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Weighing your 401(k) options at retirement

So you're ready to retire. You've 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's a good chance your 401(k) is one of your single largest assets. And the decisions you make about it can have a lasting impact for you and your family.

By the numbers

- Employers automatically withhold **20%** of your withdrawal if you take cash distributions from your 401(k).
- Early 401(k) withdrawals will be hit with a **10%** penalty tax.

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 investment professional, who can help you decide what is best for you.

To help get a dialogue going with your investment professional, we've compiled a list of options you might want to refer to when considering what to do with your 401(k) distribution at retirement — a distribution that could be valued at several hundred thousand dollars or more. Although this is not an all-inclusive list of options, it can get you started down the right path.

Take your 401(k) distribution in cash

The possibility of taking the proceeds from your 401(k) distribution 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're handing over to the government almost a third 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. If you are younger than age 55, the IRS hits you with an additional 10% penalty. To make matters worse, taxpayers in the 25% bracket or above will have at least another 5% taken from their nest egg.

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Key points

- Your 401(k) is likely to 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 investment professional and/or tax adviser can help you make smart retirement-planning decisions.

If, after taking the distribution in cash, you decide you'd like to roll it into an IRA, you can still do so. However, you must reinvest the assets within 60 days of the date you received the distribution if you want the 20% withheld by your employer to be credited to you when you file your year-end tax return.

The bottom line is that, before taking the cash, you should think about all that hard work and sacrificing you've done, only to now be penalized and taxed. If you are still tempted, a meeting with your investment professional will likely quell any remaining doubts you might have about the effect even a small cash distribution at retirement will have on your retirement income.

Roll your assets into an IRA

Of all the distribution choices available to you at retirement, rolling over assets to another tax-deferred investment offers the most investment flexibility and the least exposure to taxes and penalties.

A rollover is a lump-sum distribution that is "rolled" into, for example, a rollover IRA. To do this, you should request a check for the amount you wish to roll over from your 401(k) and have it made out to the IRA's trustee. You can request that the check be sent to you or directly to the new trustee. Please note, however, that unless you're 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 rough guidelines you can follow.

- Traditional IRA – If you need the income immediately at retirement, you can simply roll your 401(k) assets into a rollover IRA. A rollover IRA requires account owners to begin taking distributions, at least annually, at age 70½.
- Roth IRA – Once you've completed the rollover, you can, if you wish, convert the assets to a Roth IRA. You will be required to pay income taxes, but not penalties, on the amount you convert. This strategy might work best for people who don't need the income immediately and would like to continue putting money away indefinitely. The Roth IRA has no required minimum distributions and no age at which you must stop contributing and begin taking distributions. In addition, distributions from a Roth IRA are tax free if certain requirements are met.

The entire balance can be rolled into a traditional IRA — tax free. Even post-tax contributions in your 401(k) account can be rolled over to an IRA. The key is to roll your assets into an investment that offers a wide variety of investment choices that meet your financial objectives.

Among the most popular choices for traditional IRAs, for example, are mutual funds. Allocating IRA assets among mutual funds offers investors professional, full-time management, diversification (to help reduce risk), and the flexibility to move from one fund to another as investment needs change. Keep in mind, however, that the principal value and return of mutual funds will fluctuate with changes in market conditions, and your investment may be worth more or less upon withdrawal than you originally paid.

Take 72(t) payments

Another option for those needing a source of income at retirement is to take 72(t) substantially equal periodic payments. These 72(t) payouts are made to IRA owners under age 59½, without penalty, provided the distribution amount is taken for the greater of five years or attainment of age 59½. You may elect to receive 72(t) distributions after your assets are in a rollover IRA or a Roth IRA. It's also a good idea to check with your 401(k) plan to see if it allows 72(t) payouts.

Anyone who is currently receiving 72(t) payouts from his or her traditional IRA may convert all or a portion of a traditional IRA to a Roth IRA. The conversion is made without penalty provided the 72(t) payouts continue to be made, either from the Roth IRA or any remaining balance in the traditional IRA, for the remainder of the required distribution period.

Capitalize on net unrealized appreciation

If your 401(k) plan consists mostly of company stock, there's some good news for you as well. The lower capital gains rate makes the tax breaks available on company stock even more valuable. So, instead of opting for a rollover IRA, you might benefit more from placing the stock in a regular brokerage account and taking

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advantage of a little-known tax strategy involving net unrealized appreciation (NUA).

What is NUA? Very simply, it's 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 only have to pay income tax on the cost-basis portion of the value of the stock. The NUA isn't taxed until you sell the stock, when it will be taxed at the 15% long-term capital gains rate (as opposed to an income tax rate that could be as high as 35%).

Say you own 25,000 shares of your employer's stock —your per share cost basis is $10. This means the total cost basis of your account is $250,000 (25,000 x $10). A current trading price of $30 per share gives your stock a current market value of $750,000 (25,000 x $30). If you take a distribution from your 401(k), you'll owe taxes on the $250,000 at your income rate, plus a 10% penalty if you are under age 55 (the distribution could also raise you to a higher tax bracket). Taxes on the $500,000 NUA, however, will be deferred until you sell the stock.

Is the NUA strategy right for you? It depends on a number of variables, including your age and tax bracket. However, to help arrive at an answer, you should ask yourself the following questions:

- 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 don't choose to roll it into a traditional IRA?
- 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's best for you. Again, you would do well to discuss this issue with your investment professional. After all, you've been planning for a long time to have the kind of retirement some people only dream about — planning that could be put in jeopardy by making an uninformed decision.

Contact your investment professional for more information.

Resources

Rowland, Mary, *A Commonsense Guide to Your 401(k)*, Bloomberg Press, 1999, 265 pages, $19.95.

Slesnick, Twila; Suttle, John C., *IRAs, 401(k)s, and Other Retirement Plans: Taking Your Money Out*, Nolo Press, 2003, 336 pages, $34.99.

Flores, Dan L., *The Retirement Revolution: A Strategic Guide to Understanding and Investing Lump Sum Distributions from Qualified Retirement Plans*, iUniverse.com, 2003, 356 pages, $22.95.

HP-RET-401KOPT-FLY-3/04