



WHAT HAPPENS TO YOUR 401(K) WHEN YOU LEAVE A JOB?



In the Revenue Act of 1978, there was a provision included that's purpose was to incentivize employers to provide their employees with tax deferred compensation to be saved for retirement purposes. This provision—Internal Revenue Code Section 401(k) Cash and Deferred Arrangements—went on to become what we now refer to as a 401(k) plan.

401(k) plans **quickly grew** to become one of, if not the most, popular types of employer-sponsored retirement plans in the United States. Now, countless Americans depend on the money they put into 401(k) plans to keep them financially secure throughout their retirement. What is a 401(k), though, and what happens when you leave the job that manages it? In this guide, we provide you with an overview of what a 401(k) is, how to start one, how you can transfer your money when you get a new job, and how to ensure you are doing everything you can to maximize your investment returns.



WHAT IS A 401(K)?

Simply put, a 401(k) is a company-sponsored retirement savings plan offered by U.S. employers that comes with a specific set of tax advantages. 401(k) plans were designed by the U.S. Congress in an effort to encourage Americans to save for retirement. How it works is fairly straightforward: any employee who opts in to a 401(k) plan has a predetermined percentage of their paycheck diverted and sent to an investment account. Their employer may match a portion, or all of that predetermined 401(k) contribution.

With a 401(k) plan, the employee also gets to choose among a number of investment options offered by their employer. Typically mutual funds, these investments are designed to reduce the risk of investment losses as the employee nears retirement.

Traditional 401(k) vs. Roth 401(k)

There are two types of 401(k)s— a traditional 401(k) and a Roth 401(k). What makes these two types of 401(k)s different is **the way they are taxed**. With a traditional 401(k), all employee contributions (which are deducted from gross income) are considered pre-tax. These contributions reduce taxable income, but future withdrawals from the 401(k) will be taxed.

In contrast, employee contributions to Roth 401(k)s are made with after-tax income. These employees will not see a tax deduction during their contribution years, but their future withdrawals will be tax-free.

It is important to note that not all U.S. employers offer a Roth 401(k) plan option. If an employer does have a Roth 401(k) option, an employee can pick just the Roth or just the Traditional or a mix of both. There are, however, annual limits on tax-deductible contributions no matter which option an employee chooses.



Contribution Limits

The maximum amount that an employee or employer can contribute to a 401(k) plan is adjusted periodically by the Internal Revenue Service (IRS) to account for inflation. For 2022, the limit an employee can contribute is **\$20,500 per year**. If they are over the age of 50, however, that employee can make an additional \$6,500 **catch-up contribution**.

If that employee's employer also contributes, the total contribution amount for the year cannot exceed **\$61,000**. If that employee is aged 50 or more, their adjusted limit (to account for catch-up contributions) is \$67,500.

Catch-Up Contributions

Catch-up contributions were created by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) to enable older workers—aged 50 and higher—to set aside more earnings for their retirement. Originally meant to expire on December 31, 2010, the **Pension Protection Act of 2006** ended up making these higher benefit limits permanent to help older employees reach their retirement goals.

From 2015 to 2019, employees were permitted to contribute additional elective salary deferrals up to \$6,000. As of 2022, that number has risen to \$6,500.

It is also important to note that despite the name, an employee does not need to be “behind” on their plan contributions in order to be eligible to make this additional elective deferral.

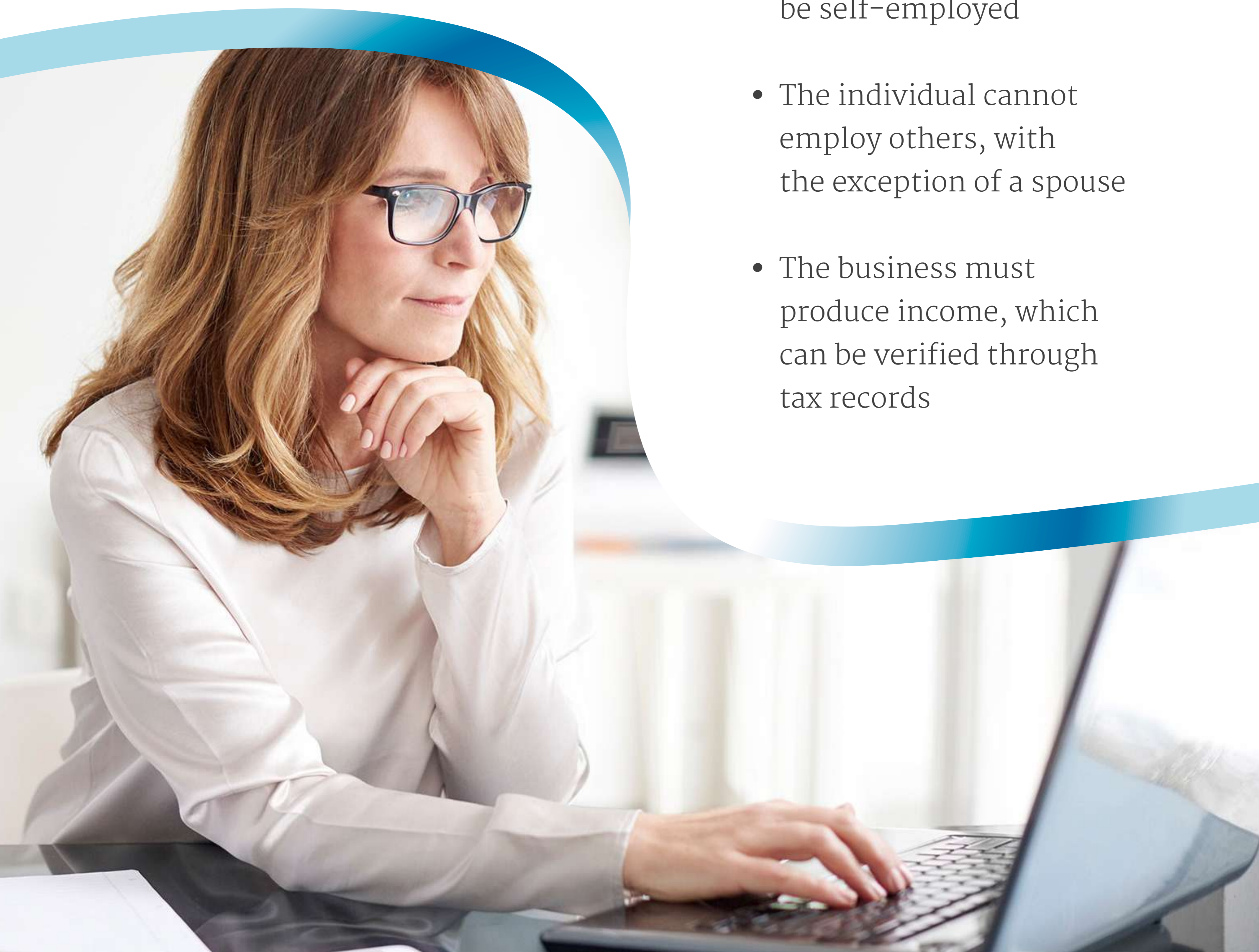


HOW TO START A 401(K)

Since quite a few companies offer 401(k) plans—with some offering to match part if not all of an employee's contributions—most individuals start their 401(k) through work. If you are self-employed, say an independent contractor or small business owner with no employees, you may be able to qualify for an independent 401(k), also known as a solo 401(k) plan.

Independent 401(k) plans, which can be created through most online brokers, enable freelancers, independent contractors, and business owners to fund their own retirement. A benefit of a solo 401(k) plan is that you can contribute to the account as both employer and employee. There are requirements, however, that must be met in order to be eligible for this type of plan:

- The individual must be self-employed
- The individual cannot employ others, with the exception of a spouse
- The business must produce income, which can be verified through tax records





401(K) INVESTMENT OPTIONS

When an individual receives a 401(k) through their employer, they typically get to choose between several investment options. Most of these investment options tend to be mutual funds that range in risk, target-date funds, foreign funds, real estate funds, and bond funds.

When an individual is choosing which funds to invest in, they will want to keep a few factors in mind:

- What are your financial goals?
- What is your risk tolerance? How will you build a portfolio that grows, but won't keep you up at night?
- How do you plan to diversify your portfolio to minimize risk and maximize returns?
- How long do you have before retirement?

These questions can sometimes be hard to answer, which is why most people opt to work with a financial advisor to help ensure they are making the right choices to meet their financial goals.

WHAT HAPPENS TO YOUR 401K WHEN YOU LEAVE A JOB?

There are four options for an employee who leaves a job where they have been contributing to a 401(k) account:

Withdrawal the Money

Unless someone has no other option or needs financial assistance immediately, withdrawing funds from a 401(k) account is typically the worst-case scenario. Not only will the money withdrawn be taxable, the person withdrawing it will also have to pay a 10% early distribution tax. The only way to avoid this additional tax is if someone is over 59^{1/2}, permanently disabled, or meets specific IRS criteria.

Roll the 401(k) Into an IRA

When someone chooses to **move their 401(k) savings over to an IRA**, they are able to avoid immediate taxes and maintain the account's tax-advantaged status. Additionally, rolling a 401(k) over into an IRA also opens the door to choose from a larger variety of investments options including stocks, bonds, CDs, ETFs, and mutual funds.



There are three ways you can rollover a 401(k) into an IRA, including:

- **Direct rollover** | An employee can coordinate with their retirement plan administrator to make a distribution payment directly to another retirement plan or to an IRA. The benefit of this rollover option is that no taxes will be withheld from the transfer amount
- **Trustee-to-trustee transfer** | If an individual is receiving their distribution from an IRA, the financial institution holding the IRA can make the payment go directly from one IRA to another IRA or retirement plan. Like a direct rollover, no taxes will be withheld from the transfer amount using this method
- **60-day rollover** | If an individual receives a distribution from their retirement plan directly, they have 60 days to deposit all or a portion of the payment amount into an IRA. Be aware, a retirement plan distribution paid out like this is subject to mandatory withholding of 20%, even if the receiving individual intends to roll it over into an IRA

The IRS has strict rules and regulations around 401(k) IRA rollovers, so it is important to research ahead of time before making any decisions. Working with a **tax professional** who has experience with 401(k) and IRA plan optimization and distribution may be the best way to avoid any unnecessary money being withheld.



Leave the 401(k) With the Old Employer

It is not uncommon for employers to permit an employee to keep a 401(k) account in their old plan indefinitely, even if that employee is leaving the company. The main drawback to this approach is that the departing employee can no longer make contributions to their account and must also stick to the predetermined investment choices.

Move the 401(k) to a New Employer

Just like an IRA rollover, an individual maintaining the account's tax-deferred status and avoiding immediate taxes. This is oftentimes the best option for individuals who don't have the time or expertise to make decisions about new investment opportunities and want their new plan administrator to help.

TAKING WITHDRAWALS FROM A 401(K)

An individual looking to withdraw money from their 401(k) plan, whether it be a traditional plan or a Roth, must be at least age 59½ **or meet other criteria** set by the IRS. If an individual does not meet these requirements, they will most likely have to pay an additional 10% early-distribution penalty tax on top of any other tax they may owe.

Once an employee has paid money into a 401(k) account, it can be difficult to withdraw that money without having to pay taxes. With a traditional 401(k), any money removed from the account will be taxed as if it is ordinary income. An employee with a Roth 401(k), in contrast, has already paid income tax on that money, and in turn will not owe any money on their withdrawal (assuming they meet qualified distribution requirements, which are certain conditions and restrictions set by the IRS.)

SAVE MORE FOR RETIREMENT BY WORKING WITH AN ADVISOR

Want to ensure you are making the right decisions for your retirement? At JL Smith, we work side by side with individuals, families, and businesses to create comprehensive financial plans geared toward meeting both short-term and long-term financial goals. Whether you need help optimizing your 401(k) or want to increase your household's lifetime benefits, JL Smith's fiduciary advisors guarantee trusted advice and service you can count on.

Have questions about your 401(k) call us at (440) 934-9181 or **schedule a complimentary consultation** on our website at www.jlsmithgroup.com.

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