MFS®

RETIREMENT

AN IRA DILEMMA: TO ROLL OR NOT TO ROLL

When you take a distribution from your company's retirement plan — at retirement or when you change jobs — you may find yourself with a sizable sum of money. This windfall is often referred to as a lump-sum distribution. In addition to wondering what you should do with this money, you also may have concerns about taxes and investing issues that you never had to think about before, such as early withdrawal penalties and a 20% mandatory withholding.

Because this money could play such a large part in helping to ensure that your years in retirement are comfortable, it is important for you to understand your options and make decisions that will serve your needs now and in the future.

The following are answers to some of the most commonly asked questions about lump-sum distributions. Among the answers, you will find information on rollover IRAs, which may be your best option to consider for working toward your goals with your retirement funds while offering flexible investment and distribution options.

What are the potential drawbacks involved in taking a lump-sum distribution?

You run the risk of jeopardizing the quality of your future retirement. As more employers allow lump-sum distributions, people who might have had fairly modest incomes suddenly find themselves having to decide what to do with what may be thousands to hundreds of thousands of dollars. Such a large sum of money can tempt people to do things they may regret later. For example, having worked hard for the past five years without a vacation, you may be tempted to take a once-in-a-lifetime trip. Even if you have always been financially disciplined, the temptation might still seem too great to resist.

Key points

When changing jobs or getting ready to retire, you will need to decide what to do with the assets in your employer-sponsored retirement plan account. A rollover IRA may be right for you. Consider these features and benefits:

- Tax-deferred investing
- A potential income stream during retirement
- Easy access to your assets in an emergency*
- A broad range of investment choices
- A convenient vehicle for consolidating retirement assets

* Current income taxes and a possible 10% tax penalty apply when you take your retirement money prior to age 59½.

This material should be used as helpful hints only. Each person's situation is different. You should consult your investment professional or other relevant professional before making any decisions.

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Can I use part of a distribution for important current expenses?

Although you may think it makes sense to use part of a lump-sum payment to eliminate large outstanding debts or pay off mortgages, a sound retirement can be jeopardized if this money is not used wisely. It may look like a lot of money now, but as people retire earlier and live longer, estimates of how much an individual will need for a comfortable retirement are continually revised upward. Your nest egg may have to be a source of income for 20 or 30 years or more. So, if you spend even a little of your lump sum prematurely — even to pay down your debts — you may have a smaller nest egg and less income during retirement. Keep in mind that you will have to pay income taxes on any money you withdraw now.

In addition, you may be subject to an early withdrawal penalty tax of 10%, unless you meet one of the age or other exemptions provided in the Internal Revenue Code.

What if I am leaving my job and am offered a lump-sum distribution?

One best first step might be to do nothing. In most cases, you will not be forced to take your money out of the company retirement plan immediately, which gives you time to make careful decisions.

If you have been participating in the company's 401(k) plan, you may be able to keep your money in that plan. Your other options include rolling your retirement money into an IRA or into another retirement plan offered by your new employer.

What exactly is a rollover?

A rollover is a transfer of money from one employer's qualified retirement plan or IRA to another employer plan or IRA. Rollovers keep retirement money tax deferred until withdrawals begin.

How does a rollover IRA work?

One of the most popular choices for rollovers is a transfer of the assets from a retirement plan into an IRA, perhaps with a mutual fund company, which may offer more investment choices than are available in a 401(k). However you may be OK with the options and enjoy lower costs in the employer plan.

Rollovers that are not made directly from one plan to another are subject to strict time frames, and missing the deadline can result in a tax liability and a possible penalty. A financial advisor can help guide you through the process. To avoid potential complications, a rollover should be a direct, trustee-to-trustee transfer. In a direct rollover, no check will be made out to you.

But what if I need the money before I'm 59½?

There are many reasons why you may need income, whether it is to take an early retirement, start a business or sustain yourself while you are between jobs. How you take the distribution and which account you withdraw it from can have an impact on whether you pay any penalties. As an example, if you separated from service after January 1 of the year you turned 55, distributions from your old employer's plan are no longer subject to an early distribution penalty. So if you are between 55 and 59½, moving that money into your new employer's plan or an IRA could eliminate potentially favorable tax treatment. If you need to generate income from your retirement plan distribution right away, talk to your financial or tax advisor before you take any action.

Under Internal Revenue Code Section 72(t), your payments will not be subject to a 10% early withdrawal penalty as long as you take your money out in "substantially equal payments" based on life expectancy tables. The IRS has approved three different calculation methods, which results in varying levels of payments. However, a tax penalty will apply if you change the amount or stop payments before the greater of five years or the amount of time before you turn age 59½. In other words, you must continue the payments for the longer of the two periods.

Is an IRA cheaper than my employer's plan?

Both employer plans and IRAs may involve fees and investment-related expenses. Since your employer may pay some of the plan's expenses, you may find your 401(k) is cheaper than the IRA you are considering. Or you may find the IRA to be the cheaper option. The key is to do a side-by-side comparison of the investment options, fees, expenses and services to find the option that best fits your individual needs.

How much will it cost in taxes if I take the money now?

You might be surprised. By removing even what seems like a small amount from your nest egg, you are opening yourself up to tax liability and therefore reducing the amount of money that can remain working for you. The table on page 3 shows two of the choices available to a person changing jobs who is 34 years old and in the 22% tax bracket and whose investment earns a hypothetical 6% annual return.

Cost breakdown of distribution options

Based on annual growth rate of 6%

	Taking money now	Directly rolling over distribution
Distribution	$20,000	$20,000
20% withholding tax	($4,000)	$0
10% early withdrawal penalty	($2,000)	$0
2% additional current tax owed	($400)	$0
Available for reinvestment	$13,600	$20,000
Net value in 10 years*	$22,365	$24,356
Net value in 20 years*	$36,778	$43,617
Net value in 30 years*	$60,481	$89,598

*All gains in the "Taking money now" example are adjusted for a 15% tax rate in the year the gains are earned, representing the current federal tax rate on long-term capital gains and dividends. The rate can vary at different income levels. The values in the "Directly rolling over distribution" example assume the taxpayer is in the 22% federal tax bracket (the 10- and 20-year examples also include a 10% penalty for early distribution) and takes a full distribution at 10, 20 or 30 years. State taxes may also apply to distributions.

These examples are for illustrative purposes only and are not intended to predict the returns of any investment choices. Rates of return will vary over time, particularly for long-term investments. There is no guarantee the selected rate of return can be achieved. The performance of the investments will fluctuate with market conditions.

Source: MFS calculation.

A rollover might be right for me. What should I do now?

If you decide to roll over your distribution, you will need to determine how to invest your money. Among the most popular choices for IRAs are mutual funds, which offer professional, full-time management, diversification (to help reduce risk) and the flexibility to move from one fund to another as your needs change. Keep in mind that all investments, including mutual funds, carry a certain amount of risk, including the possible loss of the principal amount invested. The principal value and return of mutual funds will fluctuate with changes in market conditions, and shares, when redeemed, may be worth more or less than their original cost. Also, diversification does not guarantee a profit or protect against loss.

There are advantages and disadvantages to rolling money out of your employer's plan and into an IRA. You will need to compare such features as investment options, services, fees and expenses, withdrawal options, required minimum distributions, tax treatment and your unique financial needs and retirement goals. Please be aware that rolling over retirement assets into one IRA account could potentially increase fees as the underlying funds may be subject to sales loads, higher management fees, 12b-1 fees, and IRA account fees such as custodial fees. For assistance in determining if a rollover to an IRA is appropriate for you, consult your investment professional.

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