Do You Have a Retirement Plan With a Former Employer?

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If you left behind a 401(k), 403(b), or 457 governmental deferred compensation plan at a former job – or are about to, and assuming you're not ready to retire yet, you generally have four options:

1. Leave your savings with your former employer. You may be able to leave your savings in your former employer's retirement plan. If your balance is $5,000 or less, however, your employer may require you to take your money.

Before settling on this alternative, review your plan's investments, costs, services, withdrawal restrictions, and distribution choices. Also find out the rules for former employees' accounts, such as if you'll still be able to borrow from your plan, if that was an available option. Then compare your plan with an IRA, and if you have one, your new employer's retirement plan.

2. Move your retirement savings to your new employer's plan. You can now roll over eligible distributions tax free from a 401(k), 403(b), or 457 governmental plan to any such plan that accepts rollovers.

For example, if you left your teaching job and went to work for a private company, you can now roll over your 403(b) savings to a 401(k) plan that accepts rollovers. Or if you left your government job for a job with a nonprofit organization, you can roll over your 457 governmental plan savings to a 403(b) plan, if your new employer has this type of plan that accepts rollovers.

Before you move your savings, compare your new employer retirement plan to your current plan and an IRA. Evaluate investments, services, withdrawal restrictions, loan provisions, distribution options, and costs.

Get all the details. Before you roll over your employer retirement plan savings, contact your plan administrator or a tax advisor for complete information about the rules and tax consequences.

For instance, if you roll over your savings from one employer plan to another, or to an IRA, review the withdrawal restrictions since your money becomes subject to the rules of the new plan or IRA. Or as another example: If your 401(k) plan includes greatly appreciated company stock that you want to continue to own, get the details about favorable tax treatment if you transfer your shares to a taxable account.

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3. Roll your retirement savings over to a traditional IRA. Once you've left your employer, you also have the option of directly rolling over part or all of your eligible distribution from your 401(k) or 403(b) plan to a traditional IRA. Plus, you can also now roll over an eligible distribution from your 457 governmental plan to a traditional IRA.

Consolidating your retirement savings into a traditional IRA streamlines your paperwork, makes it easier to develop and maintain your investment plan, and simplifies your required minimum distribution calculations when you reach age 70½. IRAs may also offer you a broader selection of investment options than your current or new employer plan.

Traditional IRAs may also offer you and your beneficiaries more flexible and tax-favored distribution options than your employer retirement plan. Traditional IRAs, however, don't offer loans, as do some employer plans.

Furthermore, if you're eligible, rolling over your employer plan savings to a traditional IRA gives you the option of converting your savings to a Roth IRA. (You can't roll over savings from your former employer's plan directly to a Roth IRA.)

In favorable contrast to a traditional IRA, you can withdraw earnings free from federal taxes from a Roth IRA, if you meet the specified conditions. Moreover, you aren't required to begin taking minimum distributions at age 70½, as you are with a traditional IRA.

You can convert part or all of your traditional IRA to a Roth IRA if you're a single taxpayer or married taxpayer filing jointly, and your modified adjusted gross income in the year you convert doesn't exceed $100,000. Importantly, you'll owe taxes at your regular income tax rate on the amount you convert.

Go direct. If you decide to roll over your 401(k), 403(b), or 457 governmental plan savings to a traditional IRA, make sure you arrange a direct rollover to avoid triggering income taxes, and possibly the 10% early withdrawal tax.

If you don't go the direct route, you'll receive a check payable to you and you'll have 60 days to reinvest your money in an IRA. However, your check will be reduced by 20% because federal tax law requires your former employer to withhold that amount as prepayment for federal income taxes.

So unless you come up with that 20% out-of-pocket and add it to your IRA within 60 days, the 20% will be considered a withdrawal and you'll owe income taxes, and possibly the 10% tax penalty, on the taxable portion of your withdrawal. If you add back the 20%, the IRS will refund that amount, but only after you file your tax return for the year.

4. Cash out. As a last resort after you've left your job, you can take a distribution of part or all of the vested portion of your employer-sponsored retirement plan. But you'll lose a significant chunk of your savings to federal income taxes, possibly state income taxes, and for 401(k) and 403(b) plans, possibly to the 10% early withdrawal tax penalty.

Plus, your employer is required to withhold 20% up-front as prepayment for the federal income taxes you'll owe. Moreover, you'll lose out on future years of earnings and tax-deferred growth.

For 401(k) and 403(b) plans, if you do end up taking your money, there are some exceptions to the 10% early withdrawal tax penalty.

The exceptions include distributions when you separate from service during the year of your 55th birthday or later, or if you take withdrawals as a series of IRS-defined substantially equal periodic payments made over your life, or over the joint lives of you and your beneficiary. Exceptions also include withdrawals if you become permanently disabled, or for unreimbursed medical expenses that exceed 7.5% of your adjusted gross income.

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