Apathy, Spending Spree, or IRA?

The Motley Fool

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Apathy or spending spree — take your pick. Those are the two main choices Americans tend to make when handling money in a former employer's work retirement plan.

But there is an alternative: control.

It's a difficult choice, particularly when faced with a mountain (or even an anthill) of formerly off-limits funds and a circular announcing a plasma-TV sales event. Studies show that 42% of workers give in to temptation and cash out their work retirement plans — 401(k)s, 403(b)s), etc. — when they change jobs. And we change jobs a lot. According to the Department of Labor, Americans move to a new employer once every four years, leaving a trail of money in our former bosses' plans.

But resistance has its perks: It doesn't trigger taxes, nor does it make us suffer through early-withdrawal penalties and fees. And it can pay off big-time in retirement (when, likely, plasma-TV prices will be more reasonable). All it takes is a little bit of legwork to move that money from a former work retirement plan into a self-directed IRA. And as long as it's IRA season and discount brokers are gunning for your business, you might as well get rolling.

What's the rush? For those with a money trail as long as their resume, consider this real-world warning a reader sent to me:

My late ex-husband worked for seven employers in 15 years, acquiring a 401(k) at each. Before he passed away in 2004, leaving no close relatives, he asked me to deal with his estate. His paperwork was chaotic, to put it kindly. I contacted all the trustees I could identify, inquiring about the accounts. Two out of seven responded (one in writing, one by phone), saying he had withdrawn the funds. Some refused to give me any information. Some just ignored me. One kept my letter for over a year, then stuffed it into an envelope and mailed it back to me with no information at all. My advice — roll those 401(k)s into your IRA IMMEDIATELY upon leaving an employer, or you and your heirs may never see the money again!

With the average 401(k) balance in the $50,000 range, it seems a shame to either fritter away those retirement dollars by cashing out or forgetting about long, lost accounts until it's too late.

Why move?

You may be forced to: Most employer-sponsored retirement plans will force you to move your money (via rollover or direct transfer) if you have less than $5,000 in your account. If you have $5,000 or more, though, you may leave the money in your 401(k) until the normal retirement age specified by that plan.

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You'll have more investment choices: Most employer-sponsored retirement plans offer a limited number of investment options. When you roll that money into a self-directed IRA, your choices open up: You've got the entire market (including mutual fund families, money market funds, and ETFs) at your disposal. And, by the way, work retirement plans aren't free to participants. Even if they aren't clearly stated, administrative fees are baked into the plan. With an IRA at a discount-brokerage firm, all of those fees are spelled out up front. (Things to look for include transfer fees, minimum account balances, administration fees, inactivity fees, and trading commissions. Learn more here on opening an account.)

You'll have more freedom in retirement. Uncle Sam has lot of rules for retirees, one of which requires people aged 70 1/2 to begin taking distributions. If your retirement funds are in a 401(k) plan, you are also subject to the distribution rules set forth by the plan administrator. Those tend to be more rigid than those at the companies that manage IRAs. Customer service can also be a factor. Discount brokers tend to act more like banks — focusing on keeping your business. On the other hand, 401(k)s have a captive audience of company employees and a stream of new business whenever anyone is hired. If it's the investment choices within the plan keeping you there, you'll likely have access to the same ones in an IRA.

Roth or traditional IRA?: The IRS allows 401(k) transfers only to traditional IRAs, which are treated similarly in terms of taxes — your contributions are made with pre-tax dollars, and you pay the piper when you withdraw the funds. So the Roth IRA, which requires you to pay taxes now on your contributions so you can avoid The Man at retirement, is off the table.

There is a workaround, however. You can roll your money into a traditional IRA and then convert it to a Roth IRA. That entails paying taxes on everything in your 401(k) — unless you have some after-tax contributions. Depending on the size of your 401(k), converting may or may not be practical. If you can afford to pay the taxes without withdrawing cash from the IRA, then it might be worth it. The prospect of a tax-free retirement is very appealing. If you have to take the money out of the IRA account to pay the taxes, however, it may be best to leave it in a traditional IRA.

And the amount you roll over into an IRA is not limited, since whatever money you stashed in your old 401(k) was already accounted for, tax-wise, in the years in which you put it away. In other words, the rollover amount does not count as IRA investments for the year in which you do the rollover.

Moving money into a new employer's plan: Rolling old 401(k) money into a new 401(k) plan is one option, though not all employers permit transfers from old 401(k)s into the new. There are advantages and disadvantages to doing so, but it all depends on the details of the new plan.

For example, moving money into a 401(k) instead of an IRA preserves your opportunity to take a loan from the plan (for a down payment on a house, for example). That is, if the new plan offers that

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option. A drawback to going straight from one 401(k) to another would be if the investment choices in the new plan stink (say, if you could pick only company stock) or if the plan fees were outrageous.

If you're chomping at the bit to invest in your new plan because your boss offers to match a percentage of your investing dollars, dream on. You won't get matching funds on your transfer. But still, a good plan has those other lovely qualities mentioned above.

Making a plan-to-plan move: Fool tax expert Roy Lewis explains how it's done:

"Transferring your money to a new employer's 401(k) plan generally can be done in one of two ways. You can take a distribution of the funds from your prior employer and deposit it (roll it over) into the new employer's plan. Second, if the new plan permits it, you can make the transfer through a trustee-to-trustee transfer.

"The trustee-to-trustee transfer option is always preferable because the IRS requires that if you take a distribution, even one that you will roll over to another 401(k) plan, the employer must withhold 20% of the amount distributed for tax purposes. You won't be able to get this money back until you file your tax return for the year in which the distribution took place and claim that amount as taxes withheld. Additionally, if you aren't yet 59 1/2 and don't deposit the distribution check and/or the amount withheld — which must be obtained from sources outside the distribution — within 60 days of the distribution, those amounts will be subject to income taxes and the 10% early distribution penalty."

When to stay put
We nearly always advocate taking your 401(k) money with you when you leave a job. But there are times when it makes sense to leave the money with your former employer. Consider doing so if:

More on making your IRA A-OK:

Save Like It's 2006
Roth IRAs Often Beat 401(k)s
60-Second Guide to Opening an IRA
It Pays to Ignore Your IRA
Redefining the "R" in IRA

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