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Six Potential 401(k) Rollover Pitfalls

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You're about to receive a distribution from your 401(k) plan, and you're considering a rollover to a traditional IRA. While these transactions are normally straightforward and trouble-free, there are some pitfalls you'll want to avoid.

1. Consider the pros and cons of a rollover

The first mistake some people make is failing to consider the pros and cons of a rollover to an IRA in the first place. You can usually leave your money in the 401(k) plan if your balance is over $5,000 (at least until the plan's normal retirement age, typically 65). And if you're changing jobs, you may also be able to roll your distribution over to your new employer's 401(k) plan.

- Though IRAs typically offer significantly more investment opportunities and withdrawal flexibility, your 401(k) plan may offer investments that can't be replicated in an IRA (or can't be replicated at an equivalent cost).
- An IRA may give you more flexibility with distributions. Your distribution options in a 401(k) plan depend on the terms of that particular plan, and your options may be limited. However, with an IRA, the timing and amount of distributions are generally at your discretion (until you reach age 70½ and must start taking required minimum distributions in the case of a traditional IRA).
- 401(k) plans offer virtually unlimited protection from your creditors under federal law (assuming the plan is covered by ERISA; solo 401(k)s are not), whereas federal law protects your IRAs from creditors only if you declare bankruptcy. Any IRA creditor protection outside of bankruptcy depends on your particular state's law.
- Required minimum distributions from traditional IRAs must begin by April 1 following the year you reach age 70½. However, if you work past that age and are still participating in your employer's 401(k) plan, you can delay your first distribution from that plan until April 1 following the year of your retirement (if you own no more than 5% of the company).
- 401(k) plans may allow employee loans (IRAs can not allow loans).
- Most 401(k) plans don't provide an annuity payout option, while some IRAs do.

2. Not every distribution can be rolled over to an IRA

For example, required minimum distributions can't be rolled over. Neither can hardship withdrawals or certain periodic payments. Do so and you may have an excess contribution to deal with.

3. Use direct rollovers and avoid 60-day rollovers

While it may be tempting to give yourself a free 60-day loan, it's generally a mistake to use 60-day rollovers rather than direct (trustee to trustee) rollovers. If the plan sends the money to you, it's required to withhold 20% of the taxable amount. If you later want to roll the entire amount of the original distribution over to an IRA, you'll need to use other sources to make up the 20% the plan withheld. In addition, there's no need to taunt the rollover gods by risking inadvertent violation of the 60-day limit.

4. Remember the 10% penalty tax

Taxable distributions you receive from a 401(k) plan before age 59½ are normally subject to a 10% early distribution penalty, but a special rule lets you avoid the tax if you receive your distribution as a result of leaving your job during or after the year you turn age 55. But this special rule doesn't carry over to IRAs. If you roll your distribution over to an IRA, you'll need to wait until age 59½ before you can withdraw those dollars from the IRA without the 10% penalty (unless another exception applies). So if you think you may need to use the funds before age 59½, a rollover to an IRA could be a costly mistake.

5. Learn about net unrealized appreciation (NUA)

If your 401(k) plan distribution includes employer stock that's appreciated over the years, rolling that stock over into an IRA could be a serious mistake. Normally, distributions from 401(k) plans are subject to ordinary income taxes. But a special rule applies when you receive a distribution of employer stock from your plan: You pay ordinary income tax only on the cost of the stock at the time it was purchased for you by the plan. Any *appreciation* in the stock generally receives more favorable long-term capital gains treatment, regardless of how long you've owned the stock. (Any additional appreciation after the stock is distributed to you is either long-term or short-term capital gains, depending on your holding period.) These special NUA rules don't apply if you roll the stock over to an IRA.

6. And if you're rolling over Roth 401(k) dollars to a Roth IRA ...

If your Roth 401(k) distribution isn't qualified (tax-free) because you haven't yet satisfied the five-year holding period, be aware that when you roll those dollars into your Roth IRA, they'll now be subject to the Roth IRA's five-year holding period, no matter how long those dollars were in the 401(k) plan. So, for example, if you establish your first Roth IRA to accept your rollover, you'll have to wait five more years until your distribution from the Roth IRA will be qualified and tax-free.

Caution: *When evaluating whether to initiate a rollover from an employer plan to an IRA always be sure to (1) ask about possible surrender charges that may be imposed by your employer plan, or new surrender charges that your IRA may impose, (2) compare investment fees and expenses charged by your IRA (and investment funds) with those charged by your employer plan (if any), and (3) understand any accumulated rights or guarantees that you may be giving up by transferring funds out of your employer plan.*

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