What Is the Most Tax-Efficient Way to Take a Distribution from a Retirement Plan?

If you receive a distribution from a qualified retirement plan such as a 401(k), you need to consider whether to pay taxes now or to roll over the account to another tax-deferred plan. A correctly implemented rollover can avoid current taxes and allow the funds to continue accumulating tax deferred.

Paying Current Taxes with a Lump-Sum Distribution

If you decide to take a lump-sum distribution, income taxes are due on the total amount of the distribution and are due in the year in which you cash out. Employers are required to withhold 20% automatically from the check and apply it toward federal income taxes, so you will receive only 80% of your total vested value in the plan.

The advantage of a lump-sum distribution is that you can spend or invest the balance as you wish. The problem with this approach is parting with all those tax dollars. Income taxes on the total distribution are taxed at your marginal income tax rate. If the distribution is large, it could easily move you into a higher tax bracket. Distributions taken prior to age 59½ are subject to an additional 10% federal income tax penalty.

If you were born prior to 1936, there are two special options that can help reduce your tax burden on a lump sum.

The first special option, **10-year averaging,** enables you to treat the distribution as if it were received in equal installments over a 10-year period. You then calculate your tax liability using the 1986 tax tables for a single filer.

The second option, **capital gains tax treatment,** allows you to have the pre-1974 portion of your distribution taxed at a flat rate of 20%. The balance can be taxed under 10-year averaging, if you qualify.

To qualify for either of these special options, you must have participated in the retirement plan for at least five years and you must be receiving a total distribution of your retirement account.

Note that these special tax treatments are one-time propositions for those born prior to 1936. Once you elect to use a special option, future distributions will be subject to ordinary income taxes.

Deferring Taxes with a Rollover

If you don’t qualify for the above options or don’t want to pay current taxes on your lump-sum distribution, you can roll the money into a traditional IRA.

If you choose a rollover from a tax-deferred plan to a Roth IRA, you must pay income taxes on the total amount converted in that tax year. However, future withdrawals of earnings from a Roth IRA are free of federal income tax after age 59½ as long as the account has been held for at least five tax years.

If you elect to use an IRA rollover, you can avoid potential tax and penalty problems by electing a direct trustee-to-trustee transfer; in other words, the money never passes through your hands. IRA rollovers must be completed within 60 days of the distribution to avoid current taxes and penalties.

An IRA rollover allows your retirement nest egg to continue compounding tax deferred. Remember that you must begin taking annual required minimum distributions (RMDs) from tax-deferred retirement plans after you turn 70½ (the first distribution must be taken no later than April 1 of the year after the year in which you reach age 70½). Failure to take an RMD subjects the funds that should have been withdrawn to a 50% federal income tax penalty.

Of course, there is also the possibility that you may be able to keep the funds with your former employer's plan or move it to your new employer's plan, if allowed by the plans.

Before you decide which method to take for distributions from a qualified retirement plan, or a non qualified retirement plan, lets what is beneficial for your own personal situation.

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