Leaving Your Job? Here Are 5 Options for Your 401(k)

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When you move on from one job to the next, you have options about what to do with your 401(k) or similar retirement plan.

You can:

- Leave it where it is.
- Roll it over into your new employer's plan or a personal 401(k) if you are self-employed.
- Convert it to an IRA.
- Convert it to a Roth IRA.
- Cash it out.

Some options have tax consequences and penalties, so choosing the right option for you can save you a lot of money.

401(k) Rollover: What the Terminology Means

Before we get too far, here are some terms involving 401(k) rollovers that are important to understand.

401(k)

A 401(k) is a plan employers offer that allows employees to save and invest for retirement. (The name comes from a subsection of the tax code.) Employees contribute pretax money directly from their paychecks, and many employers match those contributions up to a certain level.

There is often a vesting schedule, or a period of time you must remain in the plan until all of the money your employer contributes as a match is yours. Money in 401(k) plans is protected from claims from creditors. When you reach a certain age, usually 70 ½, you must start taking distributions from a 401(k).

IRA

An IRA, or individual retirement account, is an investment account designed to build savings for retirement. There are two main types of IRA: traditional and Roth. The main difference between the two involves taxes.

With a traditional IRA, contributions are tax-deductible within certain income limits. You don't owe taxes until you withdraw the money. With a Roth IRA, contributions are not tax-deductible, but when you withdraw the money later, you won't owe any paying taxes.

Money in IRAs is not usually protected from creditors except in the case of bankruptcy. When you reach 70 ½, you must begin taking distributions from a traditional IRA, but Roth IRAs don't require minimum distributions as long as the account holder is alive.

403(b)

People who work for some nonprofits or schools, or as ministers, often have 403(b) plans instead of 401(k)s. The plans are similar, and rolling over a 403(b) is much like rolling over a 401(k).

Rollover

A rollover is when the money from one 401(k) goes directly into a different 401(k), IRA or another approved retirement plan.

Direct Rollover

When someone leaves a job and wants to withdraw their funds from their employer-sponsored 401(k), the old plan makes a check directly payable to another retirement plan or IRA.

Indirect Rollover

This is when the owner of the retirement plan receives a check from the old 401(k) plan made out to them. To avoid tax penalties, you have 60 days to deposit all of it into an approved retirement plan. You'll still likely be subject to a 20% mandatory income tax withholding, which you won't get back until your file that year's taxes.

Cashing Out

Cashing out is when you withdraw all of the money from your 401(k) to do something else with it. There are steep taxex and early withdrawal penalties associated with cashing out a 401(k), especially if you haven't reached age 59-1/2.

5 Options for Your 401(k) When You Leave Your Job

Let's take a closer look at the options we outlined earlier about what to do with a 401(k) when you leave a job.

1. Remain in Your Old Employer's Plan

Some companies allow you to keep your money in their 401(k) plan even if you're not working there anymore. Exceptions are if you have less than $5,000 in the plan you might be required to move it or if you have less than $1,000, the plan can automatically transfer it out and write you a check for the balance.

There are pros and cons to remaining in an old 401(k).

Pros:

- You don't need to make a decision immediately. You can look at your new plan or other options when you have the time.

- Your money continues to earn interest, even though you're no longer contributing to the account.

Cons:

- You'll have multiple plans to manage if you enroll in a new employer plan.
- You cannot contribute more to the plan.
- Your investment choices and access might be limited.

"A reason to stay in the existing plan is you like the choice of investment options, and it's a plan with a lot of options that suit your needs," said Jeff Pedersen, a Sioux City, Iowa-based certified financial planner and vice president of private wealth management for Baird. "Generally, 401(k) expenses are less than what they would be for an individual IRA."

2. Roll Your 401(k) Into a New Employer's Plan

When you make a job change, sometimes simplifying things makes sense. With many different plans, it can be difficult to know if you're on track to reach your retirement goals.

"It's not uncommon that somebody gets to retirement age, and says 'I've got three or four different 401(k) plans' and so I take a look at it and ask, 'OK, how easy is it to manage and are they even being managed?'" Pedersen said.

Pros:

- There's no tax on the amount you roll over.
- You'll have more of your retirement savings consolidated into one place so you can monitor it easily.
- You might be able to delay required minimum distributions until after age 70 ½ if you are still working and currently enrolled in your company's 401(k) plan.

Cons:

> If you had company stock in the old plan, there might be tax consequences to rolling it into a new plan.

3. Roll Your 401(k) Into a Traditional IRA

IRAs have some benefits 401(k) plans do not, mainly involving the choice of investments. IRAs often have many more options for how to invest your money. There is no limit to how much you can roll over into an IRA.

Pros:

- There's no tax on the amount you roll over.
- Your investments continue to grow tax-deferred, meaning you pay taxes when you withdraw the money, which you can begin to do at age 59 ½.
- You can consolidate many retirement plans into one IRA.
- You can give to a charity tax-free via a qualified charitable distribution (QCD) which you cannot do from a 401(k).

Cons:

You need to choose your investments or have someone manage them for you because the rollover will enter the account as cash.

4. Roll Your 401(k) Into a Roth IRA

The biggest difference between rolling a 401(k) into a Roth IRA versus a traditional IRA is taxes. If you roll your 401(k) into a Roth IRA, you will owe income taxes on the amount you roll over since that money has never been taxed before.

Pros:

The money will grow tax-free if you remain in the Roth IRA for a minimum of five years and don't withdraw your earnings before age 59 ½. You will not pay taxes when you take distributions in retirement.

Cons:

- There are income limits for Roth IRAs if you want to continue to keep contributing to it after a rollover. Married people earning less than $193,000 combined and single people earning less than $122,000 can make the maximum yearly contribution.
- Some 401(k) plans do not allow direct rollovers into a Roth IRA because of the tax implications.

5. Cash Out Your 401(k)

Cashing out your 401(k) is also an option, but it has many drawbacks.

"You're going to get taxed on it plus pay a penalty if you're under 59 ½," Pedersen said. "So depending on your income, you can figure that you're going to give up anywhere from 15% to 50% in the form of taxes and penalties."

Pros:

You'll have immediate access to cash.

Cons:

- It's taxable as income at the current tax rate, and 20% will be automatically withheld.
- It's subject to a 10% early withdrawal penalty.
- Your money will no longer grow tax-deferred.
- It could impact your retirement planning.

How to Decide Which Option to Choose

Every situation is different, so there is no perfect answer about what is the best option for your retirement accounts.

"Unless there's something specific about that existing plan that makes you say, 'I don't want to move these assets,' generally most plans are comparable," Pedersen said. "They offer a wide range and variety of investments. You don't want 12 different 401(k) (plans) hanging out there, because you're not going to be

managing them, so you either want to roll them all to your current employer, or you want to roll anything from past plans to an IRA. That way, you're basically managing your accounts."

Some things to consider:

- Check fees of the plans you are looking into.
- Decide if you are okay with having limited investment options or want a wide variety.
- Think about when you anticipate tapping into the funds.
- If you are in a high tax bracket now and might not be in several years, tax-deferred options such as another 401(k) or a traditional IRA might be best. If you are expecting to be in a higher tax bracket in the future, it might make more sense to pay the taxes on the money now by choosing a Roth IRA.

It doesn't need to be all or nothing. Some plans allow a partial rollover.

How to Roll Over a 401(k) in 3 Steps

Deciding where to put your money is the hard part. Making it actually happen is relatively easy if you follow three basic steps.

1. Decide where you want your money to go (your new company's 401(k), IRA, cash payout).
2. Open an account. You will need the account number and financial institution to give to the old plan administrator.
3. Contact your plan administrator and begin the rollover process.

Sometimes, you can do the entire process online and it's simple. Some companies require a formal filing request with a notary. Find out what your plan requires.

There are a few other things to remember:

- Know when you are eligible for your 401(k) plan at your new job. It's often after one year of service. Don't try to move your money too early.
- If you are doing a direct rollover, make sure the check is written to the financial institution for the new account with your name as the custodian.
- Some plans will mail a check or transfer funds directly to the new plan. Others will send a check to you, and you will need to make the deposit. Find out what you will need to do and make sure you complete the tasks within any time limits.

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