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RETIREMENT

By the numbers

- Employers automatically withhold **20%** of your withdrawal if you take cash distributions from your 401(k).[1]
- Early 401(k) withdrawals may be hit with a **10%** penalty tax.[1]

[1] irs.gov

This material should be used as helpful hints only. Each person's situation is different. You should consult your investment professional or other relevant professional before making any decisions.

WEIGHING YOUR 401(k) OPTIONS AT RETIREMENT

So you are ready to retire. You have worked hard for many years, and now it's nearly time for you to sit back and enjoy the fruits of your labor. But before you retire, you need to take a careful look at your 401(k). There is a good chance your 401(k) is one of your single largest assets. And the decisions you make about it can have a lasting impact on you and your family.

Of all the issues you have to face upon retirement, taking care of your 401(k) just might be the most important of all. The decisions you make about the proceeds from your 401(k) plan can have a tremendous bearing on how financially secure you are for the rest of your life. That's why, before you do anything else, you should meet with your financial advisor, who can help you decide what is best for you.

To help get a dialogue going with your financial advisor, we have compiled a list of options you might want to refer to when considering what to do with your 401(k) distribution at retirement — a distribution that could be valued at hundreds of thousands of dollars or more. Although this is not an all-inclusive list, it can get you started down the right path.

Take your 401(k) distribution in cash

The possibility of taking the proceeds from your 401(k) distribution in cash when you retire is enticing. Before you have a check for the entire distribution (or even part of it) made out to you, there are a few things you should keep in mind.

By having the check made out in your name, you could be handing over to the government a quarter or more of your account. When a distribution is not rolled over directly into an employer retirement plan or IRA — as is the case when it is taken in cash — the employer automatically withholds 20% of the money for federal taxes, and depending on your state of residence, state taxes may also be withheld. If you do not do a rollover within 60 days of receiving the distribution, you will have an additional federal tax liability of 5% if you are in the 25% bracket, and if you are younger

Key points

- Your 401(k) may be your single largest retirement asset.
- The wrong decision can result in substantial taxes, penalties and an unnecessary reduction of your hard-earned retirement assets.
- A qualified financial and/or tax advisor can help you make smart retirement planning decisions.

than age 55 when you leave your job, the IRS generally hits you with an additional 10% penalty.

If after taking the distribution in cash you decide you would like to roll it into an IRA, you can still do so. However, you must reinvest the assets within 60 days of the date you received the distribution, and if you want to make the rollover "whole," you need to deposit other money to make up the 20% withheld by your employer. If you do so, the 20% withheld by your employer will be credited to you when you file your year-end tax return.

The bottom line is that before taking the cash you should think about all that hard work and sacrificing you have done, only to now be penalized. If you are still tempted, a meeting with your financial advisor will likely quell any remaining doubts you might have about the effect even a small cash distribution at retirement could have on your retirement income.

Roll your assets into an IRA

Of all the distribution choices available to you at retirement, rolling over assets to an IRA may offer the most investment flexibility and the least current exposure to taxes and penalties.

A rollover is a transfer of some or all of your plan account into, for example, a rollover IRA. If you do a "direct rollover," the money passes directly to the IRA and no taxes will be withheld. To do this, ask your plan administrator about the plan's procedures. The plan may issue a check for the amount you wish to roll over from your 401(k) made out to the IRA's trustee and send it to you for delivery to the new trustee, or the plan may send the check directly to the new trustee. Please note, however, that unless you are taking the distribution in cash, the check should never be made out to you.

Although what you ultimately decide to do will depend on your individual situation, there are some things to consider.

- Roth IRA – You can roll the assets into a Roth IRA. You will be required to pay income taxes, but not penalties, on the amount you convert.[2] This strategy might work best for people who do not need the income immediately and would like to continue putting money away indefinitely.

  The Roth IRA has no required minimum distributions during the owner's lifetime and no age at which you must stop contributing. In addition, distributions from a Roth IRA are tax free if certain requirements are met.
- Traditional IRA – Distributions from your 401(k) plan are exempt from the 10% penalty if you retire after reaching age 55, but distributions from a traditional IRA are subject to the 10% early withdrawal penalty until you reach age 59½, so a rollover of the entire distribution may not be your best choice if you are under 59½ and anticipate needing to take some or all of the money before reaching age 59½.

There are advantages and disadvantages to rolling your money out of your employer plan and into an IRA. You will want to consider how your unique circumstances and retirement goals will be affected by features such as investment options, services, fees and expenses, withdrawal options, required minimum distributions and tax treatment. Please be aware that rolling over retirement assets into an IRA account could potentially increase fees, as the underlying funds may be subject to sales loads, higher management fees, 12b-1 fees and IRA account fees such as custodial fees. For assistance in determining if a rollover to an IRA is appropriate for you, consult your investment professional.

Take 72(t) payments

Your employer's plan may offer various distribution options besides a lump-sum distribution. You may be able to elect to receive your account balance as a stream of periodic payments, so you will be taxed on only the payments you receive and the remainder of your account can continue to potentially grow tax deferred. If your plan does not offer this option, you may consider rolling your account balance into an IRA where you could establish a stream of payments. Even if you are under age 59½, you can avoid the 10% early withdrawal penalty by setting up "72(t)" distributions. Under IRS Code Section 72(t), substantially equal periodic payments are made to IRA owners under age 59½ without penalty, provided the distribution amount, calculated using one of the IRS-approved methods, is taken for the longer of five years or until the attainment of age 59½. You may elect to receive 72(t) distributions after your assets are placed in a rollover IRA or a Roth IRA.

[2] The penalty will not apply as long as you do not withdraw the amount rolled into the Roth IRA for five years.

An IRA from which you are receiving 72(t) payouts can be converted to a Roth IRA without being subject to the 10% penalty tax and without the conversion being treated as a modification of the series of periodic payments. You must continue to receive 72(t) payouts from the Roth until the end of the distribution period. Such payments may be nonqualified payments under the Roth rules.

Capitalize on net unrealized appreciation

If your 401(k) plan consists mostly of company stock, a rollover to an IRA might not be your best option. The long-term capital gains rate available on company stock is currently lower than most income tax rates. So you might benefit more by placing the stock in a regular brokerage account and taking advantage of a tax strategy involving net unrealized appreciation (NUA).

What is NUA? Very simply, it is the difference between the cost basis of the stock you own (the price per share at which you originally purchased the stock) and the current market price. If there is a substantial difference between the cost basis and the current market price, you might benefit most from this strategy. By placing the stocks from your 401(k) into a brokerage account, you will have to pay income tax only on the cost-basis portion of the value of the stock. The NUA is not taxed until you sell the stock, when it is taxed at the long-term capital gains rate (which is currently a lower rate than the corresponding income tax rate).

To take advantage of NUA, your entire 401(k) balance must be distributed in a single tax year. Any nonemployer stock or other investments can be rolled into an IRA to avoid current taxation, but the employer stock must be distributed in kind to a taxable account. If you sell the stock before the distribution or roll the stock into an IRA, NUA treatment is no longer an option. Let's say you own $250,000 of employer stock and you have a $50,000 cost basis (what you paid for the stock). If you roll the stock into an IRA, you will avoid any current taxation but will pay taxes at ordinary income tax rates when you take a distribution from the IRA.

On the other hand, if you take the stock as a taxable distribution, the $50,000 of basis will be added to your taxable income this year. There could also be a 10% early distribution penalty if you are younger than 55 when you leave your job. The $200,000 in gain will not be taxed until you sell the stock and will be taxed at the long-term capital gain rate.

Is the NUA strategy right for you? It depends on a number of variables, including your age and tax bracket. However, to try to arrive at an answer, you should consider the following questions and consult both your financial and tax advisors:

- How much has the stock appreciated?
- What is its future growth potential?
- How long do I plan to hold it?
- Do I plan to leave it to my heirs?
- Can I afford to pay the taxes up front if I do not choose to roll it into a traditional IRA?
- Am I exposed to too much risk by maintaining so much of one stock, and do I need to diversify out of the stock?

Think it through

Regardless of which option you choose, the key is to think it through and make the decision that is best for you based on your financial needs, goals and risk tolerance. Again, you may do well to discuss this issue with your financial advisor. After all, you have been planning for a long time to have the kind of retirement some people only dream about — a retirement that could be put in jeopardy if you make an uninformed decision.

Contact your financial advisor for more information or visit mfs.com.

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