Top 7 Reasons to Roll Over Your 401(k) to an IRA

The benefits of rolling over your 401(k) when you leave a job

Whenever you change jobs, you have several options with your 401(k) plan account. You can cash it out, leave it where it is, transfer it into your new employer's 401(k) plan (if one exists), or roll it over into an individual retirement account (IRA).

Forget about cashing it out—taxes and other penalties are likely to be staggering. For most people, rolling over a 401(k)—or the 403(b) cousin, for those in the public or nonprofit sector—into an IRA is the best choice. Below are seven reasons why. Keep in mind these reasons assume that you are not on the verge of retirement or at an age when you must start taking required minimum distributions (RMDs) from a plan.

KEY TAKEAWAYS

- Some of the top reasons to roll over your 401(k) into an IRA are more investment choices, better communication, lower fees, and the potential to open a Roth account.
- Other benefits include cash incentives from brokers to open an IRA, fewer rules, and estate planning advantages.
- Be sure to weigh the features of your 401(k) plan, both the old employer and the new one (if they offer one), and how they compare to those offered in an IRA.

1. More Investment Choices

Your 401(k) is limited to a few planets in the investment universe. In all likelihood, you have the choice of a few mutual funds—mostly equity funds and a bond fund or two—and that's it. However, with an IRA, most types of investments are available to you, not just mutual funds but also individual stocks, bonds, and exchange-traded funds (ETFs), to name just a few.

"IRAs open a larger universe of investment choices," says Russ Blahetka, CFP, founder, and managing director of Vestnomics Wealth Management LLC in Campbell, CA. "Most 401(k) plans do not allow the use of risk management, such as options, but IRAs do. It is even possible to hold income-producing real estate in your IRA."

You can also buy and sell your holdings anytime you want. Most 401(k) plans limit the number of times per year you can rebalance your portfolio, as the pros put it, or restrict you to certain times of the year.

2. Better Communication

If you leave your account with your old employer, you might be treated as a second-class citizen, though not deliberately. It just might be harder to get communications regarding the plans (often news is distributed through company email) or get in touch with an advisor or administrator.

Most 401(k) plan rules state that if you have less than $1,000 in your account, an employer is automatically allowed to cash it out and give it to you; if you have between $1,000 and $5,000, your employer is allowed to put it in an IRA.[1]

And having ready access to information is extra important in the unlikely event something goes south at your old workplace. "I have a client whose former employer went into bankruptcy. His 401(k) was frozen for three years since the court needed to make sure there was no monkey business there," says Michael Zhuang, founder and principal of MZ Capital Management in Bethesda, MD. "During [that time], my client had no access, and he was constantly worried about losing his retirement fund."

3. Lower Fees and Costs

You'd have to crunch the numbers on this one, but rolling over into an IRA could save you a lot in management fees, administrative fees, and fund expense ratios—all those little costs that can eat into investment returns over time. The funds offered by the 401(k) plan may be more expensive than the norm for their asset class. And then, there is the overall annual fee that the plan administrator charges.

"Investors should be careful about transaction costs associated with buying certain investments and the expense ratios, 12b-1 fees, or loads associated with mutual funds. All of these can easily be more than 1% of total assets per year," says Mark Hebner, founder and president of Index Fund Advisors Inc. in Irvine, CA.

Admittedly, the opposite could be true. The bigger 401(k) plans with millions to invest have access to institutional-class funds that charge lower fees than their retail counterparts. Of course, your IRA won't be free of fees either. But again, you'll have more choices and more control over how you'll invest, where you'll invest, and what you'll pay.

4. The Roth Option

An IRA rollover opens up the possibility of a Roth account. (In fact, if yours is one of the increasingly common Roth 401(k)s, a Roth IRA is the preferred rollover option.) With Roth IRAs, you pay taxes on the funds you contribute when you contribute them, but then there is no tax due when you withdraw them (the opposite of a traditional IRA). Nor do you have to take RMDs at age 72—or indeed, ever—from a Roth IRA.[2]

If you believe you will be in a higher tax bracket or tax rates will be generally higher when you start needing your IRA money, a Roth might be in your best interest. If you're under the age of 59½, it's also a lot easier to withdraw funds from a Roth IRA than from a traditional one. There are no early withdrawal penalties for contributions, in most cases; though there are penalties due for any earnings taken out.[3]

Your 401(k) plan administrator may only permit rollovers to a traditional IRA. If so, you'll have to do that and then convert it to a Roth. It is important to note that there are various strategies for when and how to convert your traditional IRA to a Roth that can minimize your tax burden. As an example, should the market experience a significant downturn, converting a traditional IRA that is down, say 20% or more, to a Roth will result in fewer taxes due at the time of the conversion. If you plan to hold the investments until they recover, this could be an attractive strategy. There are other strategic moves you can make when considering a conversion, so it's probably best to consult with a financial adviser to weigh your options.

5. Cash Incentives

Brokers are eager for your business. To entice you to bring your retirement money to their company, they may throw some cash your way. As of February 2021, TD Ameritrade, for example, offers bonuses ranging from $350 to $2,500 when you roll over your 401(k) to one of its IRAs, depending on the amount you have to invest.[4] If it's not cash, free trades could be part of the package.

6. Fewer Rules

Understanding your 401(k) is no easy task since each company has a lot of leeway in how they set up the plan. In contrast, IRA regulations are standardized by the Internal Revenue Service (IRS). An IRA with one broker follows most of the same rules as with any other broker.

One often-overlooked difference between a 401(k) and an IRA has to do with IRS rules regarding taxes on distributions. The IRS requires that 20% of distributions from a 401(k) be withheld for federal taxes.[5] When you take a distribution from an IRA, you can elect to have no tax withheld.[6] While this option is available to you for IRA distributions, it's probably wise to have some tax withheld rather than potentially winding up with a big tax bill at the end of the year and possibly interest and penalties for underpayment.

However, you can choose how much to have withheld to more accurately reflect the actual amount you owe, rather than an automatic 20%. The benefit is that you're not depleting your retirement account faster than you need to, and you're allowing that money to continue compounding on a tax-deferred basis.

7. Estate Planning Advantages

Upon your death, there's a good chance that your 401(k) will be paid in one lump sum to your beneficiary, which could cause income and inheritance tax headaches. It varies depending on the particular plan, but most companies prefer to distribute the cash fast, so they don't have to maintain the account of an employee who is no longer there. Inheriting IRAs has its regulations too, but IRAs offer more payout options. Again, it comes down to control.

The 2021 contribution limit for those participating in a 401(k) or 403(b) plan is $19,500. This is the same contribution limit as 2020. The catch-up limit for those 50 and over also remains the same at $6,500.[7] *The 2021 limit for IRAs is $6,000, unchanged from 2020, while the catch-up limit is an extra $1,000.*[8]

The Bottom Line

For most people switching jobs, there are many advantages to rolling over a 401(k) into an IRA. That being said, a lot depends on the specifics of the 401(k) plan, both the old employer's and the new one—investment options, fees, loan provisions, etc. It also matters how these terms and features compare to those offered in an IRA, which you could establish with a brokerage or bank.

You could also have the best of both worlds. You don't have to roll all of your money into an IRA. Some of your balance can remain in your former company's 401(k) if you're happy with the returns you're receiving. You can then set up a new IRA or roll over the remainder into an existing account or a new rollover IRA. After you've done your rollover, you can contribute to both your new company's 401(k) and an IRA (traditional or Roth) as long as you don't go over your annual contribution limit.

However, depending on your income level, your ability to deduct your contribution to a traditional IRA may be limited.

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1. Internal Revenue Service. "401(k) Resource Guide - Plan Participants - General Distribution Rules." Accessed Feb. 22, 2021.
2. Internal Revenue Service. "Roth Comparison Chart." Accessed Feb. 22, 2021.
3. Internal Revenue Service. "Traditional and Roth IRAs." Accessed Feb. 22, 2021.

4. TD Ameritrade. "Open an Account Today and Get up to $2,500 Cash." Accessed Feb. 22, 2021.
5. Internal Revenue Service. "401(k) Resource Guide - Plan Participants - General Distribution Rules." Accessed Feb. 22, 2021.
6. Internal Revenue Service. "Rollovers of Retirement Plan and IRA Distributions." Accessed Feb. 22, 2021.