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Tapping the 401(k) in Tough Times?

Consider Rolling Everything Into an IRA

By Kevin Bourke

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Like so many, Mary recently lost her job and is looking for employment. She has two children, a mortgage, and all the other bills that come with raising a family. Mary desperately needed money, so she called her former employer's 401(k) administrator and asked to take a distribution.

This was an expensive phone call for Mary, costing her thousands in penalties and taxes, some of which may have been avoided. What could she have done differently? And what do you need to know if you find yourself in the same position?

You have several decisions to make and you're smart to be concerned about making a mistake. Making a poor choice can cost not only unnecessary taxes and penalties, but can also have long lasting financial implications, because after all, you're dealing with your retirement dollars here.

Money Talks

First, the basics. If and when your 401(k) balance is less than $5,000, your former employer will usually opt to send you a check and close your account. This could be expensive since you will likely need to pay taxes and penalties on this money, which is considered income to you. Call your former employer and ask how long you have to move your money out of the 401(k) before they liquidate the account and send you the proceeds.

If your 401(k) balance is greater than $5,000 you can breathe a little bit easier; you have some time. Typically you can leave those monies in the retirement plan indefinitely. Although as you'll see, I don't advise that you do.

If you're lucky enough to have landed another job, and that job offers a 401(k) or other retirement plan that accepts rollovers, that opens up one possibility. You can roll the balance from your old employer's plan to your new employer's plan. Just call your last employer and ask what you need to do to effect the rollover, or transfer.

But you do have another option, which in my experience is a better choice. The other option is to roll your retirement account balance to an IRA.

Why roll your 401(k) to an IRA?

1) Your investment choices are much broader in an IRA than they are in most 401(k)s.

2) You can take distributions from an IRA without the mandatory 20% withholding that 401(k)s impose. If you take a distribution from a 401(k), they will withhold 20% of that distribution, which you must replace from outside funds if you want to roll the balance back into a retirement plan or IRA, and you only have 60 days to deposit the check as well as the 20% you have to make up.

3 You can usually get more personalized investment advice from an IRA custodian, like a bank or a brokerage firm, than you might receive from your 401(k) administrator.

4) You don't have the same sort of time constraints with an IRA that you might have with a 401(k). For example, if your balance is under $5,000, an IRA isn't going to force a taxable distribution, while a 401(k) might.

5) Beneficiary designations are so important, yet many forget to update their beneficiaries as they experience life changes. My experience is that those using an IRA are more apt to keep their beneficiary designations up to date than those who use a 401(k) because an IRA often offers more support from the financial institution than the retirement plan adminstrator.

6) You can take distributions from an IRA at will. You may be subject to taxes and penalties, but at least you have the option. 401(k) and other qualified retirement plans are not that flexible.

7) Simplicity. I'm frequently surprised at how complicated some people's finances become. Sometimes individuals have multiple accounts at various former employers. Why not consolidate so that you know how much you have and how it is doing? One IRA account can hold all of those stray retirement balances allowing you to create an overall investment strategy that you can see at a glance.

What could Mary have done differently? She could have rolled her retirement plan balance over to an IRA, then taken a distribution. This way, she would have had some control.

These are difficult times; the capital markets and home values are down, unemployment is up, and your stress level may be up as well. Don't compound your financial issues by making uninformed choices. If you're between jobs, call your retirement plan administrator for information regarding your plan balance; next contact a financial institution that offers IRAs. Gather the facts, then act.

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