BAOBAB
WEALTH MANAGEMENT

THE 401(k) ROLLOVER HANDBOOK

How can you transfer your retirement savings today to have more control over them tomorrow?

What will happen to your 401(k) when you leave work?

The more appropriate question is:
What do you want to see happen with it?

You have choices when it comes to your 401(k), and, depending upon your personal finances and retirement goals, some of those choices may be better than others.

The key is to decide what you want to do with that money in advance of your retirement date. With that decision in mind, you can plan a future for those invested assets.

What should you do with your 401(k) savings?

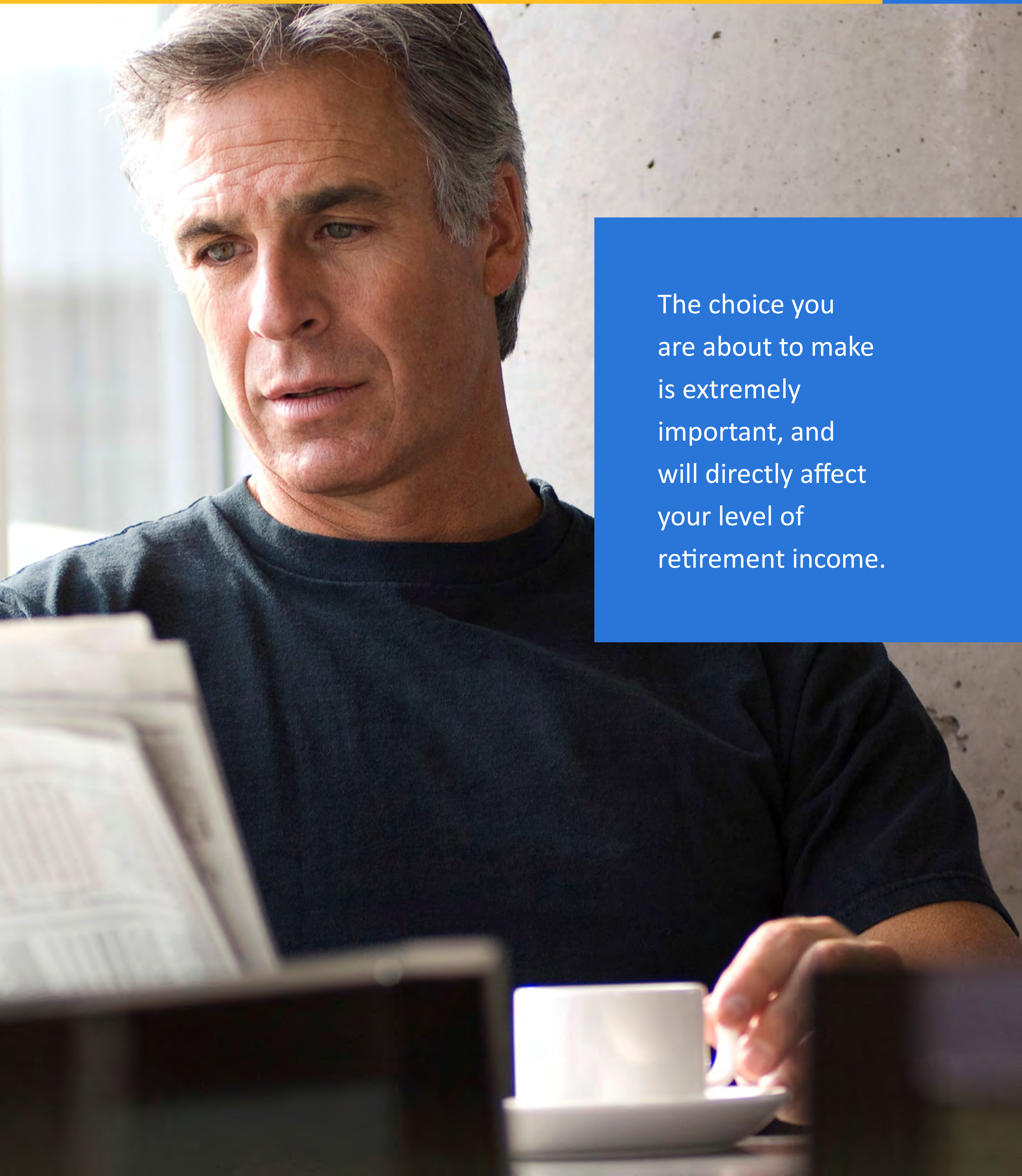
Some options will give you more control over your money than others. The choice you are about to make is extremely important, and will directly affect your level of retirement income.

You could arrange a 401(k) rollover and transfer the money into an IRA. You may find this to be a good choice if you want control over the money that has accumulated in your 401(k) account. An IRA is a retirement account you own, as opposed to one your employer owns. It permits a wide variety of investment options.[1]

An IRA also gives those assets the chance for additional years of tax-advantaged growth. If you roll over your 401(k) money into a traditional IRA, you don't have to take Required Minimum Distributions (RMD) from the IRA until after you turn 70½. Original owners of Roth IRAs never have to take RMDs. If you arrange a 401(k) rollover into a Roth IRA, those Roth IRA assets can, theoretically, enjoy tax-advantaged growth for as long as you live.[2]

Consider arranging a trustee-to-trustee transfer with the help of a financial professional. In this scenario, you don't touch the money during the transfer – and that's very important. If you do, it becomes a taxable event. *See the next section for why you shouldn't roll over your 401(k) on your own.*[3]

You could leave the money in the plan. Some employers will allow this, and, in some cases, letting the money sit for a spell may not be so bad. Your 401(k) features tax-deferred growth; so, if you already have a great deal of retirement assets in addition to your 401(k), you could withdraw retirement income from your taxable accounts as your retirement starts and let your workplace retirement plan money grow and compound for a while longer.



The choice you are about to make is extremely important, and will directly affect your level of retirement income.

The Internal Revenue Service (IRS) doesn't demand withdrawals from a 401(k) until after a 401(k) accountholder reaches age 70½. Assets held in a 401(k) are also creditor-protected, so they can't be reduced as a consequence of a lawsuit or a bankruptcy.[1]

The main demerit to leaving the money in the plan is simply stated: you don't own that 401(k) plan; your employer does. Your plan might leave you with a narrow range of investment choices – and, if too many of them seem to underperform, you may want more options. If you can direct those assets into an account you own, your options may broaden greatly.

You could cash out. This might be the worst choice you could make. Simply speaking, taking a lump sum distribution from your 401(k) plan means that you will get cash, but pay a price for it. The IRS categorizes a 401(k) distribution as regular income, so your income taxes for the year in which you cash out may be staggering.[1] Additionally, the money is no longer invested. It loses the chance to grow and compound further, as it could in an IRA or another tax-advantaged investment account.

You might be able to take serial distributions. Select 401(k) plans may give you the choice of a regular income stream. In this case, quarterly or even monthly payments would go to you. You may have the option of revising the payment amount annually, or even more frequently than that. Unlike Social Security, however, this is an income stream that you can potentially outlive – so relying on it too heavily may backfire. You would also be drawing down your 401(k) funds without reinvesting them. Since the serial distributions are cash payouts from a 401(k), they are subject to income tax.[1]

You could potentially arrange an income contract through an insurer. Retirees have been known to fund such contracts – which pay them a regular income stream – with 401(k) payouts. These contracts have some drawbacks, however.

1) The regular income payments may never be increased in response to inflation.

Simply speaking, taking a lump sum distribution from your 401(k) plan means that you will get cash, but pay a price for it.

2) Two, the money is in the hands of the insurance company and difficult to access if you need it in an emergency.

3) While some of your money may be invested through a pooled investment fund maintained by the insurer, the gain credited to your invested funds, as a byproduct of such investment, may seem very minor.

4) If you should happen to die shortly after you retire, the insurance company may "come out ahead" much more than your heirs.[1]

A 401(k) rollover is often a wise choice. A trustee-to-trustee transfer of the 401(k) funds into an IRA – an account that you own – will help you to gain control over those retirement assets.

Sources:
1 - money.cnn.com/pf/money-essentials-401k-distributions/ [5/28/15]
2 - irs.gov/retirement-plans/plan-participant-employee/retirement-topics-required-minimum-distributions-rmds [1/6/16]
3 - money.usnews.com/money/retirement/articles/2016-01-19/how-to-avoid-401-k-fees-and-penalties [1/19/16]

A rollover is often a wise choice.

Should you try to roll over your 401(k) yourself?

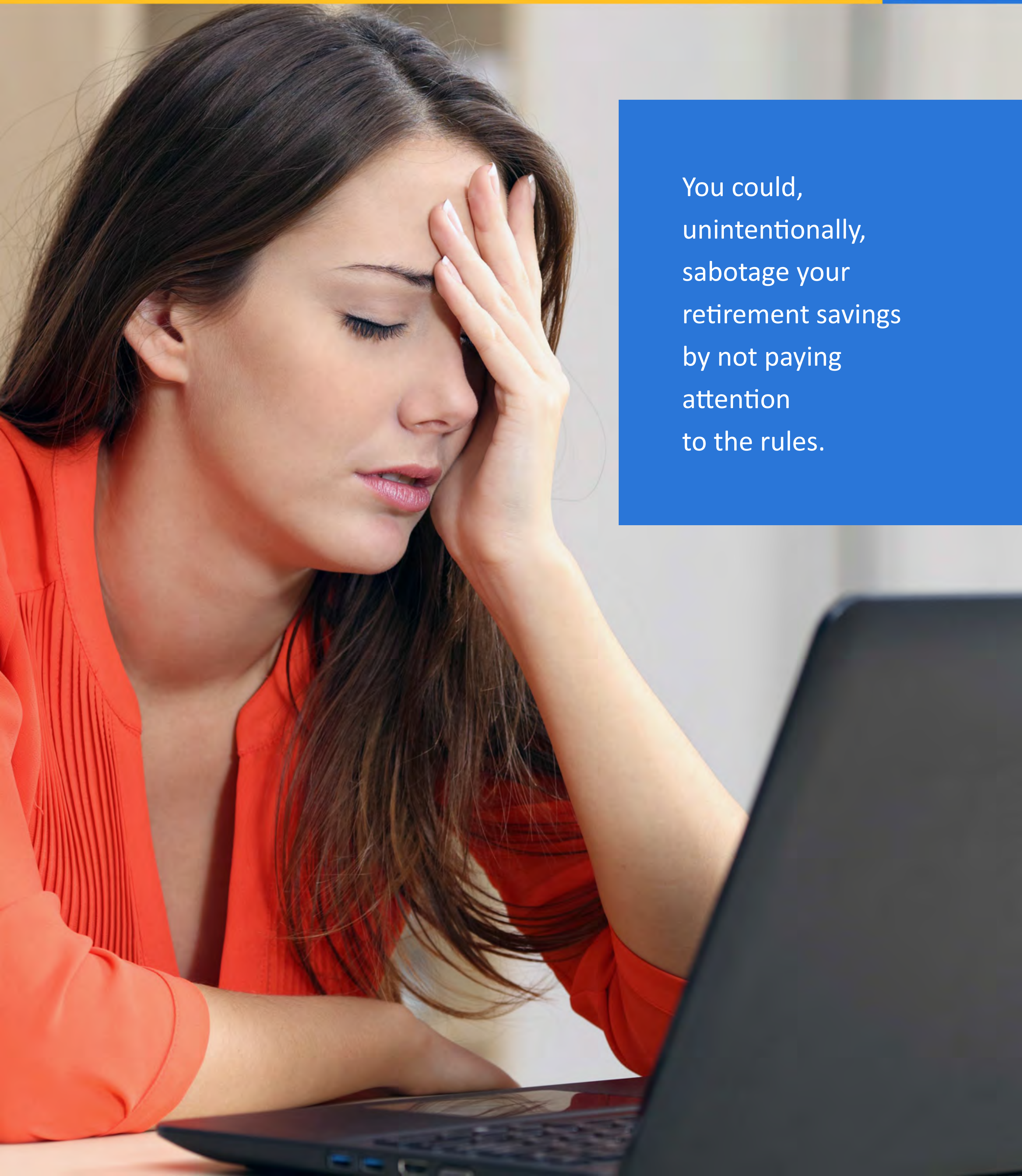
A do-it-yourself 401(k) rollover risks turning into a disaster. This isn't always the case, but you could, unintentionally, sabotage your retirement savings by attempting to do this on your own without paying enough attention to the rules.

When 401(k) assets are rolled over into an IRA, a trustee-to-trustee transfer is often the easiest, most hassle-free way to move the money, and the transfer should have no tax consequences.

In a trustee-to-trustee transfer, you never touch the money. A financial professional contacts the administrator of the 401(k) plan on your behalf and requests that the 401(k) funds be transferred into an IRA by check. After the request is made, the 401 (k) plan administrator writes a check in the amount of the 401(k) balance, payable to the new financial firm hosting the IRA that will house those funds. The financial professional oversees the transfer of assets and follows through to see that the involved paperwork is processed appropriately. Through this manner, the money from a 401(k) can be directly transferred into an IRA without tax consequences. In recognition of the trustee-to-trustee transfer, the IRS sends you a Form 1099-R with a distribution code of "G" in box 7 – indicating that this was a direct transfer and not a taxable event.[4,5]

Some retiring employees end up making indirect 401(k) rollovers. They ask the plan administrator to write them a check in the amount of their 401(k) balance and take possession of the 401(k) funds themselves. This leaves them with only 80% of their 401 (k) money and puts them at risk for higher income taxes.[4]

If you make an indirect rollover, 20% of the funds in your 401(k) will likely be withheld. The IRS will, eventually, return that money to you if you follow federal tax rules – but the rules are strict.[5]



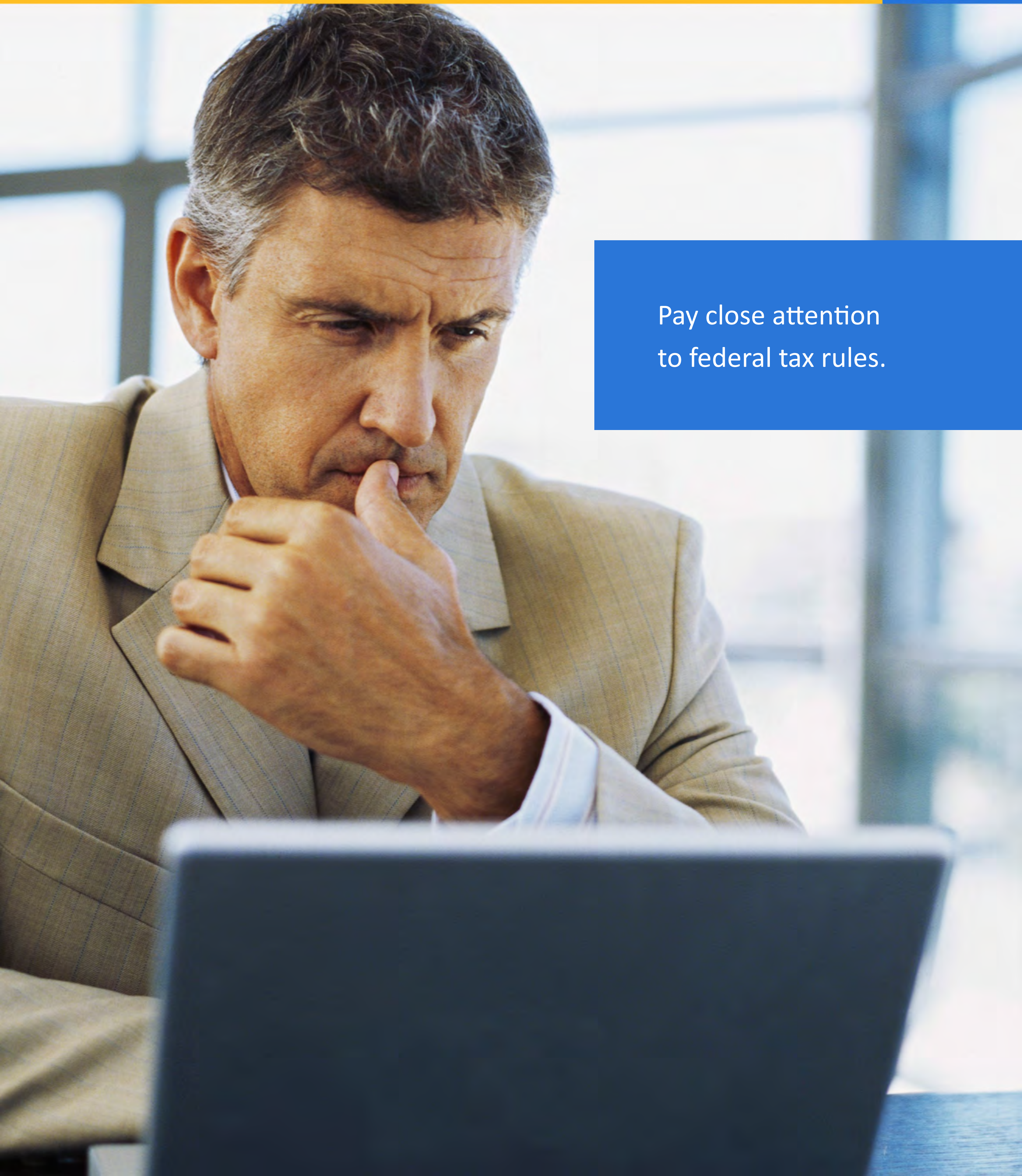
You could, unintentionally, sabotage your retirement savings by not paying attention to the rules.

Suddenly, you have a deadline to meet.

Within 60 days, you must place the entire amount, including the withheld 20%, into a new retirement account. (That's right; you have to come up with funds equivalent to the withheld 20%, from your own resources, to satisfy IRS rules.) If you fail to meet this 60-day deadline, any portion of the money that has not been placed into a new retirement account will be considered an income distribution by the IRS – thus, it will be fully taxable. If you have not yet turned 60, an early withdrawal penalty could possibly come with the distribution.[4,5]

Do you want to deal with having to make an indirect 401(k) rollover? No? A direct rollover may be a wise alternative. In a trustee-to-trustee transfer of 401(k) funds to an IRA, there is no deadline for you to pick out and set up a new retirement account, and you don't make what amounts to an interest-free loan to Uncle Sam.

Source:
4 - money.usnews.com/money/retirement/articles/2016-01-19/how-to-avoid-401-k-fees-and-penalties [1/19/16]
5 - bankrate.com/finance/money-guides/reporting-ira-rollovers-1.aspx [9/17/14]



Pay close attention to federal tax rules.

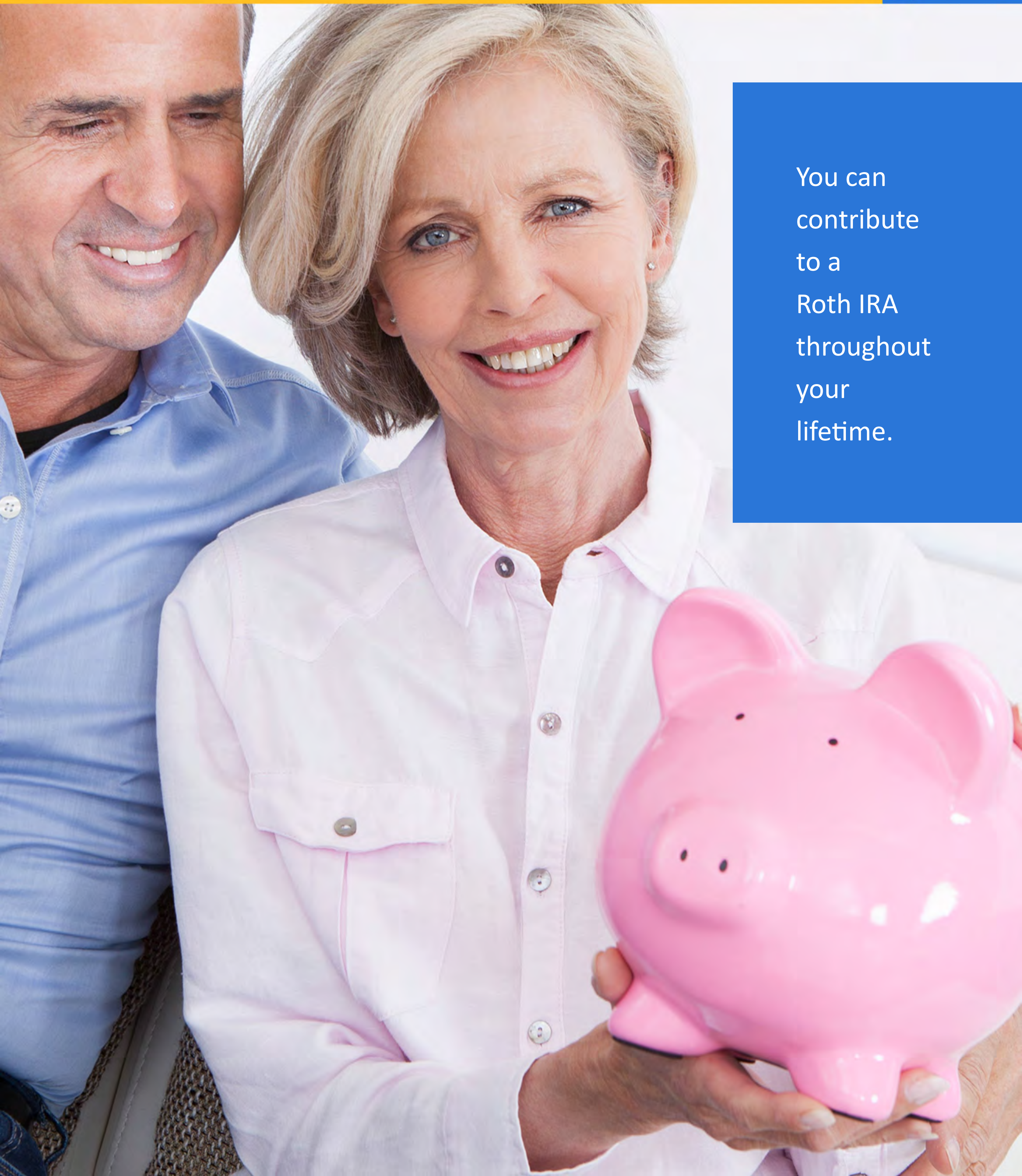
Should the funds go into a traditional IRA or a Roth IRA?

Either form of IRA may present you with potential advantages. The contribution and withdrawal rules differ, and so does the tax treatment of contributions and withdrawals.

You can keep contributing to a traditional or Roth IRA after you leave work, as long as you or your spouse have earned income. You can't contribute to a traditional IRA after age 70½, but you can contribute to a Roth IRA throughout your lifetime. Regular, non-rollover contributions to a traditional IRA are tax-deductible; regular, non-rollover contributions to a Roth IRA are not. If your income is very high, that may limit your ability to contribute to a Roth IRA. If you retire, but your spouse still participates in a workplace retirement plan, part of your traditional IRA contributions may not be tax-deductible.[6,7]

You never have to make withdrawals from a Roth IRA, whereas IRS rules require you to start taking Required Mandatory Distributions (RMDs) from a traditional IRA after you turn 70½. Withdrawals from a Roth IRA are tax-exempt, while withdrawals from traditional IRAs are taxable. Withdrawals from traditional IRAs are included in the calculation formulas used to figure how much of your Social Security benefit is taxable; withdrawals from Roth IRAs are not.[6,7]

The choice is not necessarily an either-or one, as 401(k) rollovers can have multiple destinations. Since 2014, the IRS has allowed 401(k) plan participants to roll over all "pre-tax" amounts from these plans into traditional IRAs and all "after-tax" amounts from these plans into Roth IRAs. (A little explanation of those phrases: traditional IRA contributions are made with pre-tax dollars; Roth IRA contributions, with after-tax dollars.) Similarly, pre-tax and after-tax earnings in a 401(k) account may be directed into traditional and Roth IRAs, as appropriate. A 401(k) plan participant is not permitted to roll over only the after-tax amounts in the 401(k) to a Roth IRA, while leaving the remainder of the money in the plan.[8]



You can contribute to a Roth IRA throughout your lifetime.

Is your 401(k) a Roth 401(k)? If so, the Roth-or-traditional choice is already made for you under federal tax law. Distributions from Roth 401(k)s must be rolled into Roth IRAs.[9]

Roth IRAs are subject to a "five-year rule" – the original owner of a Roth IRA has to own that IRA for five tax years before he or she can take a tax-free withdrawal from it. If you already have a Roth IRA and have owned it that long, no problem – you can take a tax-free withdrawal from that Roth IRA before or after rolling your 401(k) funds into it. If you have owned your Roth IRA for less than five years, you cannot apply the time that your money has been in a Roth 401(k) toward that 5-year rule. In fact, those 401(k) dollars you roll over into the Roth IRA will now be subject to the 5-year rule for that Roth IRA. If you create a new Roth IRA to contain money rolled over from a 401(k), the 5-year period for that IRA starts in the year that the Roth IRA is opened.[9,10]

Source:
6 - fool.com/retirement/general/2016/05/06/should-you-fund-a-roth-ira.aspx [5/6/16]
7 - irs.gov/retirement-plans/plan-participant-employee/retirement-topics-ira-contribution-limits [12/23/15]
8 - irs.gov/Retirement-Plans/Rollovers-of-After-Tax-Contributions-in-Retirement-Plans [9/2/15]
9 - investopedia.com/articles/retirement/09/roth-401k-rollover.asp [5/16/16]
10 - desmoinesregister.com/story/money/business/columnists/2016/04/20/six-potential-401k-rollover-pitfalls/83278146/ [4/20/16]

Roth IRAs are subject to a “five-year rule”.

What else should you know about 401(k) rollovers?

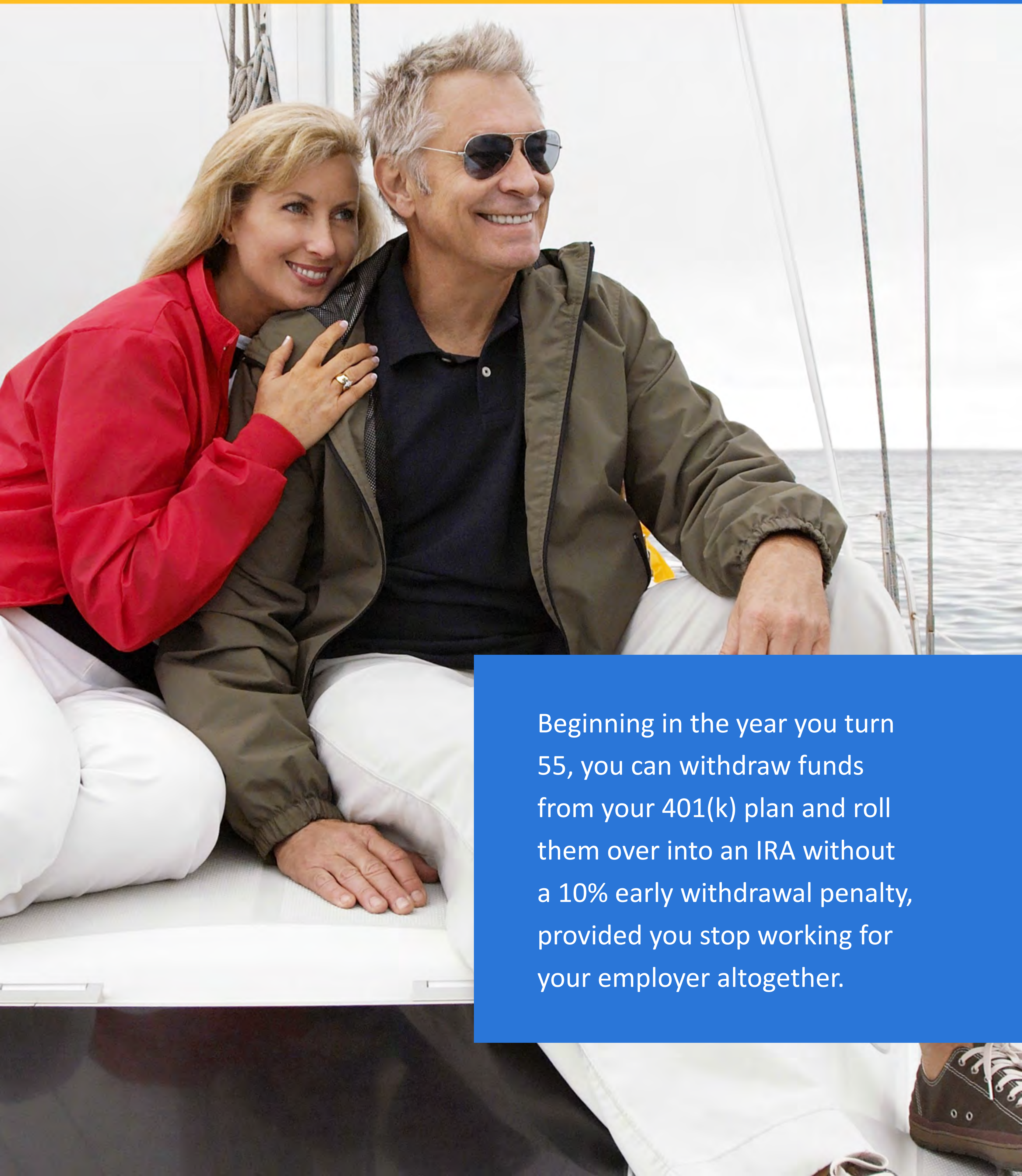
Special rules apply if you happen to retire in your fifties. Under IRS regulations, most retirement account distributions (made prior to age 59½) are not only fully taxable, but also subject to a 10% early withdrawal penalty. An exception is made for 401(k)s – the "rule of 55" applies.[10]

Beginning in the year you turn 55, you can withdraw funds from your 401(k) plan and roll them over into an IRA without a 10% early withdrawal penalty, provided you stop working for your employer altogether. For qualified public safety employees invested in a 401(k), the threshold is age 50.[10]

The hitch is, that standard early withdrawal penalty still applies to the IRA where your 401(k) funds land. With few exceptions, you will have to wait until after age 59½ to take an IRA distribution without incurring that 10% penalty.[10]

Some 401(k) distributions cannot be rolled over into IRAs. As Required Minimum Distributions (RMDs) from 401(k)s are required after a plan participant reaches age 70½; the oldest workers may wonder if they can roll their RMD amounts into an IRA. That is not allowed under IRS rules. Hardship withdrawals may not be turned into rollovers either. If actually made, these kinds of rollovers are viewed as excess IRA contributions for that particular tax year by the IRS.[10]

Do you own any stock in the company you work for? If you have some of those shares in your 401(k) account, those shares may have appreciated with time. Any unsold stock within the account, that is worth more than it was when you acquired it, has seen net unrealized appreciation, or NUA. For example, say you bought $10,000 worth of stock in your employer and now those shares are worth $150,000; the NUA on those shares is $140,000. If you roll that company stock with NUA into an IRA (or another retirement account), those assets will retain their tax-deferred status.[11]



Beginning in the year you turn 55, you can withdraw funds from your 401(k) plan and roll them over into an IRA without a 10% early withdrawal penalty, provided you stop working for your employer altogether.

There is a reason you might *not* want to roll over those funds into an IRA, however. Since you haven't sold those shares, you will be taxed only on their cost basis ($10,000) if they are held in a taxable account (i.e., a brokerage account). If you are in the 25% tax bracket, you are looking at just $2,500 in taxes on those shares in a taxable account (rather than a $35,000 tax bill) in the year those shares are distributed out of the 401(k). You will face no capital gains taxes until you sell the shares – and capital gains taxes are lower than income taxes for most taxpayers.[11]

Finally, you want to be vested in your 401(k) plan before arranging a rollover. In some plans, employees are immediately vested – that is, the employer contributions to an employee's account belong to the employee from day one of 401(k) plan participation. In other cases, vesting may take 2-3 years. *You can only keep your employer's matching contributions after you become vested in the plan.* Some employers will let you keep a portion of their matching contributions if you aren't yet fully vested, but it may take as long as 5-6 years to become 100% vested in a plan.[4]

Source:
4 - money.usnews.com/money/retirement/articles/2016-01-19/how-to-avoid-401-k-fees-and-penalties [1/19/16]
10 - desmoinesregister.com/story/money/business/columnists/2016/04/20/six-potential-401k-rollover-pitfalls/83278146/ [4/20/16]
11 - fool.com/investing/general/2015/07/08/net-unrealized-appreciation-the-right-strategy-cou.aspx [7/8/15]

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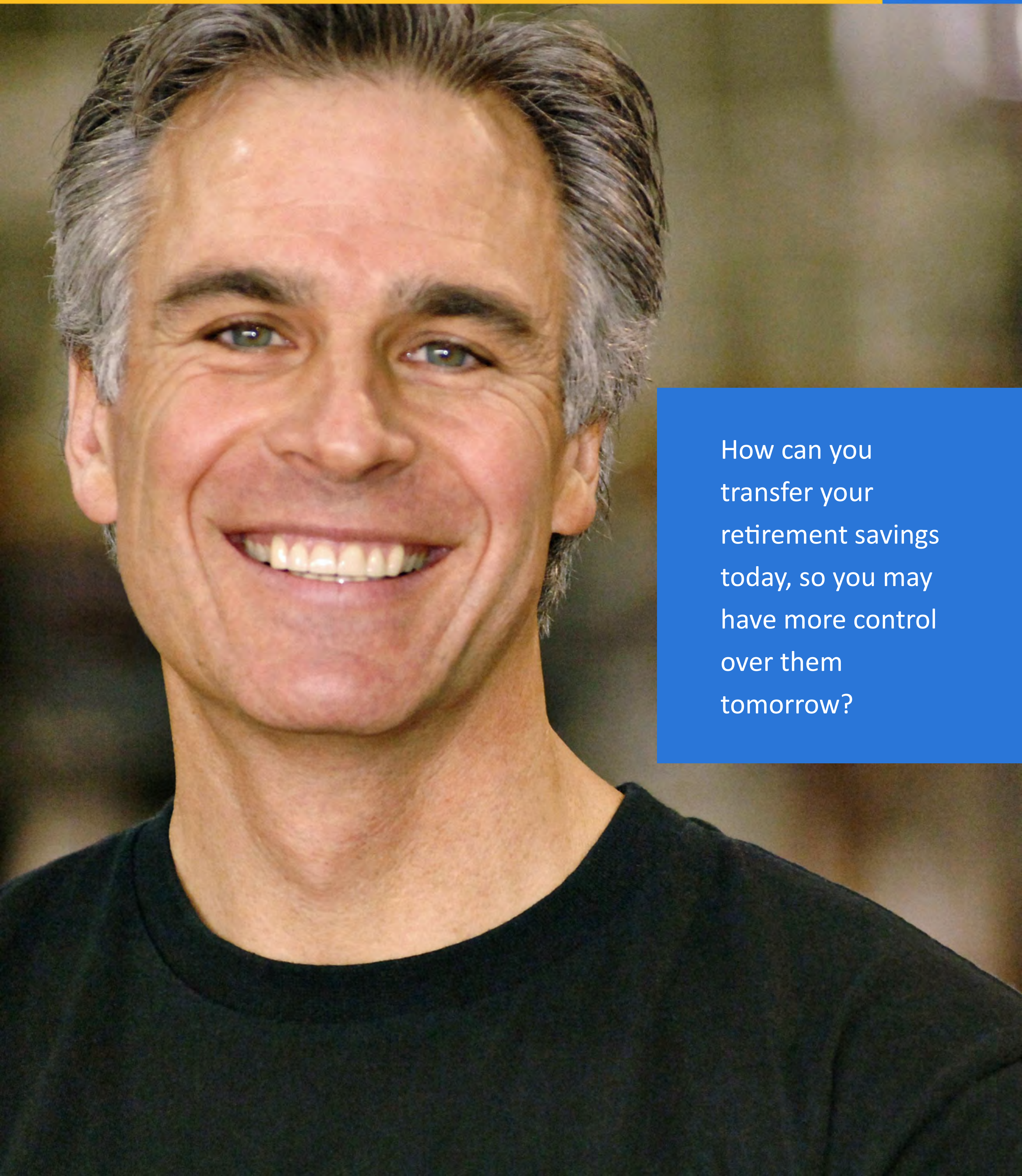
Make an informed choice that feels comfortable to you.

Assuming you have contributed to one or more retirement plans during the course of your life, seeking to build sufficient savings that can be converted into retirement income, the financial move you are about to make with those savings will be crucial. A direct rollover of retirement funds to an IRA often makes a lot of sense.

How can you transfer your retirement savings today, so you may have more control over them tomorrow? A 401(k) rollover may be your best choice, arranged with the help of a financial professional.



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