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Your 401k Profit Sharing Plan: What to Do When You Change Jobs

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The COVID-era has ushered in a wave of changes on many fronts. Over the last year many industries were forced to enact extensive layoffs such as banks, commercial real estate, and retail, while other industries have hired and grown such as information technology and e-commerce. Widespread shutdowns have led to technological efficiencies that have made work-at-home a very lucrative option for employees. The demand for work-at-home could lead people to new jobs that offer this option permanently. All in all, many jobs have been lost, many jobs have also been gained, and the demands of employees are changing. Now, what does this have to do with your 401K?

When you change jobs, typically you are so busy contemplating all the changes associated with your new position that you probably never thought about what to do with your 401k or profit-sharing plan that you had at your previous job. Do not worry, you have time, and you have choices.

Once you have made the decision to change jobs, the most important question facing you is what to do with your 401k and profit-sharing money. A common mistake made by people changing jobs is that they do not understand the consequences of mishandling their 401k and profit-sharing plans. Far too many people end up cashing out their retirement savings when they change jobs and use it for something else. Not only do they harm their future retirement, but they also end up paying a great deal of penalties and taxes which oftentimes defeats the purpose of the job change, greater income!

Perhaps a simple example will highlight the ramifications of not handling your 401k plan correctly. Let us assume you have $100,000 in your 401k/profit sharing plan. Instead of establishing a rollover into another tax deferred plan, you decide to cash out and buy a new car, wardrobe, and throw a party for yourself. Your 401k Plan Administrator will be required to withhold 20% for taxes (as required by the IRS), so you will receive a check for $80,000. Further, come April 15th, when tax filings are due, you will be surprised to find out that if you are under 59 ½ years old, you will have to pay a 10% early withdrawal penalty or, in this example, another $10,000. You have just seen your tax deferred account shrink from $100,000 to $70,000. If you are in a tax bracket greater than 20%, you will also owe the difference between what was withheld and your tax obligation at your marginal tax rate. Note, at the time of this writing (March 2021), debates are taking place in the political arena regarding higher personal income taxes. If these materialize, the penalties associated with a misguided decision will be worse.

So, now that I have your attention, what options do you have to ensure a seamless tax-free transfer of your retirement assets? You basically have three options:

1) **Leave it alone.**

Advantages - This is the easiest option. Leaving assets with your old employer requires no action on your part. If you are satisfied with the performance of the investments, low plan fees, and administration of the plan, this is a very simple solution.

Disadvantages - The primary pitfall here is that if you adopt the plan at your new company, you will now have multiple deferred accounts to manage. Not only will this become time consuming, but you run the risk of improperly allocating investments and creating a portfolio that fails to satisfy your retirement objectives. You will also be subject to the fees and investment options established under the old plan and these could change at any time. Further, you will not have any professional guidance to design, monitor and implement changes as market conditions and your personal and family situations change.

2) **Roll the assets into your new employer 401k**.

Advantages - This is the option many professionals choose when they change jobs. However, this can be a bit tricky but is probably worth exploring if your new plan is attractive and allows you to roll previous employer plan assets into your new plan. Sometimes, there is a waiting period before you can roll assets into your new plan. If there is a waiting period, consider leaving the assets at your old plan until you are eligible to move the assets. Many employers allow ex-employees to keep their 401k accounts active for an extended period. When the waiting period is over, make sure you do not take a personal distribution as your old employer will automatically withhold 20% even though your intent is to give it to your new employer. You will want to have the old Plan Administrator roll the assets into the new plan via a "Direct Rollover". Your current Plan Administrator will guide you through the execution of a Direct Rollover. This will save you penalties ***and*** a great deal of aggravation.

Disadvantages - The principal drawback to rolling the 401k over to your new employer is that you are limited to your new plan's investment options. This can be problematic if the plan has limited options, poor performing options, investments with high expense ratios or a plan with a representative that provides a limited scope of advisory service or inappropriate recommendations. Further, 401k plans are linked to your employer's company, the decisions made by in-house management may not always be in your best interest. For instance, if your employer decides to modify investment selections or investment providers, the changes may be unfavorable to you. Your priorities as an investor/future retiree are often not prioritized when you have a 401k plan. Seeking counsel from a registered investment professional who can provide an objective overview would be worth your time.

3) **Roll your assets into an IRA.**

Advantages - This is an option many employees exercise when they leave their old companies. Over time, people change jobs several times. Along with this comes the possibility that several 401k and profit-sharing plans are rolled into the last employer's plan. While I noted above that each one of these rollovers can be tricky, the process also becomes increasingly risky as larger asset balances are left unmanaged and exposed to market volatility as you endure the waiting period.

The biggest advantage of a 401k profit sharing IRA rollover is that you always have control of your investment regimen and options. This is important because your personal and retirement needs will change over time and your asset allocation should change along with these. With an IRA you can invest in a broad array of investment instruments and options such ETF's, mutual funds, separately managed accounts, real estate, partnerships, private equity, franchises, and more. Further, the personal advice and consultation is especially important during periods of uncertain economic times and volatile market environments.

Finally, it is worth knowing that once you roll your 401k into an IRA, it is not final; you may be able to roll it into a 401k later under certain circumstances. The other important advantage of rolling into an IRA is that you maintain flexibility on designated beneficiaries.

Disadvantages – The only drawback of having an IRA which is designed and monitored by your designated investment advisor is a fee. The fees typically are comparable with the underlying costs you would pay in a 401k profit sharing plan and can oftentimes be significantly less. There is a host of inexpensive asset class vehicles that are offered at a very low cost (expense ratios) that when combined properly in a well-designed plan can actually deliver better returns, lower risk at a lower cost. Yes, there is a cost, but ***this is a win-win for the investor!***

While each person has different propensities for risk, goals, and objectives for their retirement assets, it is especially important to carefully evaluate all options available to you. I discussed the problem with a cash distribution. Yes, the penalties and taxes seem to be harsh, but some individuals do need the assets to satisfy other obligations irrespective of cost. I respect that decision. For others, there are other viable solutions to maintain a tax deferred status of your retirement account. The drawback of 401k profit sharing plans is that, over time, the accounts become quite large and as you approach retirement, each contribution becomes more meaningful as you are closer to the day you will need the asset. 401k's do not have personal investment counselors with them. In that spirit, you are on your own.

However, The Department of Labor (DOL) rules that firms advising 401(k) plans and plan participants are required to: make prudent investment recommendations without regard to their own interests, or the interests of those other than the customer; charge only reasonable compensation; and make no misrepresentations to their customers regarding recommended investments. This should help you, the 401k participant, yet it is always prudent to seek professional advice to evaluate and align all of your family investments.

You can stay close to your retirement goals by retaining proper guidance in the initial set up of your plan investments and revisiting your performance and positions on a regular basis. This is very important given the degree of market volatility across all global asset classes and the possibilities for higher tax rates in the future.

Please give me a call if I can provide any additional guidance. I can be reached at 630.341.9090.

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