Receiving a Retirement Plan Distribution: Considerations for Younger Investors

By Maria Crawford Scott

What should you do if you are young and you receive a distribution from your retirement plan because you change jobs?

Many individuals simply take the money and run, paying taxes and the early withdrawal penalty, and spending the remaining amount. But given the penalty, these decisions can be costly. Instead, planning for large expenditures and saving accordingly can prevent such situations from occurring.

One way to understand some of the considerations in dealing with these situations is by looking at a typical example.

The Murphys

Peter and Elizabeth Murphy are in their late 20s, and both are working, with a combined income of roughly $70,000, putting them in the 28% tax bracket.

Peter, however, just started a new job, having left his old firm. Since he had contributed about $3,000 annually for five years to his old company's 401(k) plan and invested in a fixed-income fund that returned an average of 7%, Peter had built up a nice savings pot of $17,250.

Peter and Elizabeth are not particularly big spenders, but the realization that they were to receive a "windfall" from Peter's retirement plan started them thinking about items they may want to buy—a new car, a dream vacation or perhaps even the down payment on a new home. So they decided to sit down and figure out how much they could spend.

The answer—$10,695 after taxes and the 10% penalty for early withdrawal—shocked them when compared to the before-taxes-and-penalty size of the distribution.

Peter did some quick calculations and, to his dismay, discovered that if he had invested outside of his tax-deferred account (an aftertax amount of $2,160 annually for five years with an average aftertax return of 5.04%) he would have had $11,945. In other words, after biting the bullet and keeping his funds essentially untouched for five years, he was at this moment worse off than if he had had access to his funds over that time period!

Peter calmed down when he did a few more calculations and realized that if he didn't spend the money now, but let it continue to grow tax-deferred for a few more years, he would eventually get ahead of the game even if he needed to pay an early withdrawal penalty. And, of course, if he waited until retirement to withdraw, he would be even further ahead.

So, saving in the tax-deferred account wasn't necessarily a bad idea, it just depended on how soon the money would be needed. Fortunately, the Murphys did not need to spend the money immediately. But they realized it would be a good idea to start making some plans so they could avoid costly errors in the future.

Up until now, Peter and Elizabeth had not really thought about their finances. Both contributed part of their salaries to 401(k) plans, investing in fixed-income vehicles because they wanted to be conservative with their savings and were not particularly interested in looking into and learning about the alternatives.

Elizabeth's retirement plan currently totals $12,652, which she invests in a fixed-income fund that has also returned about 7% annually for the last five years. Like Peter, she is 100% fully vested in her plan, which means she is entitled to the full amount. (Participants are always 100% vested in their own contributions, but employer contributions often have vesting schedules based on the number of years of employment. However, neither Elizabeth's nor Peter's plans provided employer contributions.)

The Murphys also have managed to build up $6,500 in taxable savings from gifts they received from Elizabeth's grandmother, as well as money they felt they could set aside at the end of the year in previous years. These funds are invested in a short- to intermediate-term bond fund.

When Peter switched jobs, they hadn't really thought about

Maria Crawford Scott is editor of the AAII Journal.

changing their savings routine; instead, they would continue as before—Elizabeth would continue to invest $2,500 annually in her 401(k) plan, Peter would invest $3,000 in his new 401(k) plan, and any "extra" savings at the end of the year would be invested along with their other taxable savings in their intermediate-term fixed-income fund.

Now, they began to re-evaluate their system of savings.

Their first step was to make some decisions concerning their future spending needs. Would they need access to savings prior to retirement and, if so, how soon? This would help them determine whether they should continue to save through their tax-deferred plans, or whether they should start building up their taxable savings.

The Murphys decided that they did have some spending desires in the near future. Specifically, they decided that they would like to purchase their first home within three years, and they would need about $20,000 for a down payment.

What's the best means of saving for that down payment? There are various options; the three they considered are:

- The Murphys could take the distribution from Peter's plan now, pay taxes and the penalty, and invest it with their other taxable savings in the bond fund; at the same time, they would continue to invest a combined $5,500 annually in their tax-deferred plans.
- The Murphys could roll Peter's distribution over into an IRA and invest it in a short- to intermediate-term bond fund, allowing it to grow tax-deferred for three more years, at which time they would pay taxes and the penalty; at the same time, they would continue to invest $5,500 annually in their tax-deferred plans.
- The Murphys could discontinue their $5,500 annual contributions to their tax-deferred plans and instead invest the aftertax amount in their taxable bond fund; at the same time, Peter's distribution would be rolled over into an IRA, but they would not need to withdraw funds from it.

Table 1 contrasts the three options, assuming that all investments continue to be invested in fixed-income investments with an average return of 7% pretax (5.04% after taxes).

All three options allow the Murphys to build up their taxable savings at the end of three years for use as a down payment. The first option—taking the distribution from Peter's plan now—is the least attrac-

Table 1.
The Murphys' Options for Building Savings to Spend in Three Years

Option 1. Take distribution now and invest with taxable savings; contribute annually to tax-deferred plans:

	Current Value		Amount in 3 Years
Taxable Bond Fund	$ 6,500		$7,533
Distribution From Plan	$10,695 *(after taxes & penalty)*		$12,395
		Total Taxable Savings	$19,928
Elizabeth's Plan	$12,652		$15,499
Future Tax-Deferred Contributions	$ —		$17,682
		Total Tax-Deferred Savings	$33,181

Option 2. Roll distribution over into IRA but withdraw in three years; contribute annually to tax-deferred plans:

	Current Value		Amount in 3 Years
Taxable Bond Fund	$ 6,500		$7,533
Rollover IRA for 3 Years	$17,250		$13,102 *(after taxes & penalty)*
		Total Taxable Savings	$20,635
Elizabeth's Plan	$12,652		$15,499
Future Tax-Deferred Contributions	$ —		$17,682
		Total Tax-Deferred Savings	$33,181

Option 3. Roll distribution over into IRA but don't withdraw in three years; contribute annually to taxable savings:

	Current Value		Amount in 3 Years
Taxable Bond Fund	$ 6,500		$7,533
Future Taxable Contributions	$ —		$12,489
		Total Taxable Savings	$20,022
Elizabeth's Plan	$12,652		$15,499
Rollover IRA	$17,250		$21,132
		Total Tax-Deferred Savings	$36,631

tive option; it leaves the Murphys with the same amount of tax-deferred savings as Option 2, but less taxable savings, and, in fact, they are left slighty shy of the needed $20,000. The second scenario allows the proceeds from Peter's plan to continue to grow tax-deferred for three more years, and thus provides a higher amount after taxes and penalty at the end of three years. However, the most attractive option is the third one—building their taxable savings by rerouting their annual contributions from tax-deferred plans to their taxable bond fund and not tapping any funds from Peter's old plan at any time.

Peter and Elizabeth also realize that they need to develop an asset allocation strategy for their savings. Their time frame plays a role in this decision. To the extent that they have shorter-term spending plans, those monies should be invested short-term. Thus, they decide to keep their taxable savings in their current bond fund.

On the other hand, as they learn about long-term investments they realize that they need to invest in the stock market. Unfortunately, Elizabeth's tax-deferred plan has only one stock investment option, and they are very uncomfortable with the investment style of the adviser.

Peter's new plan, though, has a number of good stock funds from which they can choose. In addition, the money from Peter's old plan can be rolled over into an IRA and invested in a mutual fund of their choosing. And one advantage of not using the IRA for near-term future spending, they realize, is that they can invest it in stock funds.

The final decision: The Murphys roll over Peter's retirement plan money into an IRA that is invested in a broad stock market index fund, which offers good diversification for their first foray into the stock market. And they start making aftertax contributions to their bond fund; this will continue for three years, until they have built up enough savings for their down payment.

The Murphys also decide that any tax-deferred contributions they do make will first go to Peter's new 401(k) plan, since it offers better options than Elizabeth's; once maximum contributions to his plan have been reached (if ever), they will then make contributions to Elizabeth's plan. For the most part, these tax-deferred contributions will not start for another three years. However, after seeing the benefits of tax-deferred compounding over long time periods, the Murphys make one last decision—they will try to add $500 to their annual savings, which will go into Peter's new 401(k) plan invested in a stock fund.

Table 2.
Length of Time Needed for Tax-Deferral Benefits to Outweigh Early Withdrawal Penalty for a One-Time Investment

Tax Bracket	Average Annual Return 4%	6%	8%	10%	12%
	Years				
15%	20.9	13.9	10.4	8.3	7.0
28%	13.4	8.9	6.7	5.3	4.5
31%	12.6	8.4	6.3	5.1	4.2
36%	11.8	7.9	5.9	4.7	3.9
39.6%	11.4	7.6	5.7	4.6	3.8

Points to Keep In Mind

The Murphys maximized savings and minimized taxes in their situation by temporarily rerouting their annual savings to taxable rather than tax-deferred vehicles. However, every situation is unique. In addition, it can be difficult to make the calculations necessary to determine the best approach. For that reason, here are some guidelines to keep in mind:

- When leaving a job and facing a distribution of tax-deferred funds, the amount you are receiving is not a "windfall," but an investment that you have made; the 10% penalty for early withdrawal of retirement funds is an additional tax that can substantially cut into your return if you must pay it. You are best off if you can roll the money over into another tax-deferred investment such as an IRA, instead of spending it when you receive it. (However, make sure you understand the rules for rollovers.)
- Time frame is important when deciding whether to contribute to tax-deferred plans or taxable savings, assuming you have a tax-deferred vehicle that you can withdraw from (such as a rollover IRA, or if you intend to switch jobs and can receive a distribution). The 10% penalty can result in an investor being worse off investing in a tax-deferred plan if the money is withdrawn soon after it is contributed (even if the actual funds are withdrawn from a different tax-deferred plan). The benefits of tax-deferred compounding take time to accumulate; the amount of time varies depending on your tax bracket and the average annual return of the investment. Eventually, the benefits can overcome the penalty. Table 2 indicates the length of time needed, at various tax brackets and rates of return, for the benefits to outweigh the penalty for a one-time investment. Remember that each annual contribution is a one-time investment.
- Time frame is also important when making the asset allocation decision. Money that will be needed soon should not be invested in riskier asset classes such as stocks; on the other hand, money that can remain invested over longer time periods can benefit from the higher average returns associated with stocks.
- The options in tax-deferred plans vary. If your annual savings amount is limited and you have the ability to contribute to several different plans (for instance, you are married and both you and your husband are participants in a 401(k) plan, or you are eligible to set up a deductible IRA), try to maximize contributions to the plan that offers the best options.

The advantages of tax-deferred savings are substantial, particularly over long time periods. To the extent that you can set aside savings in these plans, by all means do so. But most individuals also have shorter-term spending needs, as well as limited funds for saving. Developing a plan will help you maximize your assets, both now and later.