



Bay Colony Partners

Deciding What to Do with Your 401(k) Plan When You Change Jobs

When you change jobs, you need to decide what to do with the money in your 401(k) plan. Should you leave it where it is, or take it with you? Should you roll the money over into an IRA or into your new employer's retirement plan?

As you consider your options, keep in mind that one of the greatest advantages of a 401(k) plan is that it allows you to save for retirement on a tax-deferred basis. When changing jobs, it's essential to preserve the continued tax-deferred growth of these retirement funds, and to avoid current taxes and penalties that can eat into the amount of money you've saved.

Take the money and run

When you leave your current employer, you can withdraw your 401(k) funds in a lump sum. To do this, simply instruct your 401(k) plan administrator to cut you a check. Then you're free to do whatever you please with those funds. You can use them to meet expenses (e.g., medical bills, college tuition), put them toward a large purchase (e.g., a home or car), or invest them elsewhere.

While cashing out is certainly tempting, it's almost never a good idea. Taking a lump sum distribution from your 401(k) can significantly reduce your retirement savings, and is generally not advisable unless you urgently need money and have no other alternatives. Not only will you miss out on the continued tax-deferred growth of your 401(k) funds, but you'll also face an immediate tax bite.

First, you'll have to pay federal (and possibly state) income tax on the money you withdraw. If the amount is large enough, you could even be pushed into a higher tax bracket for the year. If you're under age 59½, you'll generally have to pay a 10 percent premature distribution penalty tax in addition to regular income tax, unless you qualify for an exception. (For instance, you're generally exempt from this penalty if you're 55 or older when you leave your job.) And, because your employer is also required to withhold 20 percent of your distribution for federal taxes, the amount of cash you get may be significantly less than you expect.

Note: Because lump-sum distributions from 401(k) plans involve complex tax issues, especially for individuals born before 1936, consult a tax professional for more information.

Leave the funds where they are

One option when you change jobs is simply to leave the funds in your old employer's 401(k) plan where they will continue to grow tax deferred.

However, you may not always have this opportunity. If your vested 401(k) balance is \$5,000 or less, your employer can require you to take your money out of the plan when you leave the company. (Your vested 401(k) balance consists of anything you've contributed to the plan, as well as any employer contributions you have the right to receive.)

Leaving your money in your old employer's 401(k) plan may be a good idea if you're happy with the investment alternatives offered or you need time to explore other options. You may also want to leave the funds where they are temporarily if your new employer offers a 401(k) plan but requires new employees to work for the company for a certain length of time before allowing them to participate. When the waiting period is up, you can have the plan administrator of your old employer's 401(k) transfer your funds to your new employer's 401(k) (assuming the new plan accepts rollover contributions).

Transfer the funds directly to your new employer's retirement plan or to an IRA (a direct rollover)

Just as you can always withdraw the funds from your 401(k) when you leave your job, you can always roll over your 401(k) funds to your new employer's retirement plan if the plan allows it. You can also roll over your funds to a traditional IRA. You can either transfer the funds to a traditional IRA that you already have, or open a new IRA to receive the funds. There's no dollar limit on how much 401(k) money you can transfer to an IRA.

Generally, the best way to roll over funds is to have your 401(k) plan directly transfer your funds to your new employer's retirement plan or to an IRA you've established. A direct rollover is simply a transfer of assets from the trustee or custodian of one retirement savings plan to the trustee or custodian of another (a "trustee-to-trustee transfer"). It's a seamless process that allows your retirement savings to grow tax deferred without interruption. Once you fill out the necessary paperwork, your 401(k) funds move directly to your new employer's retirement plan or to your IRA; the money never passes through your hands. And, if you directly roll over your 401(k) funds following federal rollover rules, no federal income tax will be withheld.

Note: In some cases, your old plan may mail you a check made payable to the trustee or custodian of your employer-sponsored retirement plan or IRA. If that happens, don't be concerned. This is still considered to be a direct rollover. Bring or mail the check to the institution acting as trustee or custodian of your retirement plan or IRA.

Have the distribution check made out to you, then deposit the funds in your new employer's retirement plan or in an IRA (an indirect rollover)

You can also roll over funds to an IRA or another employer-sponsored retirement plan (if that plan accepts rollover contributions) by having your 401(k) distribution check made out to you and depositing the funds to your new retirement savings vehicle yourself within 60 days. This is sometimes referred to as an indirect rollover.

However, think twice before choosing this option. Because you effectively have use of this money until you redeposit it, your 401(k) plan is required to withhold 20 percent for

federal income taxes (you get credit for this withholding when you file your federal income tax return for the year). Unless you make up this 20 percent with out-of-pocket funds when you make your rollover deposit, the 20 percent withheld will be considered a taxable distribution, subject to regular income tax and generally a 10 percent premature distribution penalty (if you're under age 59½).

If you do choose to receive the funds through an indirect rollover, don't put off redepositing the funds. If you don't make your rollover deposit within 60 days, the entire amount will be considered a taxable distribution.

Which option is better: An IRA or your new employer's plan?

Assuming that your new employer offers a retirement plan that will accept rollover contributions, is it better to roll over your 401(k) funds to the new plan or to a traditional IRA?

Each retirement savings vehicle has advantages and disadvantages. Here are some points to consider:

- A traditional IRA can offer almost unlimited investment options; a 401(k) plan limits you to the investment options offered by the plan
- A traditional IRA offers easier access to retirement funds than a 401(k)
- A traditional IRA can be converted to a Roth IRA if you qualify
- A 401(k) offers the highest level of protection from creditors (the protection afforded to IRA funds depends on state law)
- A 401(k) may allow you to borrow against the value of your account, depending on plan rules
- A 401(k) offers more flexibility if you want to contribute to the plan in the future

Finally, no matter which option you choose, you may want to discuss your particular situation with a tax professional (as well as your plan administrator) before deciding what to do with the funds in your 401(k).