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Life events

By the numbers

- The IRS requires an employer to **withhold 20% federal tax** from the money when an employee takes a 401(k) distribution in cash.
- Employees younger than 59½ **may be penalized an additional 10%** by the IRS. If you separate from service after age 55, this penalty does not apply.
- When employees roll their assets into other qualified plans or IRAs, **they are not penalized.**

401(k) plan choices for job changers

When you change jobs, it can be for any number of reasons. Regardless of what triggers a job change, however, most experts agree such an event creates a perfect opportunity to reevaluate your long-term financial plan. After all, this is one of the few times — aside from actual retirement — that you will be faced with making decisions about what to do with the money you have been saving in your 401(k) plan. Reviewing your situation at this transitional time cannot only help you feel better about your new job, it can get you refocused on your long-term savings plan.

When you leave an employer, you are likely to have several options. You may

- **stay invested** in your previous employer’s plan if your balance meets the plan’s minimum
- **invest your assets** in the new employer’s plan
- **take your distribution** in cash
- **roll over assets** to an IRA

First and foremost, you should know that by taking a cash distribution from your 401(k) plan, you will incur a tax liability and

possible penalties that will significantly lessen your after-tax payout. Although taking that distribution in cash to pay off bills or to start a new business venture may seem like a good idea, it ultimately will leave you with a smaller nest egg. By leaving your investments in your old employer’s plan on the other hand, you may be limiting your investment choices and distribution options.

As you can see, there are many pros and cons associated with each option. Following is just a summary of those options. Your financial advisor will be able to help you make the right decisions based on your individual situation.

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Key points

When you leave a job, you can

- stay invested in your current plan
- roll assets into another qualified plan with your new employer or an IRA
- take a 401(k) distribution in cash

While making choices,

- look at the whole picture of your current plan
- understand all the requirements of a new plan
- be aware of any financial penalties in taking a cash distribution

If you do a direct rollover,

- you will have no exposure to taxes or penalties
- assets can potentially continue to grow tax deferred
- make sure the new plan or IRA offers diversified choices

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Choice 1 — Stay invested in your previous employer's plan

Unless your balance is less than the plan's cash-out minimum, you generally will be able to leave the money right where it is. You should ask yourself the following questions:

- Am I **happy with my investment choices**?
- Am I **limiting my access** to these assets now that I am no longer employed there?
- Do I have any **after-tax contributions** in this plan?

On the plus side, the existence of after-tax contributions may be the most compelling reason to stay in your previous employer's plan, since it is an easy way to maintain tax deferral of earnings on those contributions. Although after-tax contributions can be rolled over to an IRA, this creates recordkeeping and reporting complications you may not want. You might also be satisfied with the performance of the investments within your previous employer's plan — investments that may not be available to you in a new plan.

On the minus side, you might be forced to give up certain privileges you enjoyed as an employee, making access to the assets more difficult in the event of an emergency. Before you decide to move your nest egg, it is important to look at the entire picture, including accessibility issues and any changes you might have made to your financial strategy. It is quite possible that, despite there being several advantages to leaving the money

where it is, your previous employer's plan may not be in line with your revamped financial plan.

Choice 2 — Invest your assets in your new employer's plan

Let's say you have looked over your new employer's retirement plan and, having decided it does fit your long-term strategy, you choose to move your assets. Doing so will ensure that your retirement assets remain tax deferred. It also will keep your assets in a centralized location.

That is the good news. The bad news is that your new employer may not allow you to participate in its plan right away, as some companies require new employees to complete a minimum of six months of service before enrolling. Some plans do allow new employees to make rollover contributions to the plan even though they have not met the eligibility requirements to start making salary deferral contributions. If the plan does not allow immediate rollovers, this may pose a problem if you are looking to transfer assets immediately upon leaving your previous employer.

Therefore, while you are waiting out the time requirement to place pretax assets into your employer's new plan, you might consider converting your money into a rollover IRA (see Choice 4).

Choice 3 — Take your distribution in cash

Let's assume you have saved diligently and are well on your way to establishing a nice nest egg for

retirement. However, the possibility of taking that money in cash when you change jobs is enticing. The new kitchen, along with the luxury import car, would be excellent additions to your everyday life. But before you have a check for the entire distribution (or even part of it) made out to you, there are a few things you should keep in mind.

By having the check made out in your name, you could be handing over to the government almost a third of your account. When a distribution is not directly rolled over into an IRA or another qualified plan — as is the case when it is taken in cash — the employer automatically withholds 20% of the money for federal taxes. If you are younger than age 59½, you may be hit with an additional 10% federal tax penalty. However, this penalty tax does not apply if you separate from your service after age 55. To make matters worse, taxpayers in the 28% bracket or above will have at least another 8% taken from the now-dwindling nest egg. In short, you may compromise your strategy of building for a comfortable retirement.

If, after taking the distribution in cash, you decide you would like to roll it into another plan or IRA, you can still do so. However, you must reinvest the assets within 60 days of the date you received the distribution to avoid taxation.

The bottom line is that, before taking the cash, you should think long and hard about all the hard work and sacrificing you have done, only to now



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be penalized and taxed. And if you are still tempted, a meeting with your financial advisor will likely quell any remaining doubts you might have about the effect even a small cash distribution could have on your retirement income.

Choice 4 — Roll your assets into an IRA

Of the four distribution choices discussed here, rolling over assets to an IRA may offer the most investment flexibility and less exposure to taxes and penalties than taking cash.

A direct rollover is a lump-sum distribution that is transferred into an IRA or other qualified plan. When changing jobs, you should request a check for the amount you wish to roll over from your 401(k) and have it made out to the trustee of the new plan or IRA (qualified plans include 401(k), 403(b), pension, and profit sharing plans). Please note that unless you are taking the distribution in cash, the check should never be made out to you.

Once you have completed the rollover, you can leave your money in the IRA or you could decide later to roll it over to a new employer’s plan when you are eligible to participate in it. Keep in mind, however, that there may be fees associated with establishing and closing the IRA and that you are allowed only one rollover per IRA in a 12-month period.

The key is to roll your assets into a vehicle that offers a wide variety of investment choices that meet your financial objectives. Among the most popular choices for traditional IRAs, for example, are mutual funds. Allocating IRA assets among mutual funds offers investors professional, full-time management, diversification (to help reduce risk), and the flexibility to move from one fund to another as investment needs change. Keep in mind, however, that the principal value and return of mutual funds will fluctuate with changes in market conditions, and your investment may be worth more or less than you originally paid upon withdrawal.

Take your time and invest wisely

What you do with your 401(k) assets when you change jobs is an important financial decision. The best thing you can do when faced with these four choices is to think things over carefully. In most cases, you will not be required to make a decision immediately, which leaves you plenty of time to meet with your financial advisor. He or she can help you decide the best way to invest those assets to try and help maximize your income at retirement.

Resource

Internal Revenue Service

irs.gov

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