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Marc A. Hebert's 'Money $ense': Potential 401(k) rollover pitfalls

By Marc A. Herbert
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YOU MAY be going to receive a distribution from your 401(k). What should you do with the money? Your first thought may be to roll the funds into your traditional IRA. This might be the way to go, but consider these steps before making a decision:

List the pros and cons of doing a rollover. If you can leave your money in the 401(k), it might make sense to do so. Consider these:

The 401(k) plan may have an excellent investment choice that you cannot buy in your IRA.

Your new employer could have a 401(k) plan with excellent investment choices. You may have the option to roll your old 401(k) into the new one.

The IRA has more investment opportunities.

The IRA has more withdrawal flexibility.

Find out if the distribution can be rolled over to an IRA. Examples of distributions that can’t be rolled over are required minimum distributions (RMDs). Hardship withdrawals are another example.

Ask if there are any penalties. Distributions taken before age 59½ are normally subject to a 10% early distribution penalty, unless an exception applies. Your 401(k) plan may have a special rule that lets you avoid the penalty if you receive your distribution as a result of leaving your job during or after the year you turn age 55 (age 50 for qualified public safety employees). This rule doesn’t apply to IRAs. The implication of this is that once you roll the funds into an IRA and take money before age 59½, you are most likely going to be hit with the 10% penalty. If you need the funds before age 59½ and meet the age 55 requirement, you may be better off leaving the funds in the 401(k) to avoid penalties upon withdrawal.

Go direct and avoid the 60-day rollover rule. If you take the distribution, you then have 60 days to put the money into your traditional IRA to avoid taxes. The first issue with doing this is that the plan is required to withhold 20% for federal income taxes from the distribution. If you wanted to put the entire amount back into your traditional IRA, you would need to come up with the extra funds. Also, there is always the potential to miss the 60-day limit. This all can be avoided by doing a direct trustee-to-trustee transfer.

Find out if your 401(k) account has any net unrealized appreciation (NUA) included. If your 401(k) plan distribution includes employer stock that has appreciated over the years, then rolling the funds into an IRA could be a mistake. Distributions from 401(k) accounts are normally subject to ordinary income tax rates.

Once again, there are special rules if you receive a distribution of employer stock from your plan. You can pay ordinary income taxes only on the cost of the stock at the time it was purchased for you by the plan.

Any appreciation in the stock before distribution, regardless of how long you have held the shares, can be eligible to receive the more favorable long-term capital gains treatment. Any additional appreciation after the stock is distributed is taxed at either the short or long-term capital gains rates depending on how long you choose to hold it. These rules don’t apply if you roll the funds over into an IRA.

Review whether your rollover is from a Roth 401(k) to a Roth IRA. One requirement for a Roth distribution to be qualified (tax-free) is to satisfy a five-year holding period. If you roll over a Roth 401(k) to a Roth IRA, the holding period for the Roth 401(k) does not carry over to the Roth IRA.

So, in order to make a qualified distribution after doing a Roth 401(k) rollover, the Roth IRA receiving the funds needs to have been open for five years.

Keep in mind that rolling over a 401(k) can be complicated and that it may be best to discuss your situation with a certified financial planner or tax advisor before taking any action.

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