

Considering Retirement...What Should You Do With Your 401(k)?

During your working years, you have been contributing to your 401(k) account. However, there comes a time when you will enter into some form of retirement, whether that means ceasing to work completely or still working but perhaps on a reduced schedule. When considering your retirement and related income streams, many are faced with the question of how best to utilize their 401(k) account. This article will attempt to address that question by providing some possible options and areas to consider.

Four possible options for handling your 401(k) in retirement are the following:

1. Take the Cash
2. Leave the Money in Your 401(k)
3. Roll Your 401(k) into an Individual Retirement Account (IRA)
4. Roll Your 401(k) into an Annuity

Each of these options is discussed below.

Option 1: Take the Cash

The first option that most retirees consider with regard to their 401(k) account is simply cashing it out. If you are over the age of 59 ½, the full amount of the distribution will be subject to ordinary income tax rates. If you are under 59 ½, in addition to paying ordinary income tax, you would also be assessed a 10% penalty for withdrawing the money early (and not rolling it over in a permissible retirement investment vehicle).

Electing to take the cash distribution grants the individual the ultimate flexibility with regard to their investment. However, one of the drawbacks to taking a lump sum distribution from your 401(k) is the potential to experience a large reduction in your savings as a result of taxes. Another drawback is that a lump sum distribution is considered taxable income in the year it is taken. This may cause you to be subject to a higher tax bracket when combined with your other annual earnings.

Option 2: Leave the Money in Your 401(k)

Your existing 401(k) plan may have an option to leave your balance in the plan when you retire. (Check with your plan sponsor to see if this is an option.) One caveat to leaving your 401(k) where it currently stands is that you are limited to the investment options provided within your plan. Although most plans offer some very conservative investment options, there are typically no safeguards against losing your principle and no income protection for retirement years. This option gives the individual limited investment flexibility as the investor is restricted to the investment choices available through the plan but does allow for deferred recognition of income and gain.

Option 3: Roll Your 401(k) into an Individual Retirement Account (IRA)

IRAs are similar to 401(k)s in their tax characteristics. There are both traditional¹ IRAs (tax-deferred investment vehicles) and ROTH IRAs (tax-free investment vehicles). Depending on the type of

¹ Also referred to as pre-tax.

401(k) you have, it can be easily transferred to an IRA. Traditional 401(k)s have the option of being rolled over into either a traditional IRA or ROTH IRA. If rolled into a traditional IRA you will maintain the tax-deferred status. However, by rolling over a traditional 401(k) into a ROTH IRA you would be required to pay ordinary income tax on the amount rolled over due to the conversion of assets that have never been taxed into an after-tax account that will allow your assets to grow and be distributed tax-free². Therefore, you would be required to pay ordinary income taxes on the 401(k) distribution prior to rolling it over into the ROTH IRA.

A benefit to rolling your 401(k) over into an IRA is the investment options that are available. Under your 401(k) plan, you are limited to the investment options offered; however, there is a wide array of investment options within IRAs. In addition, fees associated with an IRA may be lower than what you are currently paying through your 401(k) plan. If you are interested in opening an IRA account, there are many places that offer them. See below for a sample list:

- Banks
- Credit Unions
- Discount Brokerage Firms
- Mutual Fund Providers
- Consult with your CPA or financial planner for specific options and providers

After opening a traditional or ROTH IRA, you may want to contribute to the account. There are certain limitations associated with both types that include specified contribution limitations, your income, filing status, etc. If you are considering opening this type of account and want the future ability to contribute to the account, you should consult a tax professional regarding the aforementioned variables with respect to your individual situation.

Option 4: Roll Your 401(k) into an Annuity

An annuity is a financial product that is designed to accept and grow funds from an individual and then, upon annuitization, pay out a stream of payments to the individual at a later point in time³. Annuities are primarily used to secure a steady cash flow during your retirement years. Similar to an IRA, rolling your 401(k) into an annuity preserves the tax-deferred status of your retirement funds thereby delaying the date at which you will be required to pay taxes. With regard to investment choices, annuities typically have different investment options as compared to your 401(k) plan since the investment choices are provided through insurance products.

There are several options when it comes to choosing an annuity. You have the option of a fixed or variable annuity each having a number of options you can select including the type of payout you desire. The benefit to securing an annuity is that the individual has the security of income payments for a certain period of time; however depending on the lifespan of the individual, this may or may not be a suitable product. In addition, while there is flexibility with regard to annuity selection once purchased the individual is typically committed to that product for better or worse.

Conclusion

When approaching retirement, there are many investment options to consider for your 401(k) account. Knowing what options you have is half the battle. It is important to identify your needs in retirement and then choose investment vehicles that best fit those needs. It is recommended that you seek the advice of a tax professional and/or financial planner to assist you in making these important decisions.

² Assumes you are over 59 ½ when taking a distribution from the ROTH IRA and that the account has been established for at least 5 years.

³ Source: www.investopedia.com