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401(k)s – To Roll or Not to Roll?

If you've recently changed jobs, or you are considering retirement, you may find yourself trying to decide what to do with your 401(k). Generally, you have these options available to you when you stop working: roll it over (to a new employer's retirement plan or IRA), leave your 401(k) where it is, or cash it out.

Rolling Over to Another Plan or IRA

There can be some benefits to rolling a 401(k) from your former employer to your new employer's plan, rather than moving it to an IRA. These potential advantages depend on the choices available in your new employer's 401(k) plan.

Because many investments, including mutual funds, have minimums you must meet before you can invest on your own, if you do not have a lot of savings in your 401(k), it may be more difficult to diversify when you move it to an IRA. With a 401(k) plan, there are generally no investment minimums so leaving your savings in the current 401(k) or moving it to a new employer's plan could make more sense.

IRAs almost always have more investment choices. For example, you can invest in individual stocks, bonds, and mutual funds in an IRA, whereas 401(k) plans usually offer only a limited number of mutual funds.

Both 401(k) plans and IRAs have fees associated with the investments and your investment costs may be lower in a 401(k) plan. Make sure to check out all the fee and expense information before making a decision.

What is a Direct Rollover?

A direct rollover is when you authorize your former company's 401(k) plan to move your retirement savings directly to a new employer's retirement plan or IRA. Direct rollovers are tax free and allow tax deferral to continue.

What is an Indirect Rollover?

An indirect rollover occurs when you become the middleman in a rollover. If you request the account balance to be paid to you, your former employer must withhold 20 percent and forward that withholding to the IRS. You then must take care of the rollover yourself within 60 calendar days.

Although this type of rollover also allows you to continue the benefit of tax deferral, to avoid taxes and penalties with an indirect rollover, you must deposit the money you received, plus the 20 percent withheld, into a new employer's retirement plan or IRA within 60 calendar days.

If you decide that a 401(k) rollover to either a new employer's plan or an IRA is the best option for you, a direct rollover is usually the fastest way to move your account, and it will also ensure there is no federal income tax withholding or 60-day time limit. Sometimes with a direct rollover your former employer will mail you a check and it will be made payable to the trustee or custodian of your new retirement plan or IRA. If you receive a check like this don't worry, it will still be considered a direct rollover. You just need to get the check to the institution acting as the trustee of your new retirement account.

Use Caution If You Have Plan Loans

If you have a loan against your 401(k), you generally need to pay it back to the plan before asking for a rollover or you could end up with a "loan offset". A loan offset causes the remaining amount you owe on the loan to be considered a distribution, subject to income taxation, in addition to a 10 percent penalty tax if it's an early distribution. The tax and penalty can be avoided if it is a "qualified" plan loan offset, and you repay it to an IRA or other eligible retirement account by the time you file your tax return for the year (including extensions). Check with your current employer if you have an outstanding plan loan to fully understand impact of rolling over to another retirement plan or IRA.

Leave It

If you have an especially good 401(k) with your former employer, it may be better to just leave your retirement savings where it is. It will stay tax-deferred and be available for you to use later on during retirement.

Cash It Out

If you cash out, you will be able to keep only what's left over after taxes and possible IRS penalties. Keep in mind that if you cash out before the age of 59 ½, you may also have a 10 percent penalty tax on the early distribution and, in most cases, you will pay ordinary income taxes on the entire amount of the distribution. If you are age 55 or older at the time you separate from service, the 10 percent early withdrawal penalty does not apply[1]. The ability to receive penalty-free withdrawals can also impact your decision to leave your savings in the plan instead of rolling over.

A Financial Advisor Can Help

Many factors can impact whether a rollover is right for you. Your financial advisor can help you evaluate your options. ■

[1]Note: Penalty-free withdrawals for public safety workers and correction officers participating in governmental retirement plans, and for private sector firefighters, may be made after the earlier of age 50 or 25 years of service.

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