Strategies for Managing Retirement Assets in the Event of a Layoff

Layoffs are a fact of corporate life as companies grapple with economic cycles and global competition. If you get caught in a corporate downsizing and you are not immediately moving to a new employer, you generally have three options for your retirement plan assets:

1. Leave your money in the existing plan.
2. Take a cash or "lump sum" distribution.
3. Transfer the money to another qualified retirement account such as an individual retirement account (IRA).

Consider the merits of each option.

Option #1: Stay Put

You may be able to leave your savings in your existing plan if your account balance is more than $5,000.[1] By doing so, you'll continue to enjoy tax-deferred or tax-free compounding potential and receive regular account statements and performance reports. Although you will no longer be allowed to contribute to the plan, you will still have control over how your money is invested among the plan's investment selections.

Option #2: Cash Out

You may elect to have your money paid to you in one lump sum or in installments over a set number of years. A lump-sum approach has a number of drawbacks, including a 20% withholding on the pre-tax contributions and the earnings portion of the eligible rollover distribution (to help cover your ordinary income tax liability) and a 10% additional tax on early withdrawals if you separate from service before age 59½ (55 in certain circumstances). Depending on your tax bracket and state of residence, you may be liable for additional taxes and penalties. An installment approach, whereby distributions are made in substantially equal payments over the participant's or the participant's and spouse's life expectancy may not be subject to additional taxes. But this is a fairly complex option that may require the assistance of a financial advisor.

Option #3: Roll Over

You can move your retirement plan money into another qualified account, such as an IRA, using a "direct rollover" or an "indirect rollover." Note that traditional plan balances can only be rolled into traditional IRAs and new Roth-style plan balances can only be rolled into Roth IRAs. With a direct rollover, the money goes straight from your former employer's retirement plan to your IRA without you ever touching it.

The advantages of a direct rollover include simplicity and continued tax deferral on the full amount of your plan savings. IRAs may also afford more investment choices than many employer-sponsored plans. In an indirect rollover, you take a cash distribution, less 20% withholding, but must redeposit your qualified plan assets into an IRA within 60 days of withdrawal to avoid paying taxes and penalties. With this approach, however, you'd have to make up the 20% withholding out of your own pocket when you invest the money in the new IRA, or else the withheld amount would be considered a distribution, so ordinary income tax and the 10% additional tax would apply. And in either case, an IRA may be subject to higher fees and expenses than the employer-sponsored plan it replaced.

Consider Other Short-Term Funding Sources

During times of economic hardship, it may be tempting to take money intended for future needs and use it to supplement a temporary income shortfall. But remember that any funds you take out today will ultimately reduce your retirement nest egg tomorrow.

Before choosing a cash distribution from a retirement plan, consider other potential sources to meet your current income needs. For example, savings accounts and money market accounts are easily liquidated. With short-term interest rates at historically low levels, the opportunity cost for using these funds is relatively low.

[1]In general, an employer should roll assets exceeding $1,000 into an IRA in your name, unless otherwise directed by you.

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