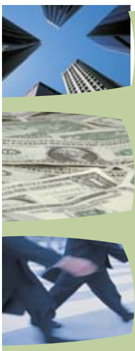

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focus on Retirement

Distributions Can Be Taxing

One of the advantages of investing in your employer's 401(k) plan is that you are able to save for retirement on a tax-deferred basis. That means that the portion of your paycheck that is deferred into your 401(k) account is not subject to taxes at the time it is contributed to the plan. In addition, you are allowed to defer taxation on any investment earnings in your account until you actually withdraw that money from the plan. Any contributions your employer may provide to you in the retirement plan are tax-deferred as well. However, once you are ready to start taking your money out of the plan, it is important to understand how your money will be subject to taxation.

There are many different ways in which your retirement plan may allow you to withdraw your money. (Not all plans will allow all of these types of withdrawals, so check with your plan sponsor to see what your plan allows.)

Let's start with what your account is meant for—retirement! At retirement, most participants would take their money either in a lump sum distribution which would result in a check payable to the participant, or a rollover which would result in a check written to another account like an IRA. In a lump sum distribution, you will only receive 80% of your account balance in cash. The IRS requires that the other 20% of your vested account balance be withheld and deposited towards federal income taxes. A common misconception is to think that the 20% withheld will equal the federal tax that is actually owed on the distribution. Unfortunately, that is rarely true. The distribution will be treated as regular income on the participant's federal tax return and he will owe taxes on the distribution equal to whatever his tax bracket percentage is for that year.

A rollover, on the other hand, does not involve any taxation to the participant at the time the money leaves the account. Your plan balance simply moves to another "qualified" investment that continues to be tax-deferred (like an IRA). The money will be taxed at the time of withdrawal from the IRA.

Some plans allow money to be taken out prior to retirement. This might happen if you no longer work for the plan sponsor (termination withdrawal) or while still employed after the attainment of a certain age (in-service withdrawal). Here you will have the same choices—a lump sum distribution or a rollover. However, there may be additional penalties. Any lump sum distributions taken prior to attaining age 59 1/2 will incur an additional 10% early withdrawal penalty. This penalty will be due at the time the tax return is filed—it is not automatically withheld at the time of distribution. Again, if a participant chooses to rollover this distribution either to an IRA or another qualified plan, he will avoid taxation of the distribution until he actually start taking the money out of the tax deferred account.

Another distribution reason might be a hardship withdrawal. These are distributions made from the plan, usually to help pay for purchasing a principal residence, being evicted from a principal residence, paying for secondary education, paying for medical expenses, paying for funeral expenses or paying for catastrophic home repairs. Hardship distributions are not subject to the 20% federal tax withholding- typically a participant may choose what amount to have withheld—but the distribution will still be subject to regular federal taxes as well as the 10% early withdrawal penalty (unless an exception applies such as disability).

Some plans allow a participants to take a loan against their account balance. When a participant takes a loan, it is not the same as a distribution because the money is due back to the plan. So, a participant will not have any taxation at the time the loan is taken even though the participant will have a check that is written to him. With a loan, the participant must make regular payments back into the account to pay off the loan. The taxation may come into play if the loan defaults or is not paid back as required. If this happens, then the outstanding principal balance of the loan will become taxable to the participant as if there was a lump sum distribution of that amount. There is no automatic 20% withholding. However, the full amount of the loan balance will be treated as taxable income and subject to the early withdrawal penalty if the participant is under age 59 1/2. This can be of particular concern if a participant leaves employment with the plan sponsor while there is an outstanding loan. That loan will default if payments are not continued, resulting in a taxable event. If a participant has an outstanding loan when leaving the plan sponsor, both regular income taxes and the potential 10% early withdrawal penalty can be avoided by paying back the loan in full rather than letting the outstanding principal balance go into default.

As you can see, the federal tax consequences of taking money out of a retirement plan are varied and complex. These distributions are typically subject to state taxes as well which are outside the scope of this article. Oftentimes, after the various taxes and penalties, a participant may only end up with half of the cash that was originally in their account balance after taxes and penalties. Be aware of your potential tax liability and talk with your advisor or accountant prior to taking any lump sum distributions.

"Before deciding to retire early…stay home a week and practice watching daytime television"-Unknown

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