit the retirement assets in a new IRA.

And here's where an indirect rollover can become complicated: You must deposit 100% of the employer plan distribution in the new IRA, even if you receive only 80% of your vested balance. This means you must find another source to replace the 20% that was withheld. If not, the difference between the total distribution (including the amount withheld for taxes) and the amount rolled over to the IRA is subject to income taxes and the 10% early-withdrawal penalty.

For workers who are 55 or older in the year they separate from service, the early-withdrawal penalty is waived on employer plan distributions. This is a major consideration if you might need access to your retirement funds in the near term. Once the assets are in the IRA, the 10% penalty *will* apply to nonqualified withdrawals before age 59½.

Before initiating an IRA rollover, consider consulting with your tax and financial professionals.

1) Investment Company Institute, 2010 (2008 data, most recent available)

2) As a result of the Pension Protection and Affordable Care Act, this threshold rises to 10% of AGI for individuals under the age of 65 starting in 2013 and for all individuals beginning in 2016.

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