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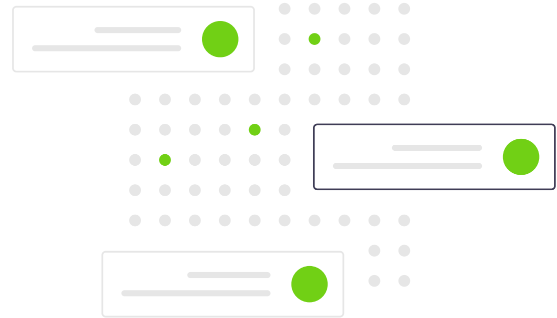
The Ultimate Guide to 401(k) Rollovers

THE DAYS OF KEEPING THE SAME JOB FOR DECADES ARE LONG GONE



Recent surveys show that American workers have been with their current company for a median of 4.2 years. There are no "forever jobs" anymore.

Today's professionals approach their careers as an exercise in stacking skills, experiences, and projects to move ahead. Which means being ready to change jobs for better opportunities, better pay, greater job satisfaction, or a better work-life balance for any stage of your journey.

Giving your two weeks' notice can be stressful

There are so many things to do when you're leaving your old job. You have to clean out your workspace and turn in your laptop and your employee ID badge. You must participate in an exit interview with your former employer. And finally, you have to sit through an awkward farewell lunch with your soon-to-be former co-workers.

Then, you get to start your new job — and do all the same things in reverse.

Get your new ID badge and equipment. Make sure you can access all the right files and folders on the network. Organize your new workspace. Attend a flurry of "getting acquainted" meetings and lunches with co-workers. Learn the layout of your office building.

And then, of course, there's a pile of paperwork to fill out.

Whether on paper or electronic, you have to complete benefit election forms, retirement account setup, insurance, emergency contact forms…the list goes on and on. All this is happening at the same time as you are trying to get up to speed, impress your new boss, and prove to your new employer that they've made the right choice in hiring you.

In this busy transition between jobs, it's tempting to delay (and even easier to completely overlook) one of the most important decisions about your financial life.

What to do with your old 401(k) plan?

Figuring out the answer may not seem like a priority when you're trying to make first impressions and hit the ground running. Many people make the choice to keep the status quo and do nothing. But, over a lifetime, doing this on autopilot can cost you money and missed opportunities.

So, let's talk about some options.

Option 1: Do nothing

Inertia may seem like the easy choice. However, you might be surprised to find out that doing nothing still requires work on your part.

Consider the administrative upkeep

Remembering about your old 401(k) account looks easy enough when you have just changed jobs. But if this is your default solution every time you change jobs, then you will be leaving a slew of orphaned 401(k) accounts in several companies over your career. A decade or two later, it may be difficult to remember where those accounts are, or that they even exist.

Which will make it difficult to keep up with the administrative updates on those accounts. Remember that employer-sponsored retirement plans are not governed by wills or any other directives. The only document that controls who gets the account upon your death is the beneficiary election form.

Let's say you get divorced and then get married again. If you forget to replace your ex's name with your new spouse's name by submitting a 401(k) beneficiary form to the plan, then your ex will be entitled to all assets in that account. That is true even if you've named your new spouse or other heirs in your will.

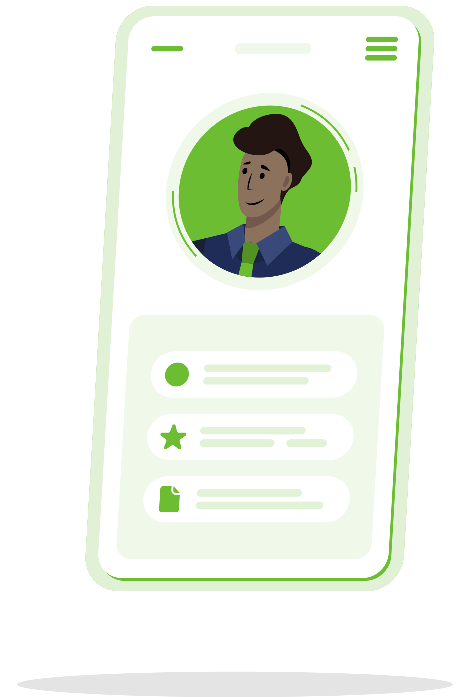
Bottom line: When you do nothing with your old 401(k) plan, you become responsible for keeping track of any future changes that have to happen related to that account.

Check account balances

Next, consider your total account balance. If you have less than $5,000 in your old 401(k), your former employer can do a mandatory force-out of your account.

This means that one of two things could happen. The first possibility is that your account will be cashed out and directly rolled over into a traditional IRA that your employer has set up (on your behalf) at a financial institution of their choice.

The other possibility is that you will receive a lump-sum distribution. That may potentially trigger a taxable event for you, which could be an unpleasant surprise. Check the plan document and the employee manual to see how your former employer handles mandatory cash-outs. That way, you will have the opportunity to choose the most tax-beneficial path.



Review investment options

How is your old 401(k) invested? If you were a long-time employee and had picked your investments years ago, they may not be the best fit for you now. Review your choices to ensure that they still make sense given your current financial goals and resources.

Does your old plan offer periodic automated rebalancing based on your risk preferences and expected retirement date such as a target date fund? Over time, the value of individual investments inside your portfolio may "drift" up or down, pushing the actual allocation outside of your desired risk/reward parameters. If your former employer's plan does not offer automated rebalancing, you'll need to periodically review account drift and rebalance it yourself.

Finally, how satisfied are you with your investment choices? In fact, one possible reason for leaving a 401(k) account with the old employer is because that plan offers unique investments that may not be available inside your new employer's plan (for example, Stable Value Funds). Alternatively, your old employer may have negotiated a favorable fee based on the size of the plan. That would mean that you may enjoy a discount on the same index funds that would "cost" you more elsewhere.

However, keeping your account with your old employer may also limit your investment options overall. Research shows that most 401(k) plans offer between 22 and 27 different investment options. While that may sound like plenty of choices, you must understand that there are nearly 8,000 mutual funds available to U.S. investors. A few dozen options in your old 401(k) can hardly compete with that!

Understand the fees

Consider how much it will cost you to keep your account parked with your old company. Most 401(k) plans are subject to three different types of fees: administrative, individual, and investment fees. All three will be automatically deducted from your account balance.

The investment fee is how much it costs to invest in a fund. If your old plan doesn't offer index funds, you'll almost certainly pay higher investment fees.

The administrative fee covers various costs of running the plan. These include statement processing fees, web hosting fees, and customer service fees. In some cases, there may be "hidden" fees, such as wrap fees or revenue sharing arrangements.

The individual fees, such as withdraw fees or loan processing fees, apply to special plan features that a participant may opt to use.
Most investment accounts have fees associated with them. Your task is to make sure that you are getting a fair level of investment management service in exchange for the fees that you pay. Some 401(k) plans are more competitively priced than others, so you will need to review the details of your situation and a few alternatives before you can make a smart choice.

Review plan rules

Even if you're no longer working at the company that sponsors your old 401(k) account, you will still be subject to the plan's rules, which are laid out in the plan document. These rules cover everything from whether (or when) you can withdraw money, to how often you are permitted to change your investment elections, etc. Make sure that those rules make sense in your situation.

Remember also that as a former employee, you won't be able to contribute additional money to your old 401(k) plan. The value of your account will rise and fall depending on how your investments perform. However, you won't be able to put more money into it.

You may also face restrictions on borrowing or taking partial distributions from your account. Your former employer may only allow you to take a full account distribution — or nothing. Check the plan document for more details.

Are there any benefits to doing nothing with my old 401(k) plan?

Yes, there are some benefits. One, it buys you time to think through your options and make an informed choice later (as long as you don't procrastinate and forget to make the move). Also, employer-sponsored retirement plans offer the best level of protection from creditors and can't be seized to pay off personal debt.

How does it work?

- If you decide to keep your old 401(k) plan with your old employer, you must do the following:
    - Review plan rules to understand any restrictions you may face as a former employee.
    - Check current investment choices and make any changes necessary to re-align your selections with your long-term goals.
    - Add the old 401(k) account to your master list of all banking and investment accounts. Review designated beneficiaries and keep those selections up to date.
    - Look through account statements at least quarterly. If an automated rebalancing is not available, consider doing a manual rebalancing annually to keep your risk/reward balance in line with your preferences and financial targets.

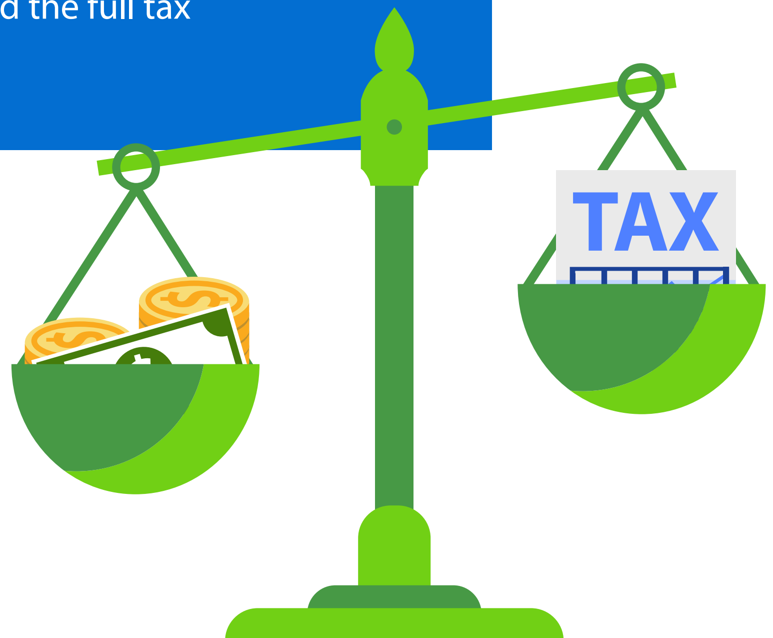
Option 2: Cash out

Let's start with a small bit of good news. The most obvious (and possibly the only) benefit of taking a full distribution from your old 401(k) plan is getting your money immediately. If you are in dire financial straits with no other options, this may be something to consider. However, that distribution will come with a price tag.

Taxes

Assuming that your account holds pre-tax money, the IRS is going to treat the distribution as taxable income to you. So, you will potentially owe federal income tax on your distribution. Keep in mind that depending on your taxable income in relationship to tax income brackets, a cash-out distribution may push you into a higher tax bracket, which means that a portion of your income for the year will be taxed at a higher rate.

Depending on where you live, you may also have to pay state income taxes on that distribution. As of 2020, only seven states have no income tax (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming). Tennessee and New Hampshire don't tax earned income, but they do tax investment income. So, check your state's rules so that you understand the full tax implications of your decision.



Early withdrawal penalty

As if paying income taxes on your distribution isn't punishment enough, in most cases you may also have to pay a 10% early withdrawal penalty if you are under age 59 ½.

So, if you have specific plans for how you will use this money, remember that you will receive less than the total account balance after you account for income taxes and penalties.

There are a few exceptions that may allow you to avoid the 10% early withdrawal penalty, including the following.

- The distribution was made to your estate or beneficiary after your death.
- The distribution was made because you are totally and permanently disabled.
- The withdrawal was made to cover qualified post-secondary education expenses.
- The withdrawal was made to cover deductible medical expenses.
- The distribution was made to pay for an IRS levy.
- The withdrawal was a Qualified Reservist Distribution (generally, one made after being called to active duty for 180 days).
- The distribution was made as an installment in a series of equal and periodic payments over your life expectancy, or over the life expectancy of you and your beneficiary or beneficiaries. If the retirement plan is not an IRA, you must have left employment before payments began.

Are there any benefits to taking an early distribution of your pre-tax 401(k) account?

That's for you to decide. Unless you need that money for a true emergency, most financial experts say your money is best left untouched until you retire. Vacations, birthday or holiday gifts, house remodeling, or a new car do not constitute a financial emergency — no matter how much you think you deserve them.

How does it work?

If you decide to cash out your old 401(k) plan, you must do the following.

- Do the math on the distribution to be fully prepared for tax and penalty consequences. Your plan's administrator will likely withhold 20% from the distribution for federal income taxes. So, if your total account value is $10,000, your distribution check would be only $8,000.
- Contact the plan's administrator, which is typically your old company's benefits or human resources department, to request a full distribution. They will send you the required paperwork to complete and return.
- Some plans require spousal consent in order to process a total distribution. You'll need to get your spouse to sign a special form, witnessed by a notary public, and return that form along with the other paperwork. If you overlook this step, it will hold up the distribution process.
- Typically, you can expect your distribution check (or direct deposit) to arrive within five to ten business days after returning the completed paperwork to your plan administrator.
- Your 401(k) plan custodian will generate and mail you a 1099-R tax form that indicates you took a full taxable distribution. You'll need this form to complete your taxes, so be sure to set it aside. Most custodians send this form to investors by late January or early February of the year following the transaction.

What if I change my mind about cashing out?

If you change your mind about the cash-out, you have 60 days to deposit the distribution into another qualified plan or a traditional IRA. This is called an "indirect rollover."

Here's how this works.

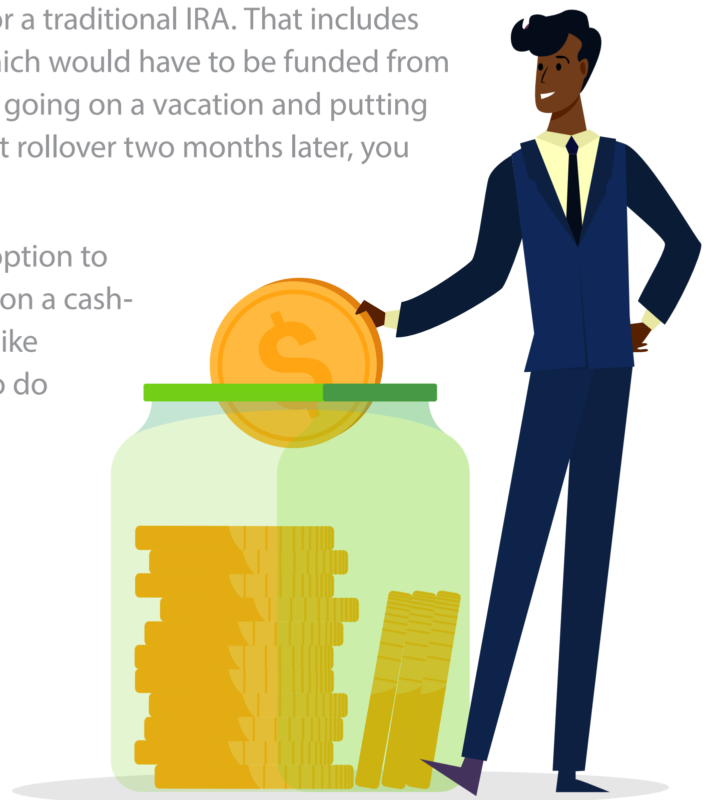
If you take the cash, your 401(k) custodian cuts a check payable to you and mails it to you to be deposited into your personal bank account (or sends that money straight to your bank account via direct deposit). If you decide that you want to put that money into a qualified savings account, you can do that within 60 days to avoid income taxes and penalties. The 20% withholding would be "returned" to you as a tax credit for the year in which the rollover process was completed.

There are a few other caveats for doing an indirect rollover.

One, you can only do an indirect rollover once every rolling 12 months. Monitor this timeline carefully, as it is not the same as once every calendar year.

Two, in order to take advantage of the indirect rollover, you must deposit the full amount that you cash out into a qualified plan or a traditional IRA. That includes the 20% that was withheld by the custodian, which would have to be funded from your other savings. So, if you are thinking about going on a vacation and putting the remainder of the distribution into an indirect rollover two months later, you are out of luck.

Bottom line: An indirect rollover is a last-resort option to consider if you have already pushed the button on a cash-out distribution and changed your mind. If you like the idea of a rollover, it is financially beneficial to do a direct rollover from the start.



Option 3: Direct rollover to a traditional IRA

What if you don't want to cash out and potentially face a tax bill, but you also don't like the thought of being tethered to your former company?

One option is to do a direct rollover from your old 401(k) to a traditional IRA. That choice comes with several potential benefits.

Keep your retirement savings for retirement

A direct rollover to a traditional IRA won't cause you to incur any undesirable tax consequences or early withdrawal penalties. Any money you have contributed, plus vested employer contributions, plus any earnings, is simply moved to another qualified account to be used later for its original purpose: to fund your retirement.

Enjoy a wider range of investment options

IRAs generally offer far more investment options than a typical 401(k) plan. With an IRA, you get access to many more mutual funds than you would have in a 401(k) plan. You may also invest in individual stocks and bonds, exchange-traded funds (ETFs), and certificates of deposit (CDs). Depending on your investment preferences and goals, that degree of flexibility can potentially make a difference.

Competitive service menu and fees

If you have the time and inclination, you can do some price-shopping to find the lowest-cost IRA provider. Just remember that you usually get what you pay for. A low-cost IRA may limit your investment options.

As you look at IRA fees, keep in mind that some custodians have asset-based fees (meaning you pay a percentage of the amount of money in your IRA), while other custodians have transaction-based fees, which you incur each time you buy or sell investments. Some investment options may have no additional trading or transaction fees. Be sure to read the fine print and estimate what a typical annual fee on an account with your size and activity would look like.

What about creditor protection?

Assets in your IRA are protected if you file for bankruptcy, but they are not necessarily protected from creditors. Whether or not your IRA offers creditor protection depends on your state of residence. Research your residency state for more details and consult with an appropriate financial advisor.

How does it work?

When a direct rollover is done right, it is designed to be an easy, clean transaction with no negative tax consequences to you. However, you must follow all the steps.

01 Open the IRA with the financial institution of your choice. Some of the household names include Charles Schwab, Citigroup, Deutsche Bank, Goldman Sachs, J.P. Morgan, Morgan Stanley, and others. An up-to-date approved list of non-bank custodians can be found on the IRA website.

02 Next, contact your former employer to request distribution and rollover forms.

03 Complete the forms and return them as instructed. Be aware that your old plan may require spousal consent before they cut the rollover check to your new IRA custodian. Check the forms carefully so that you can fill them out accurately and completely.

04 Your old 401(k) plan provider will send the distribution directly to the custodian of your new IRA. If the check comes to you instead, simply forward it to the IRA custodian (or to the financial advisor who will be managing the IRA on your behalf).

05 The original 401(k) custodian will send you a 1099-R form that indicates a direct rollover. Most custodians send this form to investors by late January or early February of the year following the transaction. Be sure to set it aside, as this is your proof that you did not take a cash distribution (and therefore won't owe taxes).

Option 4: Rollover direct to traditional IRA, then convert to a Roth IRA

A traditional IRA account holds pre-tax assets. That means your taxable income was reduced by the amount of your contributions. The growth in the account is tax-free. However, any distributions from a traditional IRA account will be taxed at the appropriate tax rate upon withdrawal.

A Roth IRA is different. It holds post-tax assets. That means you pay taxes on the amounts contributed to the account, whether in a conversion or a direct contribution. The growth in the account is still tax-free, and any distributions you eventually take from the Roth IRA are also tax-free.

When you roll your old 401(k) to a traditional IRA, there are no tax consequences for you. If you choose to convert it to a Roth IRA, the entire amount of the conversion will be treated as taxable income in the year of the conversion. Some people choose to convert the entire amount all at once. Others stagger conversions over several years to spread out the tax impact.

Why consider a Roth IRA?

If you think you may be in a higher tax bracket in the future when you need to withdraw money for retirement, then it makes sense to pay those taxes now to lock in the presumed lower rate. There are other benefits to a Roth IRA, as well.

No required minimum distributions

Traditional retirement accounts generally require you to start taking annual required minimum distributions (or RMDs for short) starting in the year you turn 72. In other words, once you reach 72 years of age, a certain amount of RMDs will have to be taken out of a traditional account — and potentially treated as taxable income — regardless of whether you need it. And if you forget to take your RMD, you may potentially owe penalties on the amount that you failed to withdraw that year.

Roth IRAs don't have required minimum distributions. So, if you can fund your lifestyle in retirement from other resources, then the Roth IRA can grow untouched until you eventually need it (or until it is transitioned to your heirs upon your death).

Qualified distributions are tax-free

The second benefit is that all qualified distributions from a Roth IRA account are tax-free. To be classified as "qualified," the distribution must occur at least five years after the year you first funded your Roth IRA, and:

- You must have reached at least age 59 ½; or
- You must be considered permanently and totally disabled; or
- The original account owner has died, and a beneficiary is taking the distribution.

Other qualified distributions include a withdrawal of up to $10,000 to be used for buying your primary residence (not a vacation home or investment property). The $10,000 is a lifetime limit, not a per-transaction limit, so you can only do this once.

Non-qualified distributions may trigger a tax bill and a penalty

You can withdraw money from a Roth IRA for non-qualified distributions. However, doing so may trigger a taxable event. And, as with most other early withdrawals, you may also face a 10% penalty for taking a non-qualified distribution if you're not at least 59 ½ years of age.

There are a few exceptions to the penalty. They include using the money:

- To buy, build, or rebuild your first home (a primary residence, not a vacation or investment property);
- To pay for unreimbursed medical expenses for you, your spouse, or your dependents that exceed 7.5% of your adjusted gross income;
- To pay for health insurance plan premiums while you're unemployed; or,
- To pay for qualified higher education costs (tuition, books, fees, supplies, room and board, and special-needs services for a university, college, vocational school, or post-secondary educational institution) for you, your spouse, your child, or your grandchild.

Finally, if you're 59 ½ or older, and you take a withdrawal from a Roth IRA that hasn't been established for at least five years, you'd still have to pay income tax on that distribution. However, you would not be subject to the 10% early withdrawal penalty.

Do not attempt a DIY on a Roth conversion!

The administrative mechanics of executing a Roth conversion are not technically complex, as you will see below. However, it is critical that you consult with an appropriate financial professional before you make this decision. The calculations that determine whether a Roth conversion makes sense for your circumstances are complicated. You must consider all relevant scenarios, and you must take into account the appropriate tax rates that will ultimately drive the financial side of the conversion.

So, while you could theoretically execute this on your own, we strongly advise you to work with a financial planner. The tax cost that results from a Roth conversion could be substantial, and it helps to know that long-term projected tax benefits are calculated using the best assumptions and an accurate methodology.

01 Work with your financial advisor to validate that the decision to convert to a Roth IRA makes financial sense in your circumstances.

02 Assuming that you are doing a one-time full conversion, you would direct your IRA custodian to convert your account to a Roth IRA. This step does not have to involve changing accounts or selling investments. Your custodian simply changes the tax classification of your account.

03 If you are planning a Roth conversion as a series of transactions to spread out the tax impact, you would need to direct your custodian accordingly and open a separate Roth IRA account.

04 This account classification change (or a partial conversion) is a taxable event. You will receive a 1099-R form in late January or early February of the year following the conversion. You must be prepared to characterize your Roth conversion income to come up with your cost basis. This is yet another situation where working with an experienced financial advisor can help.

Option 5: Direct rollover to your new 401(k)

If your new employer offers a 401(k) plan that accepts direct rollovers from other 401(k) plans, you may opt to take this route. But be sure to ask the question first, as not all plans accept rollovers.

Less administrative upkeep

The main benefit of choosing this option is less administrative hassle for you. All your employer-sponsored retirement plan assets will be in a single account. That means less paperwork, fewer statements, fewer passwords, and fewer investment options to align. It will also make it easier to maintain proper beneficiaries.

Check investment options

The option to roll your old 401(k) into your new 401(k) gives you the benefit of simplicity. Instead of updating investments or risk preferences in multiple accounts, you can do it in one account.

However, that only works if you are satisfied with your investment choices.

Research whether your new 401(k) offers investment options that you find attractive. Many employers offer excellent choices inside of their 401(k) plans, but many others do not. Perhaps you want the ease and low cost of investing in index funds, but your new plan only offers mutual funds that are run by a portfolio manager. Or, maybe you find the plan rules to be too restrictive for your liking.

If that is the case, consider this alternative. First, sign up for your new 401(k) plan and contribute just enough to take full advantage of employer matching contributions that may be offered. Then, roll your old 401(k) plan over to an IRA that will give you the freedom to invest the way you want.

If you decide to go this route, make sure that your overall investment allocation across all your accounts is appropriate for your time horizon and risk tolerance. In other words, look at your retirement savings in aggregate, rather than as individual accounts. Many professionals with multiple retirement plan accounts across different custodians or employers miss this important step.

How does it work?

The process of rolling your old 401(k) plan into your new 401(k) plan is designed to have no negative tax consequences.

01 Begin by contacting your former employer's 401(k) plan administrator to request the necessary forms. If your plan requires spousal consent, you'll need to get your spouse to sign a special form, witnessed and sealed by a notary public.

02 Return completed forms to your old 401(k) custodian, who will issue a direct rollover check to your new 401(k) custodian for your benefit. You can opt to have that check mailed directly to your new custodian, or you can have it mailed to you and pass it along as instructed by your new employer.

03 Your old 401(k) custodian will issue a 1099-R form showing that you took a full distribution and rolled it directly over to another qualified plan. The form is generally sent out by late January or early February of the year following the date of the rollover transaction.

What about company stock?

If your former employer was a publicly traded company and you own company stock in your old 401(k) plan, you might be wondering what your options are.

Before you can make any decisions, you must understand what the net unrealized appreciation (NUA) of your company stock is. The NUA represents the difference between your cost basis (or what you paid for the stock) and its current market value.

401(k) accounts and divorce

If you and your spouse are getting a divorce, you may be required by the court to give a portion of your 401(k) account balance to your spouse (or vice versa). The details are usually included in a larger document that determines the distribution of assets in a divorce that's known as a Qualified Domestic Relations Order, or QDRO for short.

For the sake of this guide, let's say that you are the party who will receive a portion of your soon-to-be ex-spouse's 401(k) as a QDRO. In legal terms, you are the alternate payee.

Here's how that process typically works.

First, your attorney will work with your ex-spouse's attorney to draft QDRO documents. These documents require demographic information about both parties and about the 401(k) account in question (among other things).

The documents must then be sent to your ex's 401(k) plan administrator for completion before being returned to you and your ex-spouse for signature. Then, the forms go to the judge for final approval.

Once the forms are approved, a certified copy of the approved form is returned to the 401(k) administrator, who establishes an account in your name within the 401(k) plan. Your portion of your ex-spouse's 401(k) account is then transferred into an account in your name.

At that point, you will have several options about what to do with your QDRO account.

01

You can keep it where it is. In most cases, you'll have access to the same investment options as other participants do in your ex-spouse's 401(k) plan. You can keep your portion of the money invested for as long as you like. However, you cannot add money to this account. You will also have to eventually take required minimum distributions (RMDs) from the account whenever your ex-spouse is required to start taking RMDs (typically, upon reaching age 72).

02

You can take a full or partial cash distribution. In that case, you would have to pay income taxes on the amount you withdraw. However, the early withdrawal penalty of 10% does not apply to distributions from a QDRO.

03

You can do a direct rollover to an IRA. A direct rollover does not trigger a taxable event. But be aware that, if you're under 59 ½ and do a rollover to an IRA and then take a distribution from that IRA, you WILL have to pay not just income taxes on the withdrawal, but also the 10% early withdrawal penalty (unless you meet one of the nine exceptions to the penalty).

When it comes to changing jobs and what to do with your old 401(k) account, you have many options available to you.

One option is to maintain the status quo and leave the account with the old employer (if plan rules allow you to do so). However, you must avoid leaving a trail of "orphaned" 401(k) accounts in the wake of your professional career. Doing so can limit your ability to stay present to those investments and make administrative updates.

You could also cash out the balance, which we do not recommend unless your financial circumstances make it an attractive option. Cashing out a 401(k) plan triggers a taxable event and potentially causes you to have to pay penalties for early withdrawal.

Alternatively, you could roll the old 401(k) balance into a traditional IRA, enjoy a greater range of investment options, and potentially save on fees. If you go this route, you will need to make important decisions about what kind of account to open, how hands-on you want to be, and which brokerage will handle your account.

Or, you might roll the old 401(k) into your new 401(k) plan if that is allowed per the plan rules.

There is no one-size-fits-all path for what to do with your old 401(k). You must choose what best fits your financial goals and resources. Your decision must also account for how hands-on (or hands-off) you wish to be in your investing, how much time you are willing to dedicate every quarter to reviewing statements and making course-correcting decisions, and what investment vehicles are available inside of each plan or account.

At the end of the day, any of those options may be right for you. What's most important is that you make a strategic choice about what to do — and that you complete the rollover correctly to avoid unnecessary taxes.

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