MFS HERITAGE PLANNING® > RETIREMENT

Weighing 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 it 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 or investment professional who can help you decide what is best for you.

To help get a dialogue going with your financial advisor or investment professional, we have compiled a list of options you might want to refer to when considering what to do with your 401(k) at retirement — an account 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) in cash

The possibility of taking the proceeds from your 401(k) 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. When you file your taxes, you will likely have an additional federal tax liability unless you ask your employer to withhold more than 20% because almost all current income tax brackets exceed 20%. If you are younger than age 55 when you leave your job, the IRS generally hits you with an additional 10% penalty.

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 tax advisor and financial advisor or investment professional can help you make smart retirement planning decisions.

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.

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If you take the distribution in cash and then you decide you would like to roll it into an IRA and avoid tax liability for the distribution, 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 additional money to make up the amount of federal (and state, if applicable) taxes withheld by your employer. The amount withheld by your employer will be credited to you when you file your income taxes.

The bottom line is that before taking all or a significant portion of your 401(k) account in cash, you should think about whether that is a tax-effective way to receive your retirement income. If you are still tempted, a meeting with your financial advisor or investment professional will likely make clear that there are better options in most circumstances.

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.

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 some or all of the assets into a Roth IRA. Amounts rolled over from a Designated Roth Account will not trigger any immediate tax liability. Amounts coming from a traditional 401(k) account would be taxable income but would not trigger a tax penalty.[1]

  The Roth IRA has no required minimum distributions during the owner's lifetime. 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.

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

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 financial advisor or investment professional.

Leave the assets where they are

Leaving your account where it is, or rolling it into an IRA, will not create a current tax liability. In that way, both options are equal. However, there may be important differences in distribution options and investment choices.

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. If so you will be taxed on only the payments you receive and the remainder of your account can continue to potentially grow tax deferred. By only taking what you need each year, you can minimize your current tax liability. If your plan's distribution options match your needs, leaving it in the plan can be a solid choice. If it doesn't offer the flexibility you want, an IRA rollover may be advantageous.

Investment choices are generally more limited in an employer plan than in an IRA. In some cases, the investments you use to prepare for retirement will be different than the investments you use in retirement. Talk to your financial advisor or investment professional about your retirement income portfolio before making a decision.

Your age matters

If you separate from your employer after January 1 of the year you turn 55, distributions from that employer's qualified retirement plan are not subject to the early distribution penalty. This exception to the penalty is not available in an IRA. If you are between the age of 55 and 59½, talk to your tax advisor and your financial advisor or investment professional before rolling your plan into an IRA.

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 non-employer 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 gains 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 tax advisor and your financial advisor or investment professional.

- 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 or investment professional. 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.

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