

# AI-01252 401k Tax Now or Later

👤 Owner	Ⓜ Rigel Arcayan
☰ Tags	Investing
🕒 Created time	@November 17, 2024 10:23 AM

Hypothetically, if a healthy and active 62 years old human has a 401K balance of \$2000000, the expected life expectancy is 30 years. Index investing return is 12% per year. Perform a pros and cons analysis of taking a lump sum at age 62 and pay the entire taxes at once or taking a withdrawal as needed or RMD requirement. Show the calculation and results of each scenario.

## Scenario 1: Lump Sum Withdrawal

### Pros:

- **Control:** You have complete control over the funds.
- **Potential for Higher Returns:** If invested wisely, the lump sum could potentially outperform a structured withdrawal plan.
- **Tax Efficiency:** Depending on your tax bracket, paying the taxes upfront might be more advantageous in the long run.

### Cons:

- **Immediate Tax Liability:** A significant tax burden upfront.
- **Risk of Mismanagement:** There's a risk of mismanaging the funds, especially if you're not a seasoned investor.
- **Potential for Overspending:** Having a large sum of money can tempt you to overspend.

### Calculation:

- **Initial Balance:** \$2,000,000
- **Annual Return:** 12%
- **Time Period:** 30 years

### Assuming a 25% tax rate on the lump sum:

- **Post-Tax Lump Sum:**  $\$2,000,000 * (1 - 0.25) = \$1,500,000$
- **Future Value of the Lump Sum After 30 Years:**  $\$1,500,000 * (1 + 0.12)^{30} \approx \$23,867,360$

### Scenario 2: Structured Withdrawal

#### Pros:

- **Reduced Tax Liability:** Taxes are paid on a smaller amount each year.
- **Guaranteed Income Stream:** A steady income stream, especially important for those who prefer a more predictable cash flow.
- **Professional Management:** If you choose a managed withdrawal plan, you can benefit from expert advice.

#### Cons:

- **Lower Potential Returns:** Structured withdrawals may not maximize the potential returns of the investment.
- **Required Minimum Distributions (RMDs):** You must withdraw a certain amount each year, regardless of your financial needs.
- **Inflation Risk:** The purchasing power of your withdrawals may decline over time.

#### Calculation:

To calculate the annual withdrawal amount that would last 30 years, we can use the "4% Rule." This rule suggests withdrawing 4% of your initial portfolio value each year, adjusted for inflation.

- **Initial Annual Withdrawal:**  $\$2,000,000 * 0.04 = \$80,000$

**Note:** This is a simplified calculation and actual withdrawal amounts may vary based on factors like investment performance, inflation, and individual needs.

#### Conclusion:

The best approach depends on your individual circumstances, risk tolerance, and financial knowledge. It's crucial to consult with a financial advisor to make an informed decision.

### **Additional Considerations:**

- **Healthcare Costs:** Factor in potential healthcare expenses, which can significantly impact retirement income.
- **Long-Term Care:** Consider the possibility of needing long-term care and the associated costs.
- **Legacy Planning:** If you want to leave a legacy, a structured withdrawal plan may be more suitable.

Remember, this is a hypothetical scenario, and actual results may vary. It's important to consult with a financial advisor to tailor a retirement plan to your specific needs.

### **A normal human being in 2024 will choose Lump Sum or Incremental withdrawal?**

The choice between a lump sum withdrawal and an incremental withdrawal for a 62-year-old in 2024 depends on various factors, including:

#### **Risk Tolerance:**

- **Risk-Averse:** Individuals who are more risk-averse may prefer incremental withdrawals to ensure a steady income stream and minimize the impact of market volatility.
- **Risk-Tolerant:** Those comfortable with risk may opt for a lump sum withdrawal, allowing them to invest the funds more aggressively and potentially achieve higher returns.

#### **Financial Knowledge and Skills:**

- **Experienced Investors:** Individuals with strong financial knowledge and investment experience may be more inclined to take a lump sum and manage their investments independently.
- **Less Experienced Investors:** Those who lack investment expertise may prefer a structured withdrawal plan to avoid making poor financial decisions.

#### **Lifestyle and Spending Needs:**

- **Consistent Income:** If a steady income stream is essential, incremental withdrawals may be more suitable.

- **Flexibility:** A lump sum withdrawal offers greater flexibility to adjust spending based on changing circumstances.

#### **Tax Implications:**

- **Immediate Tax Burden:** A lump sum withdrawal will result in a significant tax liability upfront.
- **Gradual Taxation:** Incremental withdrawals spread out the tax burden over time.

**Considering these factors, a typical individual in 2024 might lean towards an incremental withdrawal strategy for the following reasons:**

- **Risk aversion:** Many individuals are cautious about market volatility and prefer a guaranteed income stream.
- **Lack of investment expertise:** Not everyone has the knowledge or skills to manage a large lump sum effectively.
- **Tax considerations:** Gradual taxation can be more manageable than a large tax bill upfront.
- **Peace of mind:** A structured withdrawal plan can provide a sense of security and reduce financial stress.

However, it's important to note that this is a generalization, and individual circumstances may vary. Consulting with a financial advisor can help determine the best approach for each specific situation.