401(k)s – To Roll or Not to Roll – That Is the Question

If you've recently changed jobs, you may find yourself trying to decide what to do with your 401(k) account. Generally, you have four options from which to choose: leave your account where it is, cash it out, do a direct rollover, or do an indirect rollover.

If you have an especially good 401(k) with your old company, it may be better to just leave your retirement money there. It will stay tax-deferred and be available for you to use later on during retirement. If you cash out, you will be able to keep only what's left over after taxes and possible penalties. A direct rollover is when you authorize your former company's 401(k) plan to move your retirement savings to your new 401(k) or IRA.

An indirect rollover means you receive a check, less 20 percent in mandatory tax withholding and you have to take care of the rollover yourself. Both types of rollovers allow you to continue the benefit of tax deferral, but to avoid taxes and penalties with an indirect rollover you must deposit the money, including the 20 percent withheld, into a new IRA within 60 calendar days.

Keep in mind that if you cash out before the age of 59 ½, you will be subjected to a 10 percent tax on the early distribution and, in most cases, you will be taxed at ordinary income tax rates on the entire amount of the distribution. If you are age 55 or older at the time you separate from service, you may be able to avoid the 10 percent early withdrawal penalty. Also, if you have a loan against your 401(k), you generally need to pay it back before rolling over. Otherwise, the remaining amount left on the loan may be considered an early distribution and taxed as ordinary income, and you may be subject to the 10 percent tax for an early distribution.

There can be some benefits to rolling a 401(k) from your former employer to your new employer's plan, rather than moving it to an IRA. These potential advantages depend on the choices available in your new employer's 401(k) plan.

Because many investments, including mutual funds, have minimums you must meet before you can invest, if you do not have a lot of money in your 401(k), it may be more difficult to diversify when you move it to an IRA. With a rollover into a new employer's 401(k) plan, there are generally no investment minimums so it doesn't matter the amount of money you have in your current plan.

Also consider that you may have limited investment options available to you in your new 401(k). IRAs almost always have more investment choices. You can invest in individual stocks, bonds and mutual funds in an IRA, whereas 401(k)s usually offer a limited number of mutual funds. 401(k)s and IRAs often have fees associated with the investments.

Make sure to check out all this information when you get your 401(k) distribution information before making a decision to roll or not to roll.

If you decide that a 401(k) rollover to either your new employer's plan or an IRA is the best option for you, have your current 401(k) plan move your funds directly to your new account. Once the proper paperwork is completed, your money is rolled directly to your new retirement plan. This is usually the fastest way to get your account back in business without interruption.

A direct rollover will ensure federal income tax is not withheld from your 401(k) funds and eliminates the need for ensuring the rollover is complete in 60 days. Sometimes your old retirement plan will mail you a check and it will be made payable to the trustee or custodian of your new retirement plan or IRA. If you receive a check like this don't worry, it will still be considered a direct rollover. You just need to get the check to the institution acting as the trustee of your new retirement account.

As this article indicates, many factors can impact which choices make most sense for you with regard to your 401(k) account at a former employer. You should consult a professional for advice on the best option for you. ■