Retirement Plans

401(k)s – To Roll or Not to Roll – That Is the Question

If you've recently changed jobs, you may find yourself trying to decide what to do with your 401(k). Generally, you have four options from which to choose: leave your 401(k) where it is, cash it out, do a direct rollover, or do an indirect rollover.

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 tax rates on the entire amount of the distribution. If you are age 55 or older at the time you separate from service, you may be able to avoid the 10 percent early withdrawal penalty[1]. The ability to receive penalty-free withdrawals can also impact your decision to leave your savings in the plan instead of rolling over.

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.

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

Indirect Rollover

An indirect rollover occurs when you receive a check, less 20 percent in mandatory tax withholding, and you have to take care of the rollover yourself. This type of rollover also allows you to continue the benefit of tax deferral. However, 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.

Special Considerations for Plan Loans

If you have a loan against your 401(k), you generally need to pay it back to the plan before rolling over or repay it to an IRA by the time you file your tax return for the year. Otherwise, the remaining amount you owe on the loan may be considered a distribution and taxed as ordinary income, in addition to a 10 percent penalty tax if it's an early distribution.

Rolling 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.
Also consider that you may have limited investment options available to you in your 401(k). 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. 401(k) plans and IRAs often 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.

If you decide that a 401(k) rollover to either a new employer's plan or an IRA is the best option for you, have your current 401(k) plan move your funds directly to your new account. This is usually the fastest way to get your account back in business without interruption. A direct rollover will also ensure federal income tax is not withheld and it will eliminate the need for you to complete the rollover in 60 days. Sometimes 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.

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