roll with it, baby

LEAVING YOUR JOB? TAKE CARE OF YOUR 401 (K)

Retirement savings accounts, including 401(k) plans and individual retirement accounts (IRAs), provide significant tax savings to their owners. In particular, they allow their owners to accumulate funds on a tax-deferred basis. As long as assets remain in a retirement account, they're not subject to income tax. But at a certain point, usually age 70½, the owner must begin to withdraw funds from the account and pay taxes on the amounts withdrawn. From a financial planning perspective, it almost always makes the most sense to keep the funds in the retirement account for as long as possible and to delay paying income taxes.

About half of the workforce participates in a 401(k) or similar type of employer-sponsored retirement plan. In today's mobile society and fragile economy, however, many employees find themselves leaving a job before they retire or have reached the age at which they must withdraw funds from their retirement account. If you've recently retired, or lost or left your job where you had a 401(k), you can do what you want with those funds. Knowing your distribution options and how they will affect your retirement savings can make a big difference in the size of your nest egg.

ASSESS THE CHOICES

You generally have four options for your 401(k) funds with your old employer: you can leave them in the 401(k), transfer them to your new employer's 401(k), transfer them to an IRA, or take an outright distribution of the funds. For most people, rolling over the old 401(k) assets to a new 401(k) or IRA is the best tax-saving and financial-planning strategy, since it provides the opportunity for continued tax-sheltered growth.

If you decide to cash out your 401(k) with your prior employer, you'll pay income taxes on the entire amount withdrawn, and you'll also pay a 10 percent penalty if you're under age 55 when you leave your job. (If you cash out a retirement account for a reason other than leaving your job, the 10 percent penalty applies if you're under age 59½.) Your former employer will withhold 20 percent of the total fund for taxes, and you'll lose the tax deferral on any future growth of the assets. If you don't need the money for a dire emergency, you should consider one of the other options.

If you transfer retirement assets directly from your old employer's 401(k) to your new employer's 401(k), you won't pay any income taxes on the amount transferred, no income taxes will be withheld, and you won't pay the 10 percent penalty on early distributions. If you leave the money in your former employer's 401(k), you can move it later to an IRA or to another employer's 401(k).

Before rolling over your 401(k) funds to an IRA, you should compare the fees charged by the 401(k) and the IRA. Some companies, especially larger ones, negotiate institutionally priced investments with lower fees than you would pay on an IRA you set up on your own. However, a 401(k) may pay plan administration costs that an IRA does not.

You also should consider your investment options in the 401(k) and an IRA. IRAs almost always have more investment choices than 401(k)s. You can invest IRA funds in individual stocks and bonds, as well as mutual funds and exchange-traded funds. Savvy investors may enjoy the freedom of an IRA, while other people may prefer the smaller array of options in their employer's 401(k), since they've already been screened by the employer or plan sponsor. If you're satisfied with the investments in the existing 401(k), you may want to leave them there.

Another factor to contemplate is whether you think you'll need the retirement assets for a loan. Raiding your retirement account to pay current expenses is never a good idea, but it may be unavoidable in a financial emergency. You can't borrow money from your IRA; the only way to get money out of the account is to pay taxes and penalties. However, if you meet certain requirements, you can borrow money from a 401(k) without triggering income tax.

AVOID PENALTIES

If you decide to move your existing 401(k) investments to a new employer's 401(k) or to an IRA, make sure you avoid any penalties when making the switch. The easiest way to do so is to have your old employer transfer the funds directly from the existing retirement account to the new one. If your old employer distributes the money directly to you, instead of to a new account, it will withhold 20 percent of the value of the investments for income taxes. You then will have 60 days to put the remaining funds (plus your own money, equal to the 20 percent withheld) into a new 401(k) or IRA. Note that the deadline is "60 days" and not "two months." You need to calculate the due date carefully, because the IRS is pretty unforgiving about missing the deadline. In addition, you must contribute to the new 401(k) or IRA the same property you received from the old 401(k)—you can't use a rollover to "swap" property out of a retirement account.

If your old 401(k) holds stock of your former employer, the tax treatment of that stock when it's distributed from the 401(k) differs from the treatment of any other investment in the account. In general, you must take out all of your 401(k) assets and invest all of them in another retirement account in order to continue to defer taxation on those assets. However, a special rule allows taxpayers to receive all of the assets from the old 401(k), but transfer only the nonemployer stock into a new IRA and keep the employer stock outside of any retirement plan. Unlike other investment assets, rolling employer stock into a new IRA may actually produce worse tax consequences than keeping it outside of a retirement account.

Finally, give some thought to who will inherit your retirement assets when you die. Ideally, your beneficiary will be able to continue to hold the assets in an account that is tax-deferred and not be required to withdraw and pay taxes on the retirement assets right away. Historically, many 401(k) plans required a beneficiary to take all of the assets in a lump sum shortly after the account owner's death, which eliminated the tax deferral advantages of the retirement account. However, special favorable rules apply to spouses who inherit retirement funds, and new rules allowing nonspouse beneficiaries to roll over assets into an IRA recently went into effect.

The rules regarding retirement accounts are complicated, but it's important to get a handle on them before retiring or leaving a job. Consulting with your financial advisor and employer regarding your options will help clarify your options and help you choose the one that best fits your financial needs.

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