Rolling Over Your 401K to an IRA

Feb 3, 2012

by: Bob Centrella, CFA

When you are leaving a job or are retired with your assets still in your former employer's 401K plan (or any qualified retirement plan), you have three options: 1) cash out your plan; 2) keep it in your current plan; or 3) move it to another qualified retirement account. A qualified retirement account could be your new employer's 401(k) plan, a Traditional IRA, or a Roth IRA. The movement of your 401(k) to this account is called a **rollover.** First, find out if you are fully vested. You are always entitled to the money you contributed, but how much of the employer matching contributions you're entitled to depend on your tenure. If you worked there for a few years, chances are you're 100% vested.

1) Cashing out your 401(k) is a bad idea

Typically, this is the worst thing you could do to your 401(k) fund. **When you cash out your 401(k), you'll be taxed on the withdrawal.** The combined federal and state taxes could be significant due to the higher marginal tax rate that the withdrawal will bump you into. Also, you may be subjected to a 10% early withdrawal penalty if you are not yet 59 1/2. Assuming an effective combined federal and state tax rate of 35%, a $100,000 cashed out of 401(k) could cost you $45,000 in taxes and penalty leaving you with only $55,000.

2) Leaving Money in Your Old 401(k) Account

This sounds simple, but unless your old plan is that extraordinary, it's probably best not to use this option.

- First, your former employer probably doesn't want to deal with the hassles and expenses of administering your account, and may pass the expenses on to you.
- Second, you may find it more difficult to get help when you need some.
- Third, you will not be able to borrow against your 401(k) balances, which is not necessarily a bad thing, but it does leave you with less flexibility. And you likely have to pay back any borrowings.
- Lastly, this will be one additional account that you'll have to track and manage.

Also note that if your balance is below certain threshold and you do nothing, your employer may close your account and send you a check, which will put you in a situation similar to the *Cashing Out* option below. Try to avoid this, since it will give you much less time to react.

3) 401(k) rollover to IRA is often the best course of action

Unless your current employer's 401(k) plan is great — i.e., excellent investment options and low fees — keeping your 401(k) with them is usually not the best option. And unless you know for certain that your new 401(k) will be great, 401(k) to 401(k) rollover might not be that great either.

With an IRA, you can usually lower your investment expenses and gain access to a much wider variety of investment options. You can even switch to a different discount brokerage firm to take advantage of different investment options, tools, features, prices, fees, etc. Additionally, you have the option of converting your 401(k) to a Roth IRA, which allows your retirement savings to grow tax-free.

There are two ways to roll over your 401k: direct and indirect.

- If you do a **direct** rollover (also known as, a **trustee-to-trustee transfer**), there are no taxes, withholding, or penalties. A check is sent directly from your current 401(k) plan to the designated retirement account — i.e., your new employer's 401(k) or your IRA. *Although the option of rolling over to another 401(k) may not be available, unless you find another job right away*.
- If you do an **indirect** rollover, a check will come to you but minus the 20% that is required to be withheld by the employer and send to the IRS. For example, if your balance is $100,000, your employer will send you $80,000. To complete the rollover, you have to send a $100,000 check within 60 days to your new IRA custodian to match the exact original amount. Any amount under $100,000 deposited into your new retirement account will result in taxes and a 10% early withdrawal penalty if you are under age 59½. The extra $20,000 that the IRS is holding will be returned to you when you file your tax return.

Tax Implications

These are some answers to the most commonly asked tax questions when it comes to 401(k) rollover:

- **401(k) rollover to another 401(k) plan and Traditional IRA** does NOT impact your taxable income, because they are all pre-tax accounts.
- **401(k) rollover to a Roth IRA** does increase your taxable income, and potentially bump up your tax marginal rate into the next tax bracket.
  - If you anticipate high taxable income this year, it may be worth while holding off on your rollover to a Roth IRA. You can either keep your money in your current employer's plan (if they allow a rollover at a later date), or rollover to a traditional IRA then later convert it to a Roth IRA.
  - Rollover into a Roth IRA does not increase your Modified AGI, so your ability to contribute to an IRA should not be impacted by the rollover. (See clause 1b under Modified AGI on the IRS.gov web site)

How to Do a 401(k) Rollover to IRA

Now that you've decided to go with the **401(k) rollover to IRA** option, here are the main steps on how you can accomplish the rollover.

1. **Open an Individual Retirement Account (IRA) with any financial institution that offers an IRA**. Usually, this ends up being one of the many discount brokers. In general, you want to pick the investment company that offers the type of investments you want that are accessible at low trade commissions and fees.
2. **Inform your employer that you want to do a 401(k) rollover to IRA.** Make sure your employer makes the check payable to the investment company that you choose. This is called a ***trustee-to-trustee transfer*** and it helps you avoid the automatic 20% tax withholding. It is done electronically (ACH) and you never receive the check in hand.

3. **Invest Your Money.** Once the transfer is complete, your money will be sitting in some sort of interest bearing investment such as a money market account that earns very little interest. You will have to invest your money according to your asset allocation plan. This is a great time to hire a seasoned investment manager (like **Forza Investment Advisory**, www.ForzaInvestment.com). The exact investment options you have will depends on your investment manager or the investments you choose. In general, you want a well-diversified portfolio of securities – individual securities, low cost and passively managed mutual funds or ETFs.

If you are facing this decision, consider performing a 401(k) rollover to IRA to take advantage of the opportunity to lower your costs and gain greater flexibility. Remember to research the investment company well before you open an IRA with them, and do your due diligence when selecting your investments or investment managers. If you are uncertain, it's usually a good idea to consult a professional to help guide you through this process and answer your questions.

Forza Investment Advisory, LLC always offers a free, no-obligation investment consult. **Forza** specializes in transfer and management of 401K Rollovers and can guide you through the process in a seamless transition. You can reach them at 908-344-9790 or on the web at www.ForzaInvestment.com.

For a copy of Forza's **Form ADV 2**, go to the "Resources" page on the company website.