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Rolling Over Your 401K

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 consider the continued tax-deferral of these retirement funds, and, if possible, to avoid current taxes and penalties that can eat into the amount of money you've saved.

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. And while cashing out your 401K is certainly tempting, it may not be 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-deferral of your 401(k) funds, but you may face an immediate tax bite and possible penalties. One exception would be if your 401(k) plan allows Roth contributions, then only qualified distributions of your Roth contributions and earnings will be free from federal income tax. If you receive a nonqualified distribution from a Roth 401(k) account only the earnings (not your original Roth contributions) will be subject to income tax and potential early distribution penalties.

Another option is to 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. You can also roll over ("convert") your non-Roth 401(k) money to a Roth IRA. When "converting" the taxable portion of your distribution from the 401(k) plan will be included in your income at the time of the rollover.

Just as you can always withdraw the funds from your 401(k) when you leave your job, you may be permitted to roll over your 401(k) funds to your new employer's retirement plan if the new plan allows it. If you've made Roth contributions to your 401(k) plan you can only roll those funds over into a Roth IRA or another Roth 401(k) plan or Roth 403(b) plan (if your new employer's plan accepts rollovers).

Generally, the best way to roll over funds is to do a "direct rollover" to the retirement account you've chosen. 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 remain tax deferred without interruption. Once you fill out the necessary paperwork, your 401(k) funds move directly 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.

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, the IRS requires your 401(k) plan to withhold 20 percent for federal income taxes on the taxable portion of your distribution (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.

Each retirement savings vehicle has advantages and disadvantages. Just a few of the points to consider are: 1)A traditional IRA may offer investment choices while a 401(k) plan may limit you to the investment choices offered by the plan. 2)A traditional IRA can be converted to a Roth IRA if you qualify. 3) A 401(k) may allow you to borrow against the value of your account, depending on plan rules.
Finally, no matter which retirement savings vehicle you choose, you should discuss your particular situation with a financial professional and your plan administrator before deciding.

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