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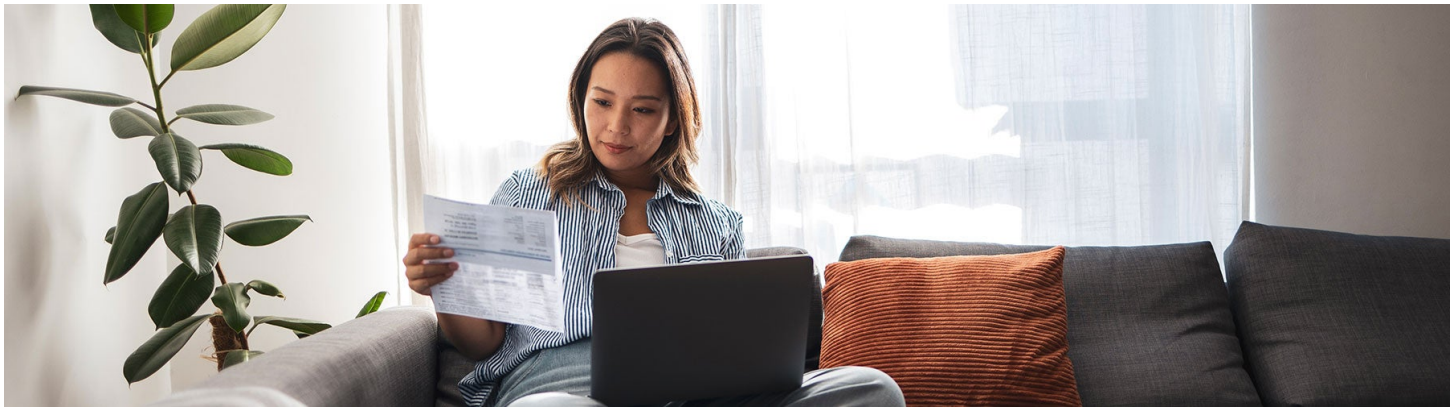

Know Your 401(k) Options

You may cash out the balance of your vested assets, roll them over, or leave them in the plan. While these options are generally available for all qualified retirement accounts, this article focuses on 401(k) plans.

Understanding Vesting: A Key to Your Benefits

Vesting refers to the process of earning ownership of assets over time. Vesting is an important concept because any contributions that are not vested are forfeited. Depending on your plan's vesting schedule, it may be optimal to wait until you are fully or nearly vested before making a change .

The vested balance of your 401(k) plan is the portion of your account that always belongs to you. Regardless of how or why you leave your job, your vested balance is yours to take. It includes your pre-tax, after-tax, and Roth contributions, as well as any investment earnings on those contributions. For employer contributions, the amount you can roll over depends on your plan's vesting schedule.

There are several types of vesting schedules.

- Under *cliff vesting*, an employee becomes fully vested after a specified period—for example, three years.
- *Graded vesting* allows employees to gain ownership gradually according to a schedule, such as 20 percent per year until fully vested.
- Some plans offer *immediate vesting*, meaning employees gain ownership of all contributions as soon as they are deposited.
- When an employee reaches the plan's full retirement age, they are considered fully vested.

Cashing Out After Leaving Your Job

Some people consider cashing out their 401(k) when leaving a job to cover immediate cash-flow needs. However, it is usually best to avoid dipping into retirement funds unless absolutely necessary. Withdrawals from these accounts are typically subject to ordinary income tax, except for amounts contributed after tax or to a Roth 401(k). If you separate from service before age 55, and you're younger than 59 ½, withdrawals are also subject to a 10 percent early-withdrawal penalty in addition to income tax.

Stay Invested

If your account balance in your company's retirement plan exceeds $5,000, you generally have the option to leave the money in the plan. Otherwise, your employer may require you to cash out the balance. Under the SECURE 2.0 Act, the maximum legal limit for mandatory distribution is $7,000. Leaving money in your former employer's plan is often the most convenient option, especially if you are not ready to move the funds or are unsure how to allocate them.

Investments left in an employer's plan will continue to grow tax-deferred until you begin taking withdrawals. Even if you do nothing, you retain the right to roll over the funds at any point in the future.

One of the main reasons to leave your 401(k) in place is the cost. Larger employers often negotiate lower fees, which may be less than those charged by other investment vehicles. In addition, leaving money in the employer's plan provides many of the same benefits you had as an active employee, such as greater protection from creditors.

Roll it Over

There are two main rollover options. You can roll your money into your new employer's plan and to an individual retirement account (IRA). The preferred method is a *direct rollover*, in which funds are transferred directly to the new custodian. Direct rollovers have specific advantages, including avoiding the mandatory 20 percent withholding on the taxable portion of the account. Employers are required to allow direct rollovers to IRAs or another employer's 401(k) plan.

The other option is a *60-day rollover*, also known as an *indirect rollover*. In this case, you receive the funds and have 60 days to deposit them into a new retirement account. With an indirect rollover, the employer must withhold 20 percent of the taxable amount, which you can reclaim when you file your tax return—if you deposit the full amount within the 60-day window.

Which one makes sense largely depends on your goals. Consider these questions:

- How do you plan to manage your investments?
- How would loan and withdrawal provisions impact or benefit you?
- Is minimizing costs a priority for you?
- What investment options does your new plan offer?

Why Roll to an IRA

If you want to maximize your investment options, an IRA is often the best choice. IRAs are not limited by the number of investment options, and funds can be moved between different custodians. This flexibility allows for a variety of active management styles and greater diversification. You can also directly manage the account and select investments that suit your preferences.

IRAs offer more flexibility regarding distributions because they are not governed by employer plan rules; instead, withdrawals are at the individual's discretion. Generally, pre-tax dollars are rolled into a traditional or rollover IRA, which remains tax deferred. After-tax dollars are rolled into a Roth IRA, where qualified withdrawals are tax free.

Why Roll to Your New Employer's 401(k) Plan

A 401(k) generally offers greater protection than an IRA. Under the Employee Retirement Income Security Act (ERISA), funds in an employer-sponsored retirement account typically cannot be seized by creditors.

If you need to borrow money, a new employer's 401(k) may allow for this through a *loan provision*. IRAs, on the other hand, do not permit loans; funds can only be accessed through a distribution. To determine whether your plan offers loan provisions, consult 401(k) plan documents.

If you are still working past the required minimum distribution (RMD) age and own no more than 5 percent of the company, you may be able to postpone your first distribution until the year after you retire.

Another reason to consider switching to a new employer's plan is cost. The new plan may offer lower investment fees than your current plan, which can make a significant difference over time.

Address Your Outstanding Loans

Be sure to repay any outstanding loans from your plan. Otherwise, they will be treated as taxable distributions. If you leave your job, you generally have 60 days to repay the loan to avoid taxes and penalties.

Aligning with Your Long-Term Financial Goals

When deciding how to manage a 401(k) from a previous employer, your choice should align with your long-term financial goals.

Key considerations include surrender charges imposed by plans, comparing investment fees and expenses, and understanding the rights you give up when transferring funds in or out of employer-sponsored plans.

Source: IRS

Resource by the CAPTRUST wealth planning team

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