How to Avoid the Pension Distribution Tax Trap

by F. Bill Billimoria, MBA, CPA, CFP

Q. I am planning to change jobs early next year. I wanted to take my $150,000 pension in a lump sum and roll it over into my IRA, but now I hear that the IRS will be able to slap a tax on my lump-sum distribution. Is that true?

A. Yes, if you do not roll it over correctly. Starting January 1, 1993, anyone who receives a lump-sum distribution directly from their employer as a result of retirement, layoff or change of job will find that lump sum automatically reduced by a 20-percent withholding tax. That means your employer will take out 20-percent of the distribution and send it straight to Uncle Sam, leaving you with only 80-percent ($120,000 in this case) of your lump sum to roll over.

Q. I thought I had 60 days to roll it over tax free?

A. Through December 31, 1992 that is correct. You can roll the funds into an IRA or another company's pension plan within 60 days of receipt and you will not pay any tax on it. After that, you are out of luck.

Q. What exactly could this cost me?

A. The government would withhold 20-percent of your lump sum, or $30,000. If you are in the 28-percent federal income tax bracket, you will pay taxes of $8,400 on the $30,000. To make matters worse, if you have not reached the mandatory retirement age of 59½, you could end up paying an additional 10-percent penalty tax of $3,000. So on the $30,000 that was withheld, you will pay taxes of $11,400 and the balance ($18,600) will be refunded to you by the IRS.

Q. That's outrageous. Is there any way around it?

A. There are two ways. You can get the 20-percent withholding back when you file your tax return if you can make up the shortfall (in this case $30,000), and add it to the 80-percent so that 100-percent is actually rolled over. Since the government will not let you use the 20-percent it withheld, you will have to find the funds elsewhere — not an easy task for most people. Furthermore, you will have to make up the 20-percent within 60 days of receipt of the original distribution. Even if you do make up the difference, the government will get to keep your $30,000 (interest free) until you file your tax return.

Q. That does not sound promising. What's the second way?

A. Have your employer transfer the lump sum directly from your custodian (pension) account to another custodian account such as an IRA. Do not touch it unless you absolutely need the money.

Q. Are employers required to tell their employees about this law?

A. Yes. They are also required to provide proper forms for the custodian-to-custodian transfer. But inevitably there will be breakdowns in communication or confusion. Especially vulnerable are small-business employers or the self-employed who may not be fully informed. The people who will be caught in this pension trap — and who will pay — will be the unwary.

Q. This tax seems sneaky to me.

A. More than a few legislators think so too. Congress dreamed up this obscure tax to help pay for extending unemployment benefits, but there is already a move to repeal this provision. But until that happens, be alert and be informed.

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