How to Keep Your Nest Egg Intact After a Layoff

By Emily Brandon
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Unexpected job loss—stressful as it is—comes with another headache: what to do about your 401(k). Without careful attention, there are plenty of taxes and penalties that could shrink your existing retirement account balance. Here is how to keep your retirement stash intact when your job is eliminated.

Find out if you are vested. All the money that you deposit into a 401(k) still belongs to you after a layoff. But you can only keep your employer's contributions if they are vested. Only about a third of 401(k) plans provided immediate vesting in 2008, which means employees can keep a 401(k) match when it is deposited, according to a Profit Sharing/401k Council of America survey. Other retirement accounts may require you to be with the company for several years before you can keep any of your employer match or gradually increase the percentage you may keep based on job tenure. Find out how much of your employer's contributions you are entitled to.

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Make your move. You have several options to maintain the tax-deferred benefits of your 401(k) when you leave a job: You can keep the money in your old employer's plan, roll it into another tax-deferred account such as an IRA, or transfer your balance into a new 401(k) when you land your next position. Transferring your old 401(k) balance to an IRA makes sense when the IRA offers better investment choices and lower expenses than your old 401(k) plan. But you may want to leave your 401(k) funds with your former employer if the company has negotiated low investment fees on behalf of employees. David Loeper, author of *Stop the Retirement Rip-off: How to Avoid Hidden Fees and Keep More of Your Money*, says savers should aim to pay 0.75 percent or less in annual fees.

Avoid transfer penalties. If you decide to move your retirement savings, have your former employer directly transfer the money into an IRA or your new employer's retirement plan. "Have the check made out to the institution where it is going instead of the check being made out to you," says IRA expert Ed Slott, founder of irahelp.com and author of *Stay Rich for Life!: Growing & Protecting Your Money in Turbulent Times*. When a check for the balance is made out to the worker, the company will withhold 20 percent for income taxes. Employees have 60 days to deposit the cash in a new tax-deferred retirement account before Uncle Sam keeps the 20 percent, and the worker may also be responsible for additional taxes. If you're under age 55, you will also have to pay a 10 percent early withdrawal penalty. The employer withholding also means you have to come up with the absent 20 percent from another source if you want to roll your entire nest egg into an IRA. For example, if you have a $10,000 401(k) balance, your former company will give you a check for $8,000. If you put only that $8,000 into a new retirement account the $2,000 will be counted as income that year and taxes and penalties may be applied.

[See 21 Ways to Cut Expenses in Retirement.]

Consider your age. IRA withdrawals before age 59½ result in a 10 percent early-withdrawal penalty. However, retirees can begin taking penalty-free 401(k) withdrawals at age 55. "If there is any possibility that you might need that money at age 57, you want to leave it in that 401(k) plan," says Kathleen Campbell, principal of Campbell Financial Partners in Fort Myers, Fla.

Leave employer stock behind. The stock of the company you work for gets special tax treatment when it is held in an employer-sponsored 401(k). "If you roll over the stock to an IRA, the deal is off forever," says Slott. When you withdraw company stock, the original cost of the shares will be taxed as ordinary income, but the appreciation of the stock is not taxed until you sell it (then it's taxed at the long-term capital-gains rate of 15 percent). If company stock is rolled over to an IRA, appreciation is taxed at the typically higher ordinary income tax rate of up to 35 percent when withdrawn from the account.

[See 10 Ways Baby Boomers Will Reinvent Retirement.]

Think before you cash out. Almost half of laid-off workers who left their job in 2008 cashed out their 401(k), according to a Hewitt Associates study of 401(k) participants who terminated employment. But early withdrawals come with a significant cost. A worker with a $5,000 401(k) balance in the 20 percent tax bracket would receive just $3,500 after taxes and penalties. "If there is any way you can avoid touching that money, I would avoid it," says Loeper. If you need to spend some of your retirement stash on necessities, at least try to avoid the 10 percent early withdrawal penalty. Both 401(k)s and IRAs can be used to pay for unreimbursed medical expenses that exceed 7.5 percent of your income without penalty. Other Uncle Sam sanctioned ways to spend an IRA, but not 401(k), balance without incurring an early withdrawal penalty include health insurance premiums after 12 consecutive weeks of unemployment, college costs, and first home expenses up to $10,000. Income tax, however, is still due on retirement account withdrawals, even when used for emergency expenses.