



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 avoids current taxes and allows 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 (except for any after-tax contributions you've made) 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. (Special rules apply to Roth accounts.)

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 10% federal income tax penalty. (Special rules may apply if you were born before 1936.)

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 if the five-tax year holding requirement has been met. Even if you are not 59½, your distribution may be tax-free if you are disabled or a first-time home purchaser (\$10,000 lifetime maximum), if you satisfy the five-year holding period.



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 generally 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 in your former employer's plan or move it to your new employer's plan, if allowed by the plans. (Make sure you understand the pros and cons of rolling funds from an employer plan to an IRA before you take any action.)

Before you decide which method to take for distributions from a qualified retirement plan, it would be prudent to consult with a professional tax advisor.

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*Please keep in mind that rolling over your qualified employer sponsored retirement plan (QRP) assets to an IRA is just one option. You generally have four options for your QRP distribution:

1. Roll over your assets into an Individual Retirement Account (IRA)
2. Leave assets in your former QRP if the plan allows
3. Move assets to your new/existing QRP if plan allows
4. Take a lump-sum distribution and pay the associated taxes

Each of these options has advantages and disadvantages and the one that is best depends on your individual circumstances. You should consider features such as investment options, fees and expenses, and services offered. Your Wells Fargo Advisors Financial Advisor can help educate you regarding your choices so you can decide which one makes the most sense for your specific situation. Before you make a decision, read the information provided in this piece to become more informed and speak with your current retirement plan administrator, and tax professional before taking any action.

When considering rolling over your assets from a QRP to an IRA, factors that should be considered and compared between QRPs and IRAs include fees and expenses, services offered, investment options, when you no longer owe the 10% additional tax for early distributions, treatment of employer stock, when required minimum distributions begin and protection of assets from creditors and bankruptcy. Investing and maintaining assets in an IRA will generally involve higher costs than those associated with QRPs. You should consult with the plan administrator and a professional tax advisor before making any decisions regarding your retirement assets.