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Retirement Guide

The Great 401(k) Escape

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If the offerings in your employer's plan aren't so great, put your money elsewhere.

Ritch S. Wright, now 60, doesn't plan to retire from his job as a Boeing finance director until 2014, when his youngest daughter should be finishing college. Yet earlier this year the Huntington Beach, Calif. resident rolled nearly $1 million, a big chunk of his Boeing 401(k), into an individual retirement account, using a little-known maneuver: an "in-service" distribution.

Employers and 401(k) plan administrators don't advertise this fact, but most workers 59 and a half and older, and even some younger ones, can roll over 401(k) funds while they're still working and contributing to the plan. This option isn't right for everyone. But in some cases it can provide more attractive investment choices, a better way to leave money to your kids or even a chance (new in 2008) to move 401(k) dollars directly into a Roth IRA.

The law allows workers to empty their 401(k) accounts once they hit 59 and a half. They can roll all the money into an IRA without paying tax now. Or they can take cash out, pay any ordinary income taxes due and spend what's left. The same goes for participants in government and not-for-profit savings plans similar to 401(k)s.

The law permits this, but employers don't have to permit it. Still, 70% of companies--and 89% of those with 5,000 or more employees--allow these in-service withdrawals, the Profit Sharing/401k Council of America found in a 2006 survey of 1,000 firms. So do some public sector employers; the federal government, for example, allows older workers to withdraw funds, but only once.

As for younger folks, the law permits them to get in-service distributions of money rolled over from previous 401(k)s; of employer (but not employee) pretax contributions; of employee aftertax contributions; and of account earnings. Here companies are less accommodating--only 16% allow this option, the 2006 survey found. Note that if a younger worker spends the cash, instead of rolling it over, he'll owe an extra 10% penalty on the taxable amount, just as he would if he got a "hardship" distribution from his 401(k) or took a loan from his 401(k) and switched jobs without repaying the loan.

One obvious reason to consider an in-service rollover is to escape a bum plan that has expensive or mediocre funds. Some small plans have annual fees on domestic equity mutual funds that top 2% a year. Outrageous. If you're stuck in one of those, you can chop your costs by rolling your 401(k) money into an IRA at a no-load fund company such as Vanguard, Fidelity or T. Rowe Price.

Even workers with reasonable 401(k) fund offerings, however, may want more choices. Only 14% of company 401(k)s offer a brokerage window that gives you access to a broad array of stocks, bonds and funds. A route around this blockade is to yank the money and send it into an IRA.

Another strategy: roll over part of your money. Jeffrey Bryant, a 56-year-old senior business analyst at PG&E in San Francisco, rolled part of his 401(k) into an IRA so he could invest in seven funds from Dimensional Fund Advisors, including small-capitalization and value funds; there were no comparable offerings in his company plan. He left the rest in his 401(k)'s bond and index funds, one with a rock-bottom expense of only 0.01%. a year--just one basis point. Bryant is buying the DFA funds through a fee-only financial planner at Merriman Berkman Next. So he's raising his total investment costs, even though the DFA funds are less expensive--at 0.29% to 0.74% a year--than the funds he sold off in his 401(k). Bryant is betting that with better funds and professional asset allocation and other advice, he'll come out ahead.

Not surprisingly, outside financial planners and brokers push rollovers, since it gives them more money to manage and collect fees for. Fifty-year-olds, as they near retirement and their 401(k) balances grow, want and are willing to pay for such help.

Wright will continue to invest the smaller amount he left in his Boeing 401(k) himself--he calls it his "play money." But he's handing management of his rolled-over funds to William Jordan, a financial planner at Sentinel Group in Laguna Hills, Calif. "I've reached that time in my life I need to become more conservative," says Wright, who has favored growth and international funds. His new objective: "Making sure I can eat all the way through retirement and making sure there is something left over for the kids."

Jordan plans to increase Wright's fixed-income allocation and construct a ladder of individual bonds with different maturity dates. In his 401(k), which doesn't let him buy individual securities, Wright's only choice would be a bond fund, whose maturity structure cannot be customized.

There are a few other reasons to consider an in-service rollover. One is a provision, new this year, that allows you to roll 401(k) money directly into a Roth IRA, where future earnings will be tax free. If your plan administrator is ready to cut a separate check with just your aftertax contributions, it appears (although the Internal Revenue Service hasn't issued rules on this) that you can roll that money directly into a Roth IRA and pay no taxes on the conversion. For now Roth rollovers are allowed only for those with family incomes of $100,000 or less. That income restriction is due to end in 2010.

Another reason to do an in-service rollover pops up if you're leaving retirement money to your kids or grandkids instead of to a spouse. A spouse who inherits either a 401(k) or an IRA can roll it into his or her own IRA with all the flexibility that an IRA offers its original owner. Kids, grandkids or other nonspousal heirs who inherit an IRA can't do that, but they can keep the money in an "inherited" IRA, potentially stretching out withdrawals and tax deferral for decades. Under a 2006 law change, kids and other nonspousal heirs can roll 401(k)s into inherited IRAs--but only if the employer permits it, which not all do. If yours is balky, get the money out now and put it into an IRA that won't have any employer getting in the way of your family's needs. (A nonspousal heir can't Rothify an inherited IRA.)

Before you rush to roll, consider some advantages to a 401(k). In a good plan the fees, particularly for index funds, may be extremely low. If you retire early, you can make penalty-free withdrawals from a 401(k) at age 55; with an IRA, you generally have to wait until you're 59 and a half. In a pinch you can take a loan (of up to $50,000) from your 401(k) but not your IRA.

Plus, if you hold your employer's stock in your 401(k), you may be eligible for a tax break at retirement. If you transfer that stock to a taxable account, you'll pay ordinary income tax (at rates of up to 35%) only on what the stock was worth at the time it was put into your 401(k). Any further appreciation won't be taxed until you sell the stock and then only at the long-term capital gains rate--which now tops out at 15%. There are some really crazy rules here that determine whether you're eligible for this break. So if you've got your employer's stock in your 401(k), check with your plan administrator and your tax adviser.