The Cost of Taking a Cash Distribution

- COMPASS advises its clients that pursuing option 4 in this article, taking a cash distribution from an employer-sponsored retirement plan, is "expensive money".
- Such an action will subject the distribution to your marginal federal and state income tax rates, plus a 10% penalty if you are under 59 1/2. A distribution could also push you into a higher federal income tax bracket.

Deciding what to do with your 401(k) balance when you leave a job does not have to be difficult. It is something that almost everyone will have to do at some point. The best approach is to look at the various options, understand the differences, and figure out how your decision will impact your ability to save for retirement. In general, here are the options available: 1. Keep your savings in your previous employer's 401(k) plan (typically allowed if you have a balance of $5,000 or more); 2. Transfer your savings to your new employer's 401(k) plan; 3. Transfer your savings to a Rollover IRA; 4. Take a cash distribution.

Let's look at a hypothetical example of an individual with $20,000 in a 401(k) who has left his or her job. This person now has to choose between the options above. Let's assume a hypothetical 8% annual return over a 20-year period. If the money was kept in a 401(k) plan or rolled into a traditional IRA, it would have grown to $93,219 over 20 years. Alternatively, you could spend the $20,000 or put it into a taxable account, but these options do not provide the benefits of tax deferral. Furthermore, the tax consequences and early withdrawal penalties involved with the cash distribution would greatly reduce the actual amount of cash received.* While cashing out from your retirement plan when you leave a job may seem like an attractive option, even the smallest withdrawal may have more sizeable financial consequences than you realize.

* Withdrawals from tax-deferred accounts will be taxed at then-current rates. Early withdrawals may be subject to surrender fees, and withdrawals made prior to age 59½ may be subject to a 10% IRS penalty tax. Past performance is no guarantee of future results. You should consult your tax advisor as to the tax consequences of a particular investment.

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