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401k Retirement Distributions

by Gary Foreman

Getting money out of your 401k after retirement

The leading edge of the baby boomers are reaching retirement age. According to AARP, approximately 8,000 boomers turn 65 every day <www.aarp.org/personal-growth/transitions/boomers_65/>.

Among the questions they'll be asking is what happens to my 401k when I retire? And with over 51 million workers having $3.5 billion in 401k accounts (Investment Company Institute) <www.ici.org/policy/retirement/plan/401k/faqs_401k>, let's see if we can't shed some light on how distributions are handled in your retirement years.

When you reach retirement, you'll have five basic options for your 401k.

You can leave your money in the plan. Some plans will allow you to remain after you leave your job. You'll still be subject to the same plan rules. Ask the plan administrator if any special rules/privileges apply to retirees. If you don't know who the administrator is, check with your HR department or call the number provided on your last plan statement.

The advantage to leaving your money in the plan is that you can continue with your present investment options. You'll also be dealing with familiar statements and there's no extra paperwork involved.

The main disadvantage to leaving it in your existing 401k account is that you're investment options are limited. You may also find that fees are higher than they would be with other options.

You can roll the money into an IRA. In many cases, you can transfer both cash and investments into a self-directed IRA account. From that point forward, it's similar to any IRA in that you're responsible for all investment choices.

One advantage is that you'll have the largest number of investment options available to you. Most self-directed IRAs allow you to invest in the full range of stocks, bonds, and mutual funds. Some even allow for metals and real estate. You'll also have access to online tools to help track and manage your account.

There are some disadvantages to taking a 401k retirement distribution and rolling it into an IRA. You'll need to watch your costs. You have more options in an IRA. Those options come with costs and fees.

Another disadvantage relates to creditors. In some states, your 401k is protected from creditors, but an IRA is not. Ask your investment adviser. He'll probably need to check with his legal department for the answer, but they should be able to find out for you.

You can take a lump-sum distribution. You can choose to take all the money out of your 401k at once. One big check made out to you.

The main advantage is that you have the money available to you right away. Perfect if you need it to buy that retirement home.

The biggest disadvantage of taking a lump-sum retirement distribution is the tax hit. Remember that any withdrawal is added to your taxable income for that year. Spreading out the distributions also spreads out the tax liability. Taking a lump-sum could push you into a tax bracket that was meant for the "wealthy" and confiscate a significant portion of your money.

A secondary tax disadvantage will occur when you invest the money outside of either a 401k or IRA account. Each year your account earnings will be taxed. They weren't taxed while they were in the retirement account. That means that there will be less available for you.

A final disadvantage is that you'll also be disrupting your investment plans. If you've built a balanced portfolio in your 401k, that will be gone. You'll need to reinvest the proceeds after you get the distribution.

You can take periodic distributions. Some 401k plans will allow you to take regularly scheduled distributions of a set amount. Plans that allow for periodic distributions will generally allow you to change the schedule or the amount on an annual basis.

The main advantage to periodic distributions is that it mimics getting a paycheck. It's predictable income.

It's also good from a tax point of view. Regular distributions will keep you at a lower tax rate leaving more in your pocket.

The biggest disadvantage is that you could outlive your income. If you take more than the account earns each year, you'll gradually deplete it. Once that trend starts, it's hard to reverse.

You can purchase an annuity. Most plans will allow you to buy an annuity from an approved insurance company with a portion or all of your 401k money.

Among the advantages is that an annuity can guarantee an income stream for lifetime. So you can't outlive your money. You can even buy one that allows for income to be paid to a surviving spouse. And, because the insurance company is responsible for investing the money, you have that burden lifted.

There are two major drawbacks to an annuity. First, you may die young leaving the insurance company as the big winner. Second, unless specifically contracted, income is not adjusted for inflation. So your check which stays the same will buy less and less each year. The longer you live the more serious the squeeze.