

Often Asked Questions Regarding IRA Rollovers and Lump Sum Distributions

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A. CURRENT TAXATION OF LUMP SUM DISTRIBUTIONS

In general, distributions from a retirement plan are taxable to the recipient unless the liability can be deferred by means of a rollover to an IRA or to another retirement plan. Some distributions are eligible for certain favorable tax treatments that may result in a lower tax liability than ordinary income tax rates.

1. What distributions are eligible for favorable income tax treatment?

Only lump-sum distributions are eligible for favorable income tax treatment.

2. What is a lump-sum distribution?

A lump-sum is the payment of an employee's entire balance from a qualified plan (and all plans of the same type sponsored by the employer) within one tax year. The distribution must be made on account of the employee's death, attainment of age 59½, or separation from service with the employer. If a client is self-employed, a distribution made on account of separation from service is a lump-sum distribution only if the client is also disabled.

3. Are there any other eligibility requirements?

An employee must have been a participant in the plan for at least five years before the year of the distribution to qualify for a preferential tax treatment.

4. What distributions do not qualify for preferential tax treatment?

Distributions that do not qualify for preferential tax treatment include amounts paid from:

- 403(b) Plans and Tax Sheltered Annuities maintained by school districts, hospitals and other non-profit organizations
- Non-qualified Deferred Compensation Plans
- Section 457 Plans offered by many municipal and governmental entities
- Individual Retirement Accounts (IRAs)
- Simplified Employee Pension Plans (SEP-IRAs)
- Savings Incentive Match Plan for Employees using IRAs (Simple IRA)



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Often Asked Questions Regarding IRA Rollovers and Lump Sum Distributions, continued

5. What favorable tax treatments are available

The specific favorable tax treatments available depend upon the employee's age and years of plan participation. Alternatives include:

- Ten-Year Averaging
- Long-Term Capital Gain Treatment

6. What is income averaging?

Income averaging allows an individual to pay income tax on a lump-sum distribution as if the amount had been received over a period of ten years, rather than all at once. The resulting tax may be less than the tax due on the entire amount since the smaller averaged amount will often be taxed at a lower rate than the total distribution. The income averaging tax liability is separate from (and in addition to) any regular income tax due for the year. The tax calculated on averaged amounts is due in its entirety for the year the distribution is received. It is not paid over a ten-year period.

TEN-YEAR AVERAGING

- Must be age 50 before January 1, 1986
- Five years participation in plan
- Averaging at 1986 federal income tax rates
- Taxed separately as if sole income

7. Who is eligible for ten-year averaging?

Ten-year averaging is available to recipients of a lump-sum distribution from qualified plans that have participated in the plan for at least five years. In addition, the recipient must have been born before January 1, 1936 to qualify.

8. What income tax rates are used to calculate tax using ten-year averaging?

Ten-year averaging uses the 1986 tax rate schedule. Ten-year averaging may be applied to the entire distribution, or only to the portion attributable to post-1973 participation in the plan. Long-term capital gain treatment may then be used for the remainder of the distribution stemming from participation in the plan prior to 1974.

9. Can ten-year averaging be used more than once?

No. Ten-year income averaging may be used just once. If an election is made to use ten-year averaging prior to age 59½, no preferential tax treatments may be used after age 59½.

*Often Asked Questions Regarding IRA Rollovers
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10. Where is the election to use ten-year averaging made?

An election to use ten-year averaging is made and the tax is computed on IRS Form 4972, Tax on Lump Sum Distributions. This form is attached to the recipient's income tax return for the year in which the distribution was paid.

TEN-YEAR AVERAGING TAXES ON SELECTED SIZE DISTRIBUTIONS		
Distribution Amount	Tax\$	% of Taxable Distribution
20,000	1,100	5.5
50,000	5,874	11.7
100,000	14,471	14.5
150,000	24,570	16.4
200,000	36,922	18.5
300,000	66,330	22.1
500,000	143,682	28.7
1,000,000	382,210	38.2

Source: IRS

11. What is long-term capital gain treatment?

For plan participants who attained age 50 before 1/1/86 (born before 1936), capital gains tax treatment may be available for the part of a qualifying lump sum distribution attributable to active participation before 1974. The part of the qualifying lump sum distribution attributable to active participation after 1973 is taxed as ordinary income, but the recipient may also be eligible for 10 year averaging.

For example, Jerry became an active participant in his employer's qualified plan on 12/10/66 and continued to work until 3/13/95, at which time he retired at age 60. He received a lump sum distribution in the amount of \$205,000. In determining active participation for purposes of the portion eligible for the capital gain election, Jerry has 96 months (12 X 8) of participation before 1974 (1966 counts as 12 months). He has 243 months of participation after 1973 (March 1995 counts as 3 months in 1995).

The portion of the qualifying lump sum distribution for capital gains is \$58,053:

$$\begin{array}{rclcl} \$205,000 & \times & \frac{96 \text{ (pre-'74 months)}}{339 \text{ (total months)}} & = & \$58,053 \end{array}$$

The portion of the qualifying lump sum distribution treated as ordinary income (and possible subject to tax averaging is \$146,947:

$$\begin{array}{rclcl} \frac{243 \text{ (post-'73 months)}}{339 \text{ (total months)}} & = & \$146,947 \end{array}$$

Tax Form 4972 is used to calculate any capital gains and tax averaging applicable to qualifying lump sum distributions.

Often Asked Questions Regarding IRA Rollovers and Lump Sum Distributions, continued

12. Who may use long-term capital gain treatment?

Individuals born prior to January 1, 1936 (i.e., plan participants who attained age 50 before 01/01/86) with pre-1974 plan contributions are eligible to elect this method of figuring the tax due on a lump sum distribution.

13. What if an individual receives more than one distribution?

Once a decision to use a favorable tax treatment has been made, the election applies to all lump-sum distributions from all plans during a given tax year, even if the distributions are from two different types of qualified plans.

An individual may not use income averaging on one distribution and rollover a second distribution to an IRA in the same year. Similarly, an individual may not pay tax at the long-term capital gain rate on the pre-1974 portion of a distribution and rollover the remaining payment to an IRA.

14. What if a distribution includes employer stock?

If part of a distribution consists of company stock, the employer provides a statement that includes the actual cost basis of the securities and the market price of the securities on the date of distribution. The difference between the two is called net unrealized appreciation (NUA).

15. What is Net Unrealized Appreciation?

Net Unrealized Appreciation (NUA) is the difference between cost basis (amount you paid) and market value of the stock in your company qualified retirement plan. This difference in value may be important to you in that there is a special federal income tax treatment available for “in-kind” distributions from your company’s qualified retirement plan.

16. What is the special tax treatment?

Under this rule, you may take your company stock out of your retirement plan “in-kind” (i.e. you receive the stock), elect not to rollover these shares into an IRA Rollover, and pay only ordinary income tax on the stock’s cost basis (original price paid for shares). If you eventually sell the shares you would pay long-term capital gains taxes on the NUA.

17. How is this an advantage?

Although you pay income taxes now on the stock’s cost basis, you defer taxation on the NUA until you sell the shares. At that time, you pay capital gains taxes, which are currently lower than ordinary income taxes. For example, federal ordinary income tax rates might be as high as 35% while the highest federal capital gains tax rate is currently 15% (this rate is scheduled to remain at 15% until 2010).

Often Asked Questions Regarding IRA Rollovers and Lump Sum Distributions, continued

18. What if some of the distribution is not company stock?

Portions that are not company stock may be rolled to an IRA rollover or another company retirement plan. These funds may also be taken as a taxable distribution. (IRC Section 402 (e)(4))

Here is an example of how this might work:

Lynn left ABC Company and received a lump-sum distribution consisting of \$600,000 of ABC Company stock and \$200,000 in cash. The plan's cost basis in the shares distributed was \$100,000. Lynn sells the stock five years later for \$1,000,000.

Lynn takes the stock as an in-kind distribution and deposits it into her brokerage account. She rolls the \$200,000 in cash into her IRA. In the year of the distribution she must pay income taxes and any applicable early distribution penalty on \$100,000 of ordinary income.

Five years later when Lynn sells all of the stock for \$1,000,000 she will pay long-term capital gains tax on the following:

- The NUA of \$500,000; (\$600,000 market value less \$100,000 cost basis) and
- The increase in value since the date of the distribution (long term capital gain of \$400,000).

19. What are some additional benefits of taking a lump sum distribution of company stock?

If you die without selling the stock, your heirs under current law will get a step-up in basis that eliminates the capital gains on any appreciation between the day of the original distribution and the day of your death (\$400,000 in the above example). They will still have to pay long-term capital gains tax on the original NUA amount (\$500,000).

Since the employer stock will not be rolled into your IRA, the value will not be subject to required minimum distributions when you turn 70½ years old. You can control when to pay income taxes on the NUA portion.

If you have charitable interests, you can avoid income taxes on the NUA by gifting shares directly to a charity or to a charitable remainder trust. This may also provide you with a tax deduction and lower the value of your estate.

20. Is there a mandatory 20% income tax withheld from my qualified plan distribution of company stock?

No, company stock distributed from your qualified retirement plan is not subject to the mandatory 20% income tax withholding. This exception does not apply to distributions other than company stock.

21. Does the 10% pre 59½ distribution penalty apply in the distribution of company stock?

Unless you are over 59½ or are 55 or older and separating from service with the company, a 10% penalty will be applied to the taxable amount of the distribution.

Often Asked Questions Regarding IRA Rollovers and Lump Sum Distributions, continued

22. Are there any other taxes associated with a retirement plan distribution?

Like premature withdrawals from IRAs, distributions from qualified plans and tax-sheltered annuities made prior to age 59½ are subject to a 10% penalty tax. This penalty is imposed on taxable distributions with the following exceptions:

- Distributions from retirement plans made to individuals who separate from service at age 55 or older.
- Divorce distributions made to a spouse (or former spouse) pursuant to a Qualified Domestic Relations Order (QDRO).
- Distributions paid to individuals on account of disability (as defined pursuant to IRC 72(m) (7))
- Distributions paid to a beneficiary on account of death.
- Distributions of **substantially equal periodic payments*** made over an individual's life (or life expectancy of the joint lives of an individual and a beneficiary) and continuing the longer of five years or age 59½ (and where specifically permitted by the plan document)

** These distributions are not subject to the 10% penalty tax.*

B. THE ROLLOVER OPTION FOR LUMP SUM DISTRIBUTIONS

Most individuals will elect to rollover their retirement plan distribution(s) into an IRA.

23. What is an IRA rollover?

A rollover is the tax-free transfer of all (or a portion) of a qualifying rollover distribution into an IRA. This transaction is reported to the IRS.

24. What is a qualifying rollover distribution?

A qualifying rollover distribution is the taxable as well as after tax portion of a distribution paid from a qualified plan. Qualified plans include pension plans, profit-sharing plans, 401(k) plans, tax-deferred savings plans, Thrift plans, ESOPs, and Keogh plans.

Some types of plans, such as 403(b) plans and tax-sheltered annuities maintained by schools, hospitals, and other non-profit organizations and 457(b) plans sponsored by state and local governments are not qualified plans, yet distributions paid from these plans are qualifying rollover distributions and are eligible for rollover to an IRA.

Often Asked Questions Regarding IRA Rollovers and Lump Sum Distributions, continued

25. What types of distributions may not be rolled over into an IRA?

The following types of distributions, are **not** qualifying rollover distributions:

- mandatory distributions received after age 70½
- installments made over a specified period of 10 years or more
- installments in a series of substantially equal periodic payments made over the life or life expectancy of the participant and a beneficiary, such as annuity payments or penalty-free withdrawals before age 59½. (Refer to question 39.)

26. What are the advantages of an IRA rollover?

An IRA rollover allows an individual to retain the tax-deferred status of the retirement plan distribution. Any income tax due on the rollover amount or the earnings on that amount is postponed until distributions are taken from the IRA.

27. How does an individual complete a rollover?

There are two methods of moving a distribution from a company-sponsored plan to your IRA. The first is a **direct** rollover.

In a **direct** rollover, a distribution is rolled-over directly from the plan to the IRA. Direct rollovers are often transacted directly from one trustee to the successor trustee, with the recipient never actually taking receipt of the funds. Alternatively, a check may be issued to the employee, but made payable to the successor custodian of an eligible IRA. This would also qualify as a direct rollover, since the plan participant is unable to negotiate the check.

The employer typically provides a distribution election form used by employees to make a direct rollover election. If not, employees should make such an election in writing, and include the name and address of the recipient IRA, along with a statement that the employee believes the recipient IRA to be an eligible IRA or IRA Rollover.

The second option is for the employee to take personal receipt of the distribution and complete the rollover within 60 days of receipt of the funds. Under this option, the employer is then required to withhold 20% of the value of the total distribution as federal income tax withholding.

28. What are the advantages of a direct rollover?

A direct rollover avoids the mandatory tax withholding of 20% of the eligible rollover amount. The individual also eliminates the risk of missing the 60-day rollover deadline.

29. What if an employee does not elect a direct rollover?

If an individual does not elect a direct rollover to an IRA, the employer must withhold 20% of the distribution and forward this amount to the IRS as a prepayment for any taxes owed for the year. The check received by the employee will be for 80% of the distribution. For example, if the distribution is valued at \$100,000, \$20,000 would be withheld, and the employee would receive \$80,000.

Often Asked Questions Regarding IRA Rollovers and Lump Sum Distributions, continued

30. Can the employee later decide to roll over the distribution?

An individual may subsequently decide to rollover the full value of the distribution within 60 days, but must replace the amount of withheld funds with money from other sources in order to avoid income taxes and possible penalties. If the withheld amount is not reimbursed and the individual rolls over only that portion of the distribution received (80%), the dollar amount withheld must be included on the individual's tax return as additional income subject to ordinary income tax. In addition, there may be a 10% penalty tax on this amount if the individual is under age 59½ at the time of the distribution.

31. What if a distribution includes employer stock?

Shares of employer stock may be included as part of a direct rollover. The individual may also elect to take a distribution of the stock certificate and complete the rollover within 60 days. If an individual receives the certificate, and the employer stock represents the entire payout, no mandatory withholding will apply. If the distribution includes cash and company stock, income tax withholding at the 20% rate will apply to the cash. The employer securities are not subject to the 20% withholding.

If after-tax dollars were used to purchase shares of employer stock, either the actual cost basis of the shares or the date of distribution price may be used to determine the number of shares to be excluded from the rollover and kept out of the IRA. Cost basis and date of distribution price will be included on a statement provided by the employer. When the shares are sold, the gain will be the difference between the sales price and the cost basis selected.

32. Can an individual roll over a retirement plan distribution into an existing IRA?

An individual may rollover a distribution into an existing Traditional IRA or into a new Traditional IRA.

33. What happens to an employee's voluntary contributions?

After-tax contributions made by an employee to a 401(k) or 403(b) tax-sheltered annuity may be rolled over to an IRA to retain their tax-deferred status and avoid current taxation and possible penalty taxes.

34. Can an individual rollover only part of a distribution?

You may rollover any part of a retirement plan distribution and keep the rest. The portion that is not rolled over may be subject to the 20% mandatory withholding, ordinary income tax and possible penalties in the year the distribution is paid. (Refer to question 30.)

35. How are distributions from an IRA taxed?

Distributions from an IRA are taxed as ordinary income in the year received. If an individual takes distribution from an IRA prior to age 59½, a 10% penalty tax on the distribution amount may also be incurred.

Often Asked Questions Regarding IRA Rollovers and Lump Sum Distributions, continued

36. What are the rules regarding distributions from an IRA?

Before age 59½, a 10% penalty tax is imposed on distributions. The penalty tax is waived on distributions that meet the exceptions listed in Internal Revenue Code section 72(t) and include:

- a. Death
- b. Disability
- c. The portion of medical expenses that exceeds 7.5% of adjusted gross income
- d. The purchase of health insurance if an individual has received unemployment compensation for more than 12 weeks and after January 1, 1998
- e. Qualifying First-time home purchase (\$10,000 lifetime maximum)
- f. Post Secondary Education related expenses for the owner or family member.
- g. Substantially equal periodic payments.
- h. Distributions taken due to an IRS Tax Levy

Note: Between the ages 59½ +70½ , an individual may take distributions from this IRA as needed on a penalty free basis. After age 70½, minimum distributions must be taken at least annually from the IRA to avoid substantial penalty taxes.

37. What are substantially equal periodic payments under IRS Code Section 72(t)?

Substantially equal payments allow you to receive distributions as a series of payments based on your life expectancy. This avoids the 10% penalty on premature distributions. These distributions must be made at least annually and continue for the **longer** of five years or until the individual reaches age 59½.

In order to be considered substantially equal payments exempt from the 10% penalty, the amounts distributed must be calculated a certain way. The IRS has approved **three** methods of determining the amounts of these payments:

a. Life Expectancy Method

Under the first method, the IRA balance is divided by life expectancy, using either your single life expectancy, your joint life expectancy with a beneficiary or by using the Uniform Lifetime Distribution Table. This is the same method used to calculate a required minimum distribution. The calculation of the distribution amount is made each year based on the value of your IRA at the end of the previous year. This method of calculating the series of substantially equal payments will provide for the smallest distribution possible.

Often Asked Questions Regarding IRA Rollovers and Lump Sum Distributions, continued

b. Amortization Method

A second alternative is called the amortization method. Under amortization, the IRA balance is divided over your life expectancy, but the balance is also projected to grow at a certain rate of return each year. You may select the growth rate used to calculate the payout as long as it does not exceed 120% of the federal mid-term rate for either one of the two (2) months immediately preceding the month in which distributions will begin. (The IRS revenue rulings that contain the IRC Section 1274 federal mid-term rates may be found at [www.irs.gov\tax-regs\fedrates.html](http://www.irs.gov/tax-regs/fedrates.html)). Due to the annual growth of the balance, the amortization method will produce a larger payment than the first method.

c. Annuitization Method

The **third** method of determining penalty-free IRA distributions is the annuitization method. This method divides the IRA balance by an annuity factor. The annuity factor represents the present value of an annuity of \$1 per year beginning in the year of the first distribution and continuing for the account holder's expected lifetime.

Since the three methods of calculating substantially equal payments generally produce different results, there is some flexibility in selecting a payment amount. Once payments begin, though, the procedure is rigid and you must comply with the exact payment schedule. If the amount of the periodic payments is modified (other than by reason of death or disability) before the later of the end of the five-year period or before you reach age 59½, the 10% penalty tax, is imposed on **all** payments previously received.

38. Can the payments be changed?

Yes. An individual who begins distributions using either the fixed amortization method or the fixed annuitization method may make a one-time switch to the life expectancy method, which reduces the required amount to be distributed. Once the switch is made to the life expectancy method, it must be used in all subsequent years. Any other change would be considered a modification and may result in penalties.

*Often Asked Questions Regarding IRA Rollovers
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39. How are Required Minimum Distributions (RMDs) calculated?

At age 70½ an individual must begin taking distributions from their IRA. Your required minimum distribution is calculated each year by dividing the IRA's value on the December 31 preceding the year of distribution by your applicable life expectancy factor. Life expectancy factors are published in IRS tables, which can be found in IRS Publication 590.

AGE	APPLICABLE DIVISOR	AGE	APPLICABLE DIVISOR	AGE	APPLICABLE DIVISOR
70	27.4	85	14.8	100	6.3
71	26.5	86	14.1	101	5.9
72	25.6	87	13.4	102	5.5
73	24.7	88	12.7	103	5.2
74	23.8	89	12.0	104	4.9
75	22.9	90	11.4	105	4.5
76	22.0	91	10.8	106	4.2
77	21.2	92	10.2	107	3.9
78	20.3	93	9.6	108	3.7
79	19.5	94	9.1	109	3.4
80	18.7	95	8.6	110	3.1
81	17.9	96	8.1	111	2.9
82	17.1	97	7.6	112	2.6
83	16.3	98	7.1	113	2.4
84	15.5	99	6.7	114	2.1

Source: IRS

Every IRA owner uses the following table – Uniform Lifetime Table – except when a spouse is the sole, primary beneficiary and the spouse is more than ten years younger than the account owner. In this case the more favorable Joint Life Expectancy Table may be used.

Individuals who postpone their first required distribution until the April 1st following the year they reach age 70½ may subtract the amount of their initial distribution from the year-end balance used to calculate their second required distribution. Failure to satisfy an RMD results in a 50% penalty.

Example:

An IRA owner's date of birth is July 6, 1939. On January 6, 2010, this IRA owner will reach age 70½ and must begin to take a RMD by December 31, 2010. However, the IRA owner may also elect to defer the first required distribution until April 1, 2011. The value of the IRA on December 31, 2009 is \$150,000.

If the IRA owner takes the initial required distribution before December 31, 2010, the RMD is:

$$\frac{\$150,000}{26.5 \text{ years}} = \$5,660$$

The IRA owner will attain age 71 during the initial distribution year, so life expectancy at age 71 is used.

Often Asked Questions Regarding IRA Rollovers and Lump Sum Distributions, continued

If the IRA owner defers the initial required distribution until April 1, 2011, the RMD for 2010 is still \$5,660.

$$\frac{\$150,000}{26.5 \text{ years}} = \$5,660$$

A second RMD for 2011 must be taken before December 31, 2011. By December 31, 2010 the IRA value has grown by 10% to \$165,000. The RMD for 2011 is:

$$\frac{\$165,000}{25.6 \text{ years}} = \$6,445$$

40. What happens when the IRA owner dies?

IRA benefits bypass probate and may be paid directly to the named beneficiaries. The distribution options available to the account beneficiaries at the IRA owner's death vary depending on whether the beneficiary is a surviving spouse and whether RMDs had begun at the time of death.

41. What is a Designated Beneficiary?

At the death of the IRA owner, the RMD rules provide additional deferral for the IRA rollover. These substantial deferral opportunities will be lost unless the IRA owner has a designated beneficiary to receive benefits. The term-designated beneficiary means an individual but not estates, charities, or entities. The term also includes an individual who is named as a beneficiary of certain trusts, which are named as IRA beneficiary. If there are multiple individual beneficiaries of a single trust, the oldest beneficiary, i.e., the individual with the shortest life expectancy is required to be treated as the designated beneficiary.

42. What happens after death of the IRA account owner?

The designated beneficiary of an IRA (for purposes of measuring required minimum distributions) is determined on September 30 of the year following the year in which the IRA owner died. Remember, however, that the period between death and the beneficiary determination date is a period during which beneficiaries can be eliminated (including disclaimed) but not replaced with a beneficiary not designated under the IRA as of the date of death. In order for an individual to be a designated beneficiary, any beneficiary must be designated under the IRA or named by the account owner as of the date of death.

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