What to Do With Your Employer Retirement Account

When an employee leaves his/her employer they usually need to decide what to do with their employer sponsored retirement plan. Given the size to which many retirement plans have grown, and the potential tax consequences associated with certain changes, this decision may play a critical role in the employee's ability to meet his/her retirement goals.

Unfortunately, few employees are aware of their options or the implications of each option.

Keep your money in your former employer's plan

Depending upon the size of your account, and whether you are leaving the plan as a result of retirement or a new job, you may be allowed to keep your retirement assets in your prior employer's retirement plan. In fact, if your account's vested balance exceeds $5,000, you're former employer is prohibited from forcing you to leave the plan.

Keeping your money where it is may be the easiest option, but it's not always the best option. This strategy may make sense under the following conditions:

- <u>You are concerned about exposing the assets to creditors</u>. Assets in a 401k plan are protected from creditors by federal law. If you take the money out of your 401k plan – especially if you take it as cash – your creditors may have access to it. The actual benefit of this may be limited however, since *most states, including New Hampshire, provide similar creditor protection for assets held in an IRA*, which you could transfer your 401k assets into.

- <u>Your former employer's plan has better investment options</u>. If your former plan has a better selection of investment options than your new employer's plan offers, you may want to keep the assets where they. However, this rationale generally makes sense only if your choice is limited to staying with your current plan or going to a new one. In most cases another choice exists, transferring the plan assets into a Rollover IRA. If you choose a custodian such as Charles Schwab, Fidelity, or Vanguard as a custodian/trustee for your Rollover IRA, the investment options available are almost limitless.

Before deciding to keep your money with your former employer, make sure that the plan allows you to do so. If not, you may receive a lump sum distribution check that has been significantly reduced for income taxes (mandatory 20% withholding on distributions to the participant).

You may also want to confirm who is paying the administration fees for the plan. Qualified retirement accounts require a fair amount of administration to ensure that they meet strict compliance rules and that the money all shows up where it's supposed to, and someone has to pay for this administration. Although many employers absorb the cost of administration themselves, others pass it on to the plan participants through ongoing fees.

Transfer to your new employer's plan

In most cases, employees are allowed to transfer 401k assets directly from their former employer's plan into their new employer's plan. As long as the transfer is directly from one plan to the other (the check should <u>not</u> be payable to the employee), this transaction should be free of taxes and penalties.

The benefits of this option include retention of assets in a creditor protected qualified retirement plan, prolonged tax deferral of gains, ability to borrow funds (allowed in most 401ks, but not in IRAs), and consolidation of accounts.

The disadvantages of transferring your assets into your new employer's plan may include the following:

- Limited choice of investment options.
- Restrictions on your ability to alter investment selections.
- Uncertainties of future plan changes (investment options, fees, etc…).
- Possible expenses – administration fees, surrender charges, and commissions.

Take the money and run (lump sum distributions)

For many employees the lure of a fat paycheck, especially if there separation from employment was unexpected (illness, termination, or layoff), can be irresistible. In fact, it is estimated that 2/3 of employees who leave their job take their account balances in a lump sum payout. This can be a very costly mistake.

While you may need the money for critical purposes – pay bills, start a business, meet emergency expenses – it is important to understand the consequences of this option.

- Any distribution that is made to you will be immediately subject to income taxation.
- Worse yet, since the distribution itself is calculated as part of your taxable income, it may increase your tax bracket and subject you to greater taxes than you anticipate. It is conceivable that federal income taxes alone will reduce your distribution by 40%.
- In addition to the tax penalty associated with a distribution, you may also be subject to additional penalties. In most instances, a distribution taken before you turn 59 ½ will be subject to a 10% penalty *in addition to the taxes*. Some exceptions to the 10% penalty may include (distribution will still be subject to income tax):
    1. Death or disability,
    2. Substantially equal periodic payments over at least five year or until you turn age 59½, whichever is longer,
    3. Medical expenses that exceed 7.5% of your Adjusted Gross Income (AGI),
    4. Distributions upon retirement in or after the year you turn age 55.

Transfer assets to a Rollover IRA

Upon leaving your employer you will have the ability to transfer your plan assets directly into a Rollover IRA. As long as the transfer is made directly from your plan to the IRA, it should not be subject to income taxes or penalties.

The greatest advantage to this option is the wide range of investment options. If you select a custodian such as Charles Schwab, Vanguard, or Fidelity Investments, you should have hundreds (if not thousands) of investment options to choose from.

Another advantage may include the options your heirs will have upon your death. Some employer sponsored plans have post-death distribution requirements that are more strict (and limiting) than those imposed by law. For instance, some plans may require assets left to your children or grandchildren to be paid immediately upon your death. Such a requirement will accelerate the taxation of the income and eliminate further tax deferral of the assets growth. In most cases, the beneficiaries of an IRA will have the option to extend the tax-advantaged nature of the account over a number of years.

One last advantage of using a Rollover IRA is that you may have the chance to convert the IRA into a Roth IRA -- it is not possible to convert a 401k into a Roth IRA. Before making a conversion you should speak to your Financial Planner or Accountant to determine the tax consequences and advisability of converting.

Before transferring your assets to a Rollover IRA you should keep in mind the following:

- If you may want to transfer your IRA assets into a 401k in the future, be sure that your transfer goes into a Rollover (or "conduit") IRA and that you do not mix it with assets from a Traditional IRA.
- Unlike a 401k, you are not allowed to borrow money from your IRA. If this is a significant issue, you may want to keep your money in the 401k. On the other hand, if the assets are in a Rollover IRA (as opposed to a traditional contributory IRA) you may be able to transfer them into your current employer's 401k if the need to borrow materializes.
- Although most states have enacted laws that provide IRAs with creditor protection similar to that of employee sponsored plan, not all states have done so. If creditor protection is an issue, you should check your state's provisions before transferring your assets.

Take out the company stock

Many people have accumulated a great deal of company stock in their 401k plans. If you have a lot of appreciated company stock in your account, discuss with your Financial Planner or Accountant the tax advantages that may be available for taking out the company stock and not rolling it into an IRA or other employer plan.

Although you'll pay ordinary income taxes on the distribution of company stock, the tax is only imposed on the value of the stock when you purchased. You don't pay taxes on the subsequent appreciation until you sell it. And when you sell the stock the gains are taxed at the more favorable capital gains tax rates (assuming you wait at least 12 months before selling them).

Since the viability of this strategy depends on a number of factors – cost basis in company stock, unrealized appreciation, current tax bracket, etc… - you should work with your advisor before implementing this strategy.