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What to Do With a 401(k) When You Change Jobs

Shop around for great fund choices and low investment expenses before moving your money.

Often you have to wait to join your new employer's 401(k) plan, but that shouldn't stop you from saving on your own.

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Every time you change jobs, you need to decide what to do with your old 401(k) plan. This can be a time to seek better mutual fund choices and lower investment costs. But it’s also important to take care to avoid fees and taxes when you move your money. Here’s how to manage your 401(k) plan when you move on to a new job:

Don’t cash out the plan. It can be tempting to withdraw all the money in your 401(k) plan each time you change jobs, but this is typically a poor financial decision. Withdrawals from 401(k)s before age 55 are typically subject to income tax and a 10 percent early withdrawal penalty, which will easily eliminate a large chunk of your savings. A 40-year-old worker in the 25 percent tax bracket who withdraws $10,000 from his 401(k) plan will get only $6,500 after paying federal taxes and penalties.

Keep the money in tax-preferred accounts. Once you have resolved not to cash out your 401(k) plan, you have three options that will allow you to avoid paying income tax and the early withdrawal penalty: leave the money in your old 401(k) plan, roll it over to an individual retirement account or shift the balance to your new employer’s 401(k) plan. It’s a good idea to compare all three options to see which is likely to produce the best results.

Figure out where you can get the best investment options. Generally, 401(k) plans offer a limited array of investment options, while IRAs offer a much greater diversity of investment choices. In some cases, large employers use their bargaining power to select investments that are better and have lower fees than what you could find on your own in an IRA. However, many 401(k)s have poor investments with abnormally high fees, in which case you’d be better off moving the money into a different account. "Most 401(k) plans don’t give you a lot of choices as far as investments within those plans, so it makes sense to roll the money out to a rollover IRA, and then you have access to any fund you want and you can choose low-cost funds," says Gerry Barrasso, a certified financial planner and founder of United Financial Planning Group in New York.

Search for low-cost funds. The investment costs you pay directly cut into your returns. If you can find similar funds outside your 401(k) plan that charge much lower fees, you will be better off switching accounts. "Some 401(k)s have very high expenses, and in that case, it makes sense to find a better deal," says Dana Levit, a certified financial planner for Paragon Financial Advisors in Newton, Massachusetts "Make sure you are going into something that is truly better if you are going to roll out of your 401(k)."

Roll over the money directly to the new financial institution. It's a good idea to have your rollover paid directly to the new retirement plan. If the 401(k) balance is paid to you, 20 percent of the balance will be withheld for income tax. Then you will have 60 days to put the entire distribution, including the withheld 20 percent, into a new retirement account. If you fail to make the deposit within two months, you will have to pay income tax, and if you're under age 55, you will have to pay the early withdrawal penalty. For example, if you have $10,000 in a 401(k) plan, your former employer will withhold $2,000 and give you a check for $8,000. To avoid paying income tax and the early withdrawal penalty, you will need to deposit that $8,000 and $2,000 from another source into another retirement account within 60 days. In you only roll over the $8,000, the $2,000 will be considered income and taxes, and potentially the early withdrawal penalty will be applied to it. It's much simpler to have the account balance directly paid to the trustee of the new plan, in which case no tax will be withheld. "You want to do an electronic transfer directly from the 401(k) to an IRA so there is no tax implication or anything like that," Barrasso says.

Watch out for vesting schedules. While you always get to keep the money you contribute to a 401(k) plan, you don't get to keep your employer's contributions until you are vested in the plan. Find out when you become vested in your current 401(k) plan before you leave your job. "Depending on the dollar amount, it may make sense to wait until you vest," Barrasso says. "But you may not want to miss an opportunity for a small dollar amount if it is not significant."