

Baird Investor Education

Using a Rollover IRA to Consolidate Multiple Retirement Assets

Your retirement plan assets may be one of the most important legacies you take with you when you move from one job to another. Intended to help provide financial security later in life, these assets need to be managed carefully and invested wisely in order to help ensure that they will be available when eventually required.

Rollover IRAs Offer a Wide Range of Benefits

As compared with employer-sponsored retirement accounts, a rollover IRA can provide you with the broadest range of investment choices and the greatest flexibility for distribution planning. Also, a rollover IRA can typically be operated with fewer restrictions. Here's a brief overview that highlights some of the key benefits of a rollover IRA compared with an employer-sponsored plan.

1. As the IRA account owner, you make the key decisions that affect management and administrative costs, overall level of service, investment direction, and asset allocation. You can develop the precise mixture of investments that best reflects your own personal risk tolerance, investment philosophy, and financial goals. You can create IRAs that access the investment expertise of any available fund complex, and can hire and fire your investment managers by buying or selling their funds. You also control account administration through your choice of IRA custodians.
2. While you may look forward to a long and healthy career, life's uncertainties may force changes. Internal Revenue Service distribution rules for IRAs generally require IRA account holders to wait until age 59^{1/2} to make penalty-free withdrawals, but there are a variety of provisions to address special circumstances. These provisions are often broader and easier to exploit than employer plan hardship rules.

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Points to Remember

1. Retirement plan assets that are scattered among numerous accounts may be difficult to manage effectively, with hard-to-assess portfolio allocations and risks.
2. Lump-sum distributions are immediately taxable as ordinary income unless rolled over into another tax-qualified plan within 60 days.
3. IRAs generally offer more flexibility in estate planning than employer-sponsored plans.
4. Employer stock can be treated differently from other assets in a lump-sum distribution in order to harvest the benefits of long-term capital gains tax treatment.
5. IRAs may offer less protection in personal bankruptcy than employer plans.

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- IRAs are more useful in estate planning than employer-sponsored plans. IRA assets can generally be divided among multiple beneficiaries in an estate plan. Each of those beneficiaries can make use of planning structures such as the Stretch IRA concept to maintain tax-advantaged investment management during their lifetimes. Beneficiary distributions from employer-sponsored plans, in contrast, are generally taken in lump sums as cash payments. Also, except in states with explicit community property laws, IRA account holders have sole control over their beneficiary designations.

Efficient Rollovers Require Careful Planning

One common goal of planning for a lump-sum distribution is averting unnecessary tax withholding. Under federal tax rules, any lump-sum distribution that is not transferred directly from one retirement account to another is subject to a special withholding of 20%. This withholding will apply as long as the employer's check is made out to you — even if you plan to place equivalent cash in an IRA immediately. To avert the withholding, you must first create your rollover IRA, and then request that your employer transfer your assets directly to the custodian of that IRA.

Keep in mind that the 20% withholding is NOT your ultimate tax liability. If you spend the lump-sum distribution rather than reinvest it in another tax-qualified retirement account, you'll have to declare the full value of the lump sum as income and pay the full tax at filing time — at a rate of up to 35% depending on your eventual tax bracket. In addition, the IRS generally imposes a 10% penalty tax on withdrawals taken before age 55 from an employer-sponsored plan and age 59½ from an IRA.

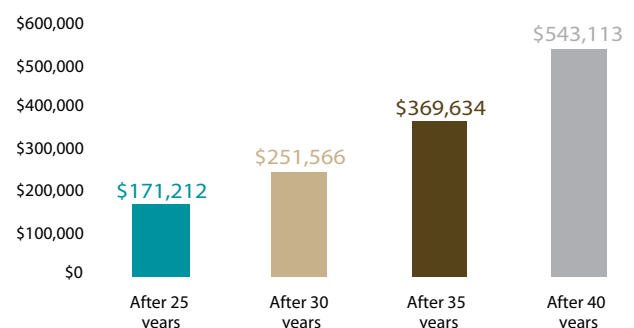
Also, if you plan to roll over the entire sum, but have the check made out to you rather than your new IRA custodian, your employer will be required to withhold the 20%. In that event, you can get the 20% refunded if you complete the rollover within 60 days. You must deposit the full amount of your distribution in your new IRA, making up the withheld 20% out of other resources. When you file your tax return for the year, you can then include a request for refund of the lump-sum withholding.

If you have after-tax contributions in your employer plan, you may opt to withdraw them without penalty when you roll over your assets. However, if you wish to leave those funds in your retirement account in order to continue tax deferral, you can include them in your rollover. When you begin regular distributions from your IRA, a prorated portion will be deemed nontaxable to reimburse you for the after-tax contributions.

How much could that cash distribution be worth when you retire?

A retirement nest egg grows most vigorously when investment proceeds are permitted to compound over long time periods. A relatively small amount of money today may become a considerable nest egg when earnings are compounded over a lifetime, as this chart illustrates.

Estimated Future Value of \$25,000 Assuming an 8% Average Annual Return



Source: Standard & Poor's. For illustrative purposes only. Example is hypothetical in nature and is not indicative of any particular investment. Past performance is not indicative of future returns.

Special Considerations for Company Stock

Many firms make some or all of their contributions to employee accounts in the form of company stock, bonds, or other securities. If you have company securities in your account and their current market value includes significant price appreciation, you could benefit from an in-kind distribution for the company securities that is separate from the lump-sum cash-out of other investments' assets.

An in-kind distribution is delivery of the actual securities rather than their cash value. The potential benefit comes from the fact that any price appreciation which occurred while the securities were held in the 401(k) can be treated as capital gains rather than ordinary income. When you take an in-kind distribution of your employer's securities, you will pay income tax only on the original cost basis of the securities; the balance of the value on the distribution date is categorized as net unrealized

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appreciation (NUA). When you sell the securities, the NUA is treated as a long-term capital gain. Any gain that might occur after the distribution date is taxed as if you bought the securities on the date of the distribution. (Note that NUA treatment is available only for publicly traded securities.)

Potential Downsides of IRA Rollovers to Consider

While there are many advantages to consolidated IRA rollovers, there are some potential drawbacks to keep in mind. Assets greater than \$1 million in an IRA may be taken to satisfy your debts in certain personal bankruptcy scenarios. Assets in an employer-sponsored plan cannot be readily taken in many circumstances. Also, you must begin taking distributions from an IRA by April 1 of the year after you reach 70^{1/2} whether or not you continue working, but employer-sponsored plans do not require distributions if you continue working past that age.

Remember, the laws governing retirement assets and taxation are complex. In addition, there are many exceptions and limitations that may apply to your situation. Therefore, you should obtain qualified professional advice before taking any action.