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Smart Strategies for 401(k) Rollovers to IRAs

Here’s how to keep your nest egg intact when you change jobs

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When you leave a job, there are three ways to preserve your retirement account balance: leave it in the existing 401(k) plan, roll the money over to an IRA, or transfer the balance to another 401(k) plan at your new job. The hard part is choosing the option that preserves as much of your retirement savings as possible. Here are some strategies to minimize taxes and fees on your retirement account when changing jobs:

Wait until you are vested. You don't get to keep employer contributions to your 401(k) until you are vested in the plan. If you leave the company before you are fully vested, you could forfeit some or all of your 401(k) match. If you have control over when you leave the company and are close to becoming vested, staying with the firm for a few more months could add thousands of dollars to your nest egg. "Look at how much you would get if you vest and how much you are going to make at this other employer and also the new match or profit-sharing contribution," says Barbara Camaglia, a certified financial planner for Legacy Financial Advisors in Beachwood, Ohio.

Initiate a direct rollover to the new account. Ask your former employer to directly transfer your 401(k) balance to an IRA or your new company's 401(k) plan. This is the simplest way to avoid taxes and penalties when closing out an old 401(k) plan. "If you are planning to leave the money tax-deferred, then the best way to do that is a trustee-to-trustee transfer," says Rosemary Danielson, a certified financial planner for Balanced Financial Planning in Overland Park, Kan. "A trustee-to-trustee transfer allows you to avoid having any tax withheld on that rollover."

If you instead get a personal check from your employer, 20 percent of your account balance will be withheld for income tax. And if you don't deposit the entire account balance, including the withheld 20 percent, into a new retirement account within 60 days, it is considered a withdrawal. You will become responsible for paying income tax and, if under age 55, a 10 percent early withdrawal penalty on any amount not rolled over. For example, if you have $100,000 in your 401(k), your employer could write you a check for $80,000. If you only deposit the $80,000 in an IRA, the $20,000 will be counted as income and taxes and the early withdrawal penalty may be applied.

Seek lower-cost investments. If you're unhappy with the fund choices in your 401(k) plan, a job change is the perfect time to seek better investments with lower fees. "IRAs give you more investment flexibility and a much wider selection," says Camaglia. However, IRAs don't always offer lower costs than 401(k) plans because some 401(k) plans are able to negotiate ultra-low fees on behalf of participants. "Some 401(k)s have some very good choices," says Camaglia. "Some 401(k)s get institutional shares, which means the expense ratios are less." If your 401(k) plan has particularly good investments, you can leave the money there or move it to your new employer's 401(k) plan.

Account for your age. Workers who take IRA distributions before age 59½ generally need to pay a 10 percent early withdrawal penalty. However, people who leave their job during the calendar year they turn 55 or later can take penalty-free 401(k), but not IRA, withdrawals. "If you have to leave your employer between 55 and 59 and you think you are going to have to utilize some of those funds for living, then it's best to leave it in the 401(k) because you can take distributions without facing the penalty," says Danielson.

Consider creditor protections. If you are in debt, money held within a 401(k) could be better protected from creditors than an IRA balance. IRA creditor protections vary by state. "Creditors can make claims against an IRA," says Ann Terranova, a certified financial planner for Union Financial Partners in San Francisco. "Not only is the 401(k) protected from creditors against the participants, but the 401(k) is also protected against the company's creditors if the company goes bankrupt."