401k Rollovers 05/01/2007

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Automotive Employees Face Retirement Plan Choices

By Rick Paler

Many people in Michigan have been affected by the news of layoffs and early retirement packages, as the automotive industry restructures itself to become more competitive within the global market place. Many of these people have given their heart and souls to their companies. In some cases, generations of families have worked for the same employer. These people never would have considered any other employer or career.

Now these same hard working individuals are faced with early retirement or starting a new career. Important financial decisions need to be made including what to do with your retirement plan.

There are four basic choices individuals have for their 401k plan when they leave a company. There are pros and cons for each option. My hope is that by educating yourself, you can avoid potentially costly mistakes.

The first choice is taking the 401k as a cash distribution. Do not do this no matter how tempting it might be. Taxes and penalties could be substantial. Taking the cash will result in the IRS withholding 20% of the value for taxes right off the top. Then if you take a cash distribution before turning 59 ½ or before 55 in the case of separation of service, the government will penalize you an additional 10% on the amount withdrawn.

In addition to the federal government penalizing you, the amount withdrawn is considered income. Therefore you will have to pay federal, state and possibly local income taxes on the withdrawal.

Here is example to illustrate what could occur if you take a cash withdrawal. Let's say you have $100,000 in your 401k. You elect a cash withdrawal; the IRS will require your employer to withhold $20,000 for taxes. Now you are left with $80,000, if you are under

55 you will be hit with a 10% penalty. Now you have only $72,000, but that is not the end of it. Now that amount is considered income and you will be taxed at the federal, state and possibly local rates. Now you can see why I consider a cash payout a last resort.

The second choice is to do nothing and leave it at you prior employer. This can be a viable option. This will work if you do not mind dealing with the company after you have left your employment and the company allows you to maintain the account.

Your account will retain its tax deferred status until you make withdraws and there are no taxes or penalties incurred by leaving the account in your 401k plan.

For those that are looking for more control over their investments, this is not a good option. Your account will remain restricted to the investment options your prior employer chooses. Some 401k plans also limit when distribution from the plan can be made and when investment choices can be altered.

Your third choice is to move your 401k plan to your new employer's retirement plan. This can only be done if your new employers plan allows for this to occur. This option will allow you to avoid taxes and penalties and retain you accounts tax deferred status.

One advantage is that you new employer's plan may allow you to take a loan against it and avoid taxes and penalties. The disadvantages are the same as leaving it with your old employer. You will lose flexibility and control of the investment choices.

The final option is rolling the balance into an individual IRA Rollover account. These retirement accounts will preserve your accounts tax free status, allowing your investments to grow tax free until you decide to withdrawal them. Distributions must begin no later than 70 ½. You will avoid all taxes and penalties including the 20% withholding tax.

These accounts give you the most control and flexibility. IRA Rollover accounts allow you to choose you're own investments, giving you the ability to invest into mutual funds, stocks, bonds or exchange traded funds (ETF's) to name a few. Additionally, changes in your investments within the account can be made at any time.

By far the best option for most people is to elect to have their 401k plan rolled into an IRA Rollover account. Before making any decisions, do your homework first and consult your investment advisor or CPA. Most advisors will answer all your questions and even assist you with completing the paperwork.

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