Beware of potential 401(k) rollover issues

THERE are a handful of reasons for why you may be eligible to roll over your 401(k) plan. Perhaps you have left the employer associated with the 401(k) plan or would like to consolidate accounts by rolling your 401(k) into your traditional IRA. Is this really the right course of action?

You might be better leaving your money in the plan. One reason to leave funds in the plan is that most 401(k) plans offer unlimited creditor protection under federal law. Make sure your type of plan is covered. Solo 401(k)s are not. In contrast, the protection from creditors for IRAs may not be as robust. Be sure to review the laws of your state in this area. Be aware that some plans force participants to take their funds out (usually for accounts with balances of $5,000 or less).

Your 401(k) plan may have investments or share classes of funds that can't be purchased in an IRA. There may be a wider selection of investment choices in your IRA, but if there is a particular fund in the 401(k) that you want, perhaps leaving the money in the 401(k) is the best option. Be sure to review the cost of investing in your 401(k) versus the cost of investing in the IRA.

Your IRA may offer you more flexibility with withdrawals. Your 401(k) plan provisions dictate the terms under which you can withdraw your money. Retirement plans usually have required minimum distributions (RMDs) starting at age 72, though if you are still working for the employer of the plan you may be able to avoid these until you actually retire. You may also have the option of borrowing from your 401(k) plan. You cannot borrow from your IRA.

If you do need to take money from either your 401(k) or IRA, you will need to review the potential penalties for early withdrawals. These generally kick in if your withdrawal is before you reach age 59½. For a 401(k) with your current employer, if you receive your distribution due to leaving your job during or after the year you turn age 55, the penalty may not apply. It should be noted that is no such exception for IRAs. If you might need the money before turning 59½, it might be best to leave it in the 401(k). IRAs do have a set of penalty exceptions, so be sure to check these out.

If you decide to roll the money from your 401(k) to your IRA, it is best to use a direct transfer (also known as a trustee-to-trustee transfer), which does not require any income tax to be withheld. If the plan sends the funds to you, it is required to withhold 20% for taxes. With this method, if you wanted to roll over the entire distribution, you will need to make up the withholding from other sources.

If your 401(k) investment includes employer stock, you will want to review the net unrealized appreciation (NUA) rules. Distributions from 401(k)s are normally subject to ordinary income taxes. However, if you receive distributions of employee stock, the ordinary income tax applies on the cost of the stock at the time it was purchased by your plan for you. If it appreciates, the appreciation will be taxed at long-term capital gains rates. Once you roll over the 401(k) to the IRA, any benefit in using the NUA rules are lost.

If your 401(k) is a Roth 401(k), there is yet another consideration. If you just established your first Roth IRA to hold the rollover, you will have to wait five years to have any distributions to be considered qualified and tax-free. It doesn't matter how long the money has been in the Roth 401(k).

Be sure to discuss your options with a certified financial planner or tax adviser.

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