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RETIREMENT PLANNING 401(K)

10 Ways to Reduce Taxes on 401(k) Distributions

How you take a distribution can greatly impact your taxes

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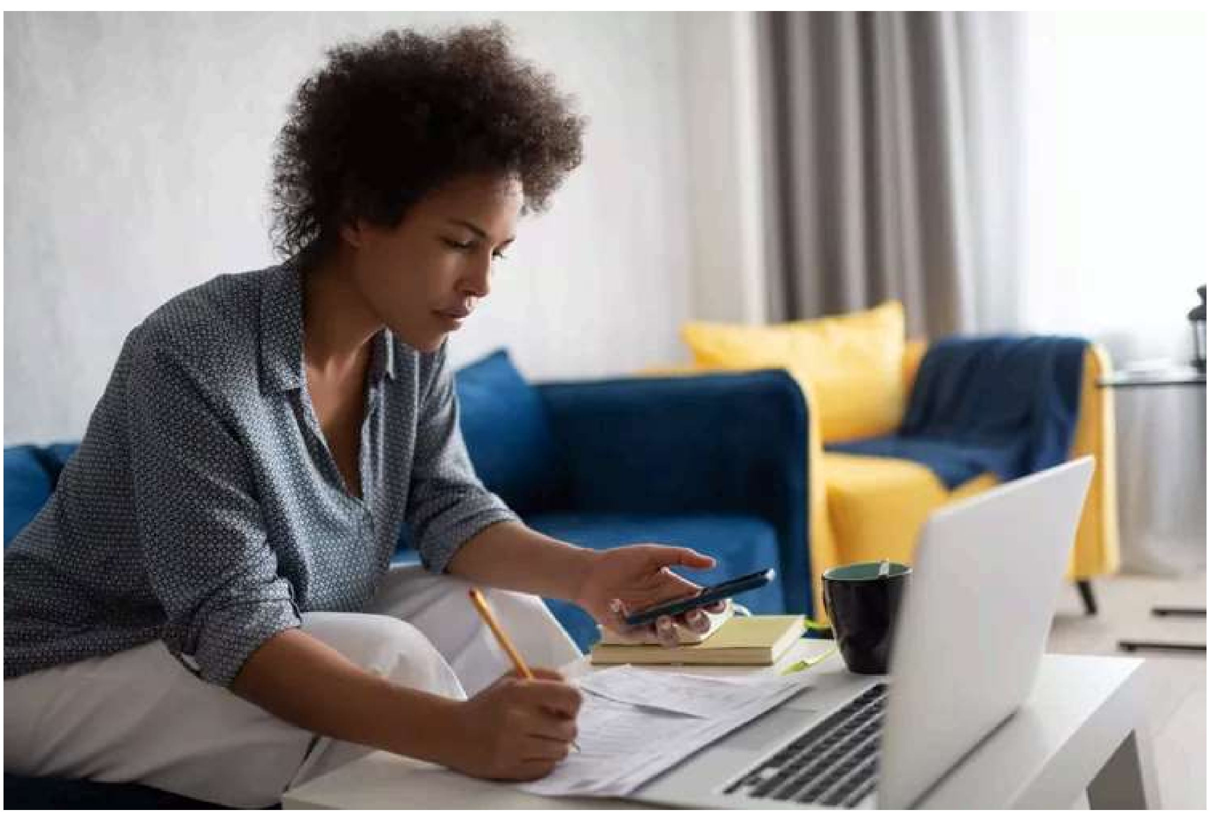
Part of the Series
Retirement Planning Guide



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distribution from your traditional 401(k). It's subject to ordinary income tax based on your tax bracket. You must add a 10% early withdrawal penalty in most cases as well if you're younger than 59½ when you take the distribution.

A 401(k) distribution could also put you in a higher marginal income tax bracket.

KEY TAKEAWAYS

- Certain strategies can alleviate the tax burden associated with 401(k) distributions.
- Net unrealized appreciation and tax-loss harvesting can reduce taxable income.
- Rolling over regular distributions to an IRA avoids automatic tax withholding by the plan administrator.
- Taking a loan from your 401(k) instead of withdrawing money avoids taxable income.

How Distributions Are Taxed

Distributions from your 401(k) are taxed as ordinary income which is based on your overall yearly income including earnings and income from retirement accounts and pensions. [1] Account holders should track their tax bracket and how the distribution might impact it.

There's a mandatory withholding of 20% of a 401(k) withdrawal to cover federal income tax. Rolling over the portion of your 401(k) into an IRA provides a way to access the funds without being subject to that 20%. [2]

1. Net Unrealized Appreciation (NUA)

You may be eligible for net unrealized appreciation (NUA) treatment if you have company stock in a 401(k) and the company stock portion is distributed to a less.[3]

Consider moving your funds to a taxable account rather than keeping the money in your 401(k) or moving it to a traditional IRA. Think twice before rolling over company stock and enlist the help of a financial professional for the best results.

2. The "Still Working" Exception

Most people know that they're subject to required minimum distributions (RMDs) at age 72 or 73 depending on your birthdate. These RMDs don't apply to your 401(k) with your current employer, however, if you're still working when you reach that age.[4]

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You can keep the funds in the account and postpone any tax reckoning. Those who own more than 5% of the business that sponsors the plan aren't eligible for this exemption. This includes any stake owned by a spouse, children, grandchildren, and parents. It can rise to over 5% after age 73. [5] [6]

3. Tax-Loss Harvesting

Tax-loss harvesting involves selling underperforming securities in your regular investment account. The losses on the securities offset the taxes on your 401(k) distribution. Tax-loss harvesting can offset some or all of an investor's tax burden generated by a 401(k) distribution when it's exercised correctly. This strategy has some limitations, however, and investors must be careful to avoid violating the wash-sale rule. [7]

4. Avoid 20% Withholding

The service provider must withhold 20% for federal income tax when you take a 401(k) distribution. [8] You'll have to wait until you file your taxes to get the extra 5% back if it turns out that you only owe 15% at tax time.

Account holders can roll over the 401(k) balance to an IRA account and take cash out of the IRA. There's no mandatory 20% federal income tax withholding on the IRA so you can choose to pay your taxes when you file rather than upon distribution. [9]

5. Take a 401(k) Loan

Some plans let you take out a loan from your 401(k) balance. You may be able to borrow from your account in this case, invest the funds, and create a consistent income stream that persists beyond your repayment.

The IRS generally allows you to borrow up to 50% of your vested loan balance up to $50,000 with a payback period of up to five years. You don't pay any taxes on this distribution or a 10% penalty. [10] Those who don't need the money as step.

> **Important:** The amount will be taxed as a cash distribution if you borrow from your 401(k) and can't repay the loan. [11]

6. Watch Your Tax Bracket

You should only take distributions to the upper limit of your tax bracket because 401(k) distributions are based on your tax bracket at the time of distribution. Detailed tax planning each year can help keep your taxable income to a minimum.

Those who are married and filing jointly can stay in the 12% marginal tax bracket on their top dollars with incomes of up to $94,300 in 2024. This increases to $96,950 in 2025. The 22% tax bracket begins at incomes of $94,300 or $96,950 respectively. [12] [1] You can limit your 401(k) withdrawals so they don't push you into a higher bracket by planning carefully.

7. Plan for Capital Gains

Long-term capital gains are taxed at 0% up to the qualifying income amount. Singles with taxable income of up to $44,625 will stay within the 0% long-term capital gains threshold in 2024. This increases to $48,350 in 2025. Married filing jointly taxpayers with taxable income up to $89,250 will stay within the 0% capital gains threshold in 2024, increasing to $96,700 in 2025. Any amount over these income levels will be taxed at 15% or 20% depending on total taxable income. [13] [14]

Retirees can subtract their pensions from their annual spending amount then calculate the taxable portion of their Social Security benefits, subtract this from the balance from the previous equation, and subtract any required minimum distribution. Any remainder should come from the retirees' 401(k). Required money above this amount can be withdrawn from positions with long-term capital gains in a brokerage account or Roth IRA.

employer if you're still working but you would be required to take RMDs from 401(k) accounts you may have with previous employers or traditional IRAs.

Roll your old 401(k)s and traditional IRAs into your current 401(k) to avoid the requirement. There are some exceptions to this rule but you can further defer taxable income until retirement if you can take advantage of this technique, at which point you might be in a lower tax bracket.[15] [16]

9. Defer Social Security

Deferring Social Security is another way of reducing your tax burden when you take a 401(k) withdrawal. Social Security benefits aren't usually taxable unless the recipient's overall annual income exceeds a set amount.[17] Sometimes a large 401(k) withdrawal is enough to push the recipient's income over that limit.

Retirees can raise their payments by almost a third if they can afford to delay collecting benefits. Your full retirement age is 66 if you were born between 1943 and 1954. You'll get 108% of your age 66 benefit and 132% of your age 70 benefit if you delay to age 67. The Social Security Administration provides a handy calculator to help you determine your benefits.[18]

10. Qualify for Disaster Relief

The IRS periodically grants relief concerning 401(k) distributions for people living in areas that are prone to hurricanes, tornadoes, earthquakes, or other forms of natural disasters. It effectively waives the 10% penalty for a certain window of time.[19]

Other events can constitute a hardship and exemption from the 10% penalty as well. They include economic challenges such as job loss, college tuition, or a down payment on a house.[20]

When Do I Qualify for a 401(k) Distribution?

You can withdraw money from your 401(k) penalty-free at age 59½. The withdrawals will be subject to ordinary income tax based on your tax bracket.

or covering costs associated with a birth or adoption. [20] [21]

What Are Some Exceptions to Avoid an Early Withdrawal Penalty?

Exceptions include homebuying expenses for a principal residence, educational tuition, expenses to prevent foreclosure or eviction, funeral expenses, and natural disaster repairs. [20]

Can I Take a Distribution From My 401(k) While I'm Still Working?

Yes, but the distribution will be taxed as ordinary income and will be subject to the 10% penalty if you're making the 401(k) withdrawal under age 59½. The penalty is waived if you qualify for a hardship. [2]

The Bottom Line

Deferring Social Security payments, rolling over old 401(k)s, setting up IRAs to avoid the mandatory 20% federal income tax, and keeping your capital gains taxes low are among the best strategies for reducing taxes on your 401(k) withdrawal. Account holders should consult a financial planner to find the best strategies for them.

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