Beware of Cashing Out

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There are better alternatives than cashing out your 401(k) or other workplace account.

Alternatives to cashing out

- *Stick with your 401(k) or other workplace account.*
- *Roll it over to your new 401(k) plan.*
- *Roll it over into a traditional IRA.*
- *Roll it over into a Roth IRA.*

Have you ever cashed out your 401(k) when changing jobs? If so, you may have been stunned to find an incredibly shrunken balance, the victim of taxes and early withdrawal penalties that can approach 50% for people in the top income tax bracket.

All too often, people make that painful mistake when managing their 401(k) savings—they cash out. Fidelity data finds that one in three 401(k) investors has cashed out of his or her plan before reaching age 59½, often when changing jobs.

Significant consequences

For many, cashing out a 401(k) seems like a relatively easy way to solve a short-term cash crunch, whether it's due to temporary cash-flow problems created by the loss of a job, or simply paying down a credit card or covering an emergency home repair. But while doing so may not seem like a big deal, especially if you have a small balance, over a long period of time, the consequences of cashing out can be significant.

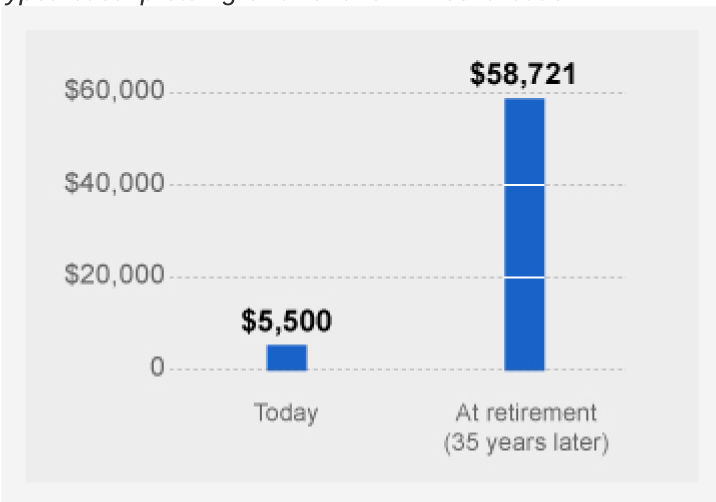
"Once you withdraw those savings, they're gone—and they can be very difficult to replace," says Ken Hevert, senior vice president of retirement products at Fidelity. "While it can be pretty tempting to cash out your 401(k) and use the money to pay off a car or your credit card bill, you may want to think twice before doing so, and weigh the impact of that decision." The power of tax-advantaged accounts such as a 401(k) is that they allow for pretax contributions to compound without taxes eroding that growth. Over time, earnings can generate their own earnings, helping you accumulate more money than you would in an ordinary taxable account.

Younger investors who cash out lose that opportunity, potentially setting their retirement savings back considerably. The average cash-out amount for those changing jobs under age 40 is $14,300, according to a Fidelity study on 401(k) participants.

Older 401(k) investors who choose to cash out may be eliminating a key part of their retirement income picture. The older a 401(k) investor is when withdrawing assets—and therefore subjecting those assets to taxes and potential penalties—the less likely he or she may be to generate a sustainable income in a retirement that could last 25 years or more.

Exhibit 1: Why every year counts

Hypothetical pretax growth of one IRA contribution



This hypothetical example assumes the following: (1) one $5,500 IRA contribution made on January 1, (2) an annual rate of return of 7%, and (3) no taxes on any earnings within the IRA. The ending values do not reflect taxes, fees or inflation. If they did, amounts would be lower. Earnings and pretax (deductible) contributions from a traditional IRA are subject to taxes when withdrawn. Earnings distributed from Roth IRAs are income tax free provided certain requirements are met. IRA distributions before age 59½, may also be subject to a 10% penalty. Systematic investing does not ensure a profit and does not protect against loss in a declining market. Consider your current and anticipated investment horizon when making an investment decision, as the illustration may not reflect this. The assumed rate of return used in this example is not guaranteed. Investments that have the potential for a 7% annual rate of return also come with risk of loss.

Whether you need $3,000 or $30,000, when you dip into your 401(k) or IRA, the impact can have long-term effects on your savings. Take a look at the hypothetical example (Exhibit 1), which illustrates how much one pretax $5,500 contribution could grow when invested through an IRA for 35 years.

The consequences of cashing out are the same whether you do it because you're switching jobs or because you've run into temporary financial trouble and need cash immediately. If you run into financial trouble, you can apply for a hardship withdrawal from your 401(k) (if the plan offers it), but in many cases you must take a loan before you can take a hardship withdrawal.

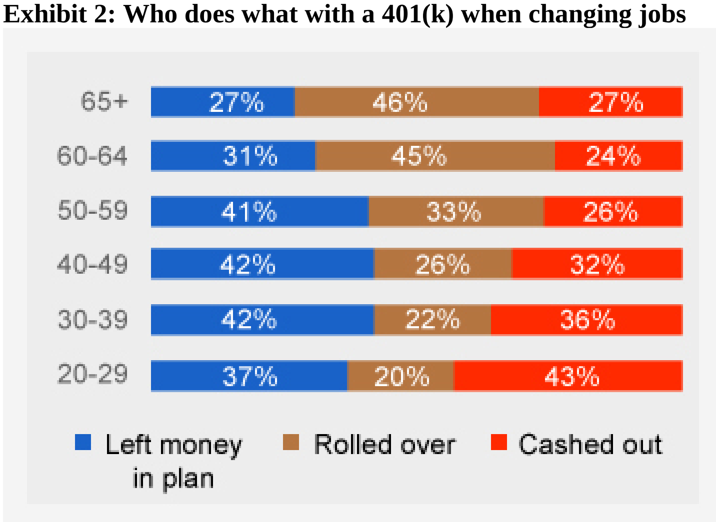
If you qualify for a hardship withdrawal and take one, you will owe ordinary income taxes and unless you qualify for an exception, you will owe an additional 10% penalty. Taking out a 401(k) loan avoids the taxes and penalties. But you'll have to pay yourself back, with interest. And since your investments will be liquidated to fund the loan, if the market shoots up you'll miss those gains. Plus, if you lose your job, many *employers require that you pay back the outstanding balance on the loan, especially if you are closing the 401(k) account.*

There also is an immediate cost to cashing out. For one, it can generate a large tax bill. Your plan administrator typically automatically withholds 20% of your balance and sends it directly to the IRS to cover the taxes you may need to pay on that withdrawal. "That means you just gave the IRS a huge chunk of the money you've been saving for years," says Hevert. "That's money you're no longer saving for retirement."

In addition to federal and state income tax, investors younger than 59½ who cash out may have to pay a 10% early withdrawal penalty. The potential result: Cashing out $50,000 in 401(k) savings may leave just $35,000 in cash after 20% withholding and a 10% early withdrawal penalty.

As Exhibit 2 shows, cashing out of a 401(k) occurs with greater frequency among younger savers.

Exhibit 2: Who does what with a 401(k) when changing jobs



Fidelity data based on the analysis of 900,000 terminating participants in workplace plans; based on 12/31/13 data. Because of rounding, figures might not total 100%.

Alternatives to cashing out

Fortunately, there are easy alternatives to liquidating your 401(k) that keep your savings intact—and, potentially, growing. If you've left a job and are considering what to do with your 401(k), here are the options:

A traditional IRA rollover. *In both traditional 401(k) and IRA accounts, contributions and earnings can grow tax free until you begin making withdrawals, when you'll pay income tax on those distributions.*

The rollover process is relatively easy—but every plan has different rules and the process can vary. Be sure to sure to request a direct rollover, whereby a check is made payable directly to your IRA provider. "The benefit of a direct rollover is that you won't face taxes or penalties," says Hevert.

You can also choose to do an indirect rollover, in which a check is made payable to you. However, in this case it's up to you to make sure the money finds its way to a tax-advantaged account such as a traditional or Roth IRA. When you cash out your plan in an indirect rollover, your 401(k) administrator may withhold 20% of your account balance. You may need to come up with that 20% out of your own pocket to put the full amount of your 401(k) balance into your IRA. Otherwise, the IRS may categorize the difference between your plan balance and your rollover contribution as a withdrawal—even though they actually have possession of that money in the form of withholding.

This process can be complicated, and any missteps may trigger penalties and taxes. For example, if you don't deposit the money into a tax-advantaged account within 60 days, it may be taxed as a withdrawal. "With an indirect rollover, it's up to you to prove at tax time that you did everything right," says Hevert. "With a direct rollover, you don't have to deal with that."

A Roth IRA rollover. *You may choose to roll your 401(k) directly into a Roth IRA to take advantage of the tax-free growth and withdrawals offered by these accounts. That move may trigger a sizable tax bill: You'll generally owe taxes on the 401(k) amount you convert to a Roth if you made only pretax contributions to the 401(k).*

Say you have $100,000 in a 401(k). Rolling the money into a Roth IRA may trigger a tax bill of up to $25,000 if you're in the 25% tax bracket. In that case, it's a good idea to pay the tax out of your own savings rather than dipping into your tax-advantaged retirement savings. "After all, you want to keep as much of your retirement savings intact as possible," says Hevert.

A Roth conversion may make sense for people who expect to face higher taxes in retirement. But there are other factors to consider, such as the other accounts you hold and your individual retirement goals.

Consider meeting with a financial advisor or your tax professional to discuss the short- and long-term pros and cons of rolling your 401(k) savings into a Roth IRA.

Stick with a 401(k). *Leaving a former employer doesn't necessarily mean you have to leave that company's retirement plan. Many plans allow former employees to leave their 401(k) account active even after they leave the company.*

Keep in mind that you won't be able to make new contributions to that plan or benefit from any employer matches. But your money will still enjoy the tax-deferred growth in that plan. Check with your plan administrator to learn more about the rules, fees, and expenses. For example, many plans require that accounts smaller than $5,000 be cashed out or rolled over.

Another option is to roll your old plan balance into your new employer's plan. Doing so can make it easier to keep track of your retirement savings. Before choosing this option, review your new plan's fees, expenses, and investment options and compare them with your old plan and those in an IRA.

Consider the following factors when deciding whether to keep your savings in a 401(k) or roll the funds into an IRA.

- **Fees and Expenses.** *Compare the underlying fees and expenses of the investment options in your old and new plans with those in the IRA. Some plans offer participants access to lower-cost or plan-specific investment options. Also, consider any fees charged by the plans, such as quarterly administration fees. Those should be compared with any fees that may be accessed in the IRA. Each IRA provider's fees are different, so it is important for people to look carefully at the provider. Examples include annual fees that may be charged at the account level, fees associated with the investments, and any fees associated with services being performed by the broker-dealer.*
- **Investment options.** *In general, 401(k) plans offer a limited menu of funds, while IRAs offer broad access to mutual funds and individual securities. Do-it-yourself investors may appreciate choosing from a larger universe of investments, while others may prefer the ease of choosing from a smaller menu.*
- **Liquidity and security.** *Keeping money in a 401(k) may protect your savings from certain creditors. At the same time, you may have more access and flexibility in an IRA when you need to withdraw money. For example, some 401(k) plans may not allow a partial withdrawal. Be sure you understand the rules of your 401(k) plan, as each plan can vary.*

If you decide to leave money in your old 401(k), make sure you keep your personal records—from beneficiaries to contact information—updated with the plan administrator. "You want to make sure you don't leave your money there and forget about it," says Hevert.

Whether you choose to move your old 401(k) to an IRA or a new 401(k), or just keep it in your old plan, the key is keeping your savings intact and benefiting from the tax-advantaged growth these plans allow.

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