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Financial Planning

401-K Payout: Lump Sum Distribution or IRA Rollover

by: G. Richard DeVed & ~~Rich~~ Robert W. Phillips

Significant sums of money are being accumulated on a taxed deferred basis in 401-K retirement accounts. Those individuals with large amounts of money in these thrift accounts generally must decide whether to take a lump sum distribution upon retirement and pay taxes on a five year or ten year averaging basis or roll the distribution over into an Individual Retirement Account (IRA). A person born before January 1, 1936 can choose between five year and ten year averaging methods; while a person born later cannot use the ten year averaging method. Five year or ten year averaging can only be used one time.

Another tax option that is available for 401-K distributions is to use no special rules and simply pay the tax at the ordinary tax rate. For the year 1988 the top tax rate would be the 33% rate.

AN EXAMPLE

Let us assume that an individual who has accumulated a tax deferred sum of $200,000 in their companies 401-K account is going to retire this year at age sixty (60). This person could pay taxes on the $200,000 lump sum distribution by the five year averaging method, the ten year averaging method, or he could roll

the sum over into an IRA. What process can be employed to help make the best decision possible?

The five year and ten year averaging taxes due can be computed and those amounts are $44,400 and $36,920 respectively. If the entire sum is rolled over into an IRA no tax is due now, but the amount in the IRA will be taxed at ordinary income tax rates as it is withdrawn.

If we make the assumption that this retirement nest egg will be invested in a conservative manner and produce an 8% taxable annual return, we can compare the averaging method with the IRA rollover.

Our retiree could choose the ten year averaging method, pay a tax of $36,920 and invest the remainder, $163,080, at the conservative 8% long term rate. This would produce an annual income of $13,046. If instead the $200,000 was rolled over into an IRA and invested at the same 8% rate it would produce an annual income of $16,000 per year or $2,954 more.

To compare the rollover option with the ten year lump sum method, we will withdraw $13,046 from our IRA rollover letting the remainder of $2,954 accumulate and compound each year and determine the number of years required to obtain a sum of money which will produce an after income tax amount equal to the ten year averaging after tax sum, which is $163,080.

Using a maximum tax rate of 33%, we can calculate the amount required. The equation is as follows, where "X" is the amount of

money that must be added to the $200,000 in order to produce an after tax sum of $163,080 at the flat 33% tax rate.

$$(\$200,000 + X) - (\$200,000 + X).33 = \$163,080$$

$$\$200,000 + X - \$66,000 - .33X = \$163,080$$

$$.67X = \$29,080$$

$$X = \$43,403$$

or $243,403 would be required to produce an after tax sum of $163,080 at a level 33% tax rate. The taxes due being $80,323 or more than twice the $36,920 of the lump sum method.

The next step is to determine the number of years required to generate $43,403 by saving $2,954 per year and compounding that amount at 8% per year. A compound annuity table tells us that ten years would be the time necessary. So in this example, the break-even amount of time for the two options is ten years. If our retiree lives beyond age seventy (70) than the rollover method will yield more money.

An IRA sum can be passed tax free to a wife if she is named as beneficiary and can be rolled into her IRA. If this situation is considered, should the retiree or his spouse live longer than ten years, the rollover method becomes the most beneficial.

DECISION ASSISTANCE TABLES

The first two tables below illustrate the years required to reach the break-even point for five and ten year averaging assuming an 8% return on the invested funds for both a 33% and a 50% flat tax rate. The third table assumes a return on invest-

ments of 12% and gives the break-even point for ten year averaging. The 50% tax rate was included along with today's 33% top tax rate to demonstrate the affect that a substantial increase in taxes would have on the number of years necessary to break-even when comparing lump sum distribution with IRA rollover.

Table 1.

COMPARISON WITH FIVE YEAR AVERAGING METHOD - 8% RETURN ON INVESTMENT

Tax deferred sum in 401-K account	Tax in 1988 using 5 year averaging method	Years to reach break-even level at		Break-even age for person retiring age 60	
		33% tax	50% tax	33% tax	50% tax
100,000	16,400	12	21	72	81
200,000	44,400	7	16 1/2	67	76 1/2
300,000	76,610	5	14	65	74
500,000	140,000	3	13	63	73

Table 2.

COMPARISON WITH TEN YEAR AVERAGING METHOD - 8% RETURN ON INVESTMENT

Tax deferred sum in 401-K account	Tax in 1988 using 10 year averaging method	Years to reach break-even level at		Break-even age for person retiring age 60	
		33% tax	50% tax	33% tax	50% tax
100,000	14,470	14	23	74	83
200,000	36,920	10	19	70	79
300,000	66,330	7	16 1/2	67	76 1/2
500,000	143,680	2 1/2	12	62 1/2	72

Table 3.

COMPARISON WITH TEN YEAR AVERAGING METHOD - 12% RETURN ON INVESTMENT

Tax deferred sum in 401-K account	Tax in 1988 using 10 year averaging method	Years to reach break-even level at		Break-even age for person retiring age 60	
		33% tax	50% tax	33% tax	50% tax
100,000	14,470	9 1/2	17	69 1/2	77
200,000	36,920	7	13	67	73
300,000	66,330	5	11	65	71
500,000	143,680	2	8	62	68

FOUR IMPORTANT CONSIDERATIONS

For the tax deferred sums compared in the above tables it is obvious that an IRA rollover becomes more advantageous:

1. The larger the sum of money involved.
2. The lower the tax rate.
3. The higher the rate of return on invested savings.
4. The longer the life expectancy.

In choosing between a lump sum distribution and an IRA rollover consideration must be given to all four of the above factors. Estimating the amount of tax deferred savings and the achievable rate of return is less difficult than forecasting life expectancy and future tax rates. A careful review of the tables developed should assist in making a more logical decision. The individual life expectancy table (Table 4) from IRS Publication 590 - IRA's is reproduced to provide additional data for this important decision.

Table 4.

CONCLUSION

Using the individual life expectancy table and returning to our $200,000 thrift account distribution example, let us look at the retirement income comparison for a life expectancy of twenty-four years. The ten year averaging method gives us $13,046 of income each year using our 8% flat rate of return. At the end of twenty-four years the income tax free sum of $163,080 is available.

The IRA rollover would produce the same $13,046 of income for the first ten years, while the $2,954 compounded at our 8% annual rate increases the $200,000 rollover to $243,403.

For the next fourteen years using our 8% return, $19,472 of income could be withdrawn each year, and the $243,403 in the retirement account would provide the same $163,080 sum after a

Life Expectancy Table

From IRS Publication 590 IRAs

TABLE I
(Single Life Expectancy)

AGE	MULTIPLE	AGE	MULTIPLE	AGE	MULTIPLE
5	76.6	42	40.6	79	10.0
6	75.6	43	39.6	80	9.5
7	74.7	44	38.7	81	8.9
8	73.7	45	37.7	82	8.4
9	72.7	46	36.8	83	7.9
10	71.7	47	35.9	84	7.4
11	70.7	48	34.9	85	6.9
12	69.7	49	34.0	86	6.5
13	68.8	50	33.1	87	6.1
14	67.8	51	32.2	88	5.7
15	66.8	52	31.3	89	5.3
16	65.8	53	30.4	90	5.0
17	64.8	54	29.5	91	4.7
18	63.9	55	28.6	92	4.4
19	62.9	56	27.7	93	4.1
20	61.9	57	26.8	94	3.9
21	60.9	58	25.9	95	3.7
22	59.9	59	25.0	96	3.4
23	59.0	60	24.2	97	3.2
24	58.0	61	23.3	98	3.0
25	57.0	62	22.5	99	2.8
26	56.0	63	21.6	100	2.7
27	55.1	64	20.8	101	2.5
28	54.1	65	20.0	102	2.3
29	53.1	66	19.2	103	2.1
30	52.2	67	18.4	104	1.9
31	51.2	68	17.6	105	1.8
32	50.2	69	16.8	106	1.6
33	49.3	70	16.0	107	1.4
34	48.3	71	15.3	108	1.3
35	47.3	72	14.6	109	1.1
36	46.4	73	13.9	110	1.0
37	45.4	74	13.2	111	.9
38	44.4	75	12.5	112	.8
39	43.5	76	11.9	113	.7
40	42.5	77	11.2	114	.6
41	41.5	78	10.6	115	.5

flat income tax at the 33% rate was paid. The rollover option in this example produces $6,426 more income per year in the later fourteen years of the twenty-four year life expectancy.

It should be pointed out in closing; in an effort to keep this analysis as simple as possible it was assumed that a constant 8% would be dispersed each year from our IRA savings. The minimum distribution required by the IRS is obtained by dividing the total sum in the IRA savings account by the life expectancy. Returning to our example and the individual life expectancy table (Table 5) we see that at age 75 the life expectancy is 12.5 years which equates to exactly an 8.0% distribution.

Table 5.

Age	Life Expectancy	Minimum Distribution
75	12.5	8.00%
76	11.9	8.40%
77	11.2	8.93%
78	10.6	9.43%
79	10.0	10.00%

As the above table shows at age 76 or in year sixteen our retiree would be required to increase his distribution to 8.4%, to 8.93% in year seventeen, etc. Since our break-even point was in year ten, this does not change the conclusion which shows that the IRA rollover was more profitable. It simply means that our retiree starting at age 76 will receive more from both approaches, and that the sum in the retirement account will decrease each year since he will be earning the flat 8% return

while paying out an amount in excess of 8%. Also, recall that the life expectancy can be increased by using the joint life expectancy tables in the IRS publications.

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