

Providing 401(k) Guidance to Departing Employees

A No Cost and Valuable Employee Benefit

RetirementDNA

mapping retirement & executive benefits for biotech & life sciences leaders

In today's day and age, the 401(k) plan has become the retirement planning foundation for millions of Americans. And, it's often used to fund needs much earlier than retirement – emergency cash needs, down payment on a house or even to pay for tuition. With the important role played by the 401(k) in the lives of your employees, we believe it makes great sense to help departing employees understand their options with their 401(k) accounts. Whether it be due to a downsizing, a merger followed by layoffs or an employee departing for a different opportunity, we believe there are strategic, fiduciary and financial benefits to be gained by offering 401(k) account guidance.

Before we take a look at the specific options your employees have for their 401(k) accounts, let's review the main benefits from an employer's perspective for providing educational information and guidance to your departing employees.

Strategic Benefit

Employee benefits that are deemed to be of high value while having no employer cost are impossible to pass up as you develop strategies that help you recruit and retain the best and brightest. Given the importance of the 401(k) account to your employees, any and all services and information that you can provide will be valued. Given the employer's emerging role as the "trusted adviser" in the financial lives of their employees, the litmus test for 401(k) services is that they must be accurate, unbiased and produce no profit to the employer. The bottom line is that helping employees who are departing indicates that you care about your people and sends a great message to those still on the team.

Fiduciary Benefit

The fiduciary issues associated with sponsoring a 401(k) plan are immense. There is no reason to assume any fiduciary liability for a departing employee, particularly since you and your 401(k) vendor's ability to communicate will have been removed by their departure. With proper guidance, most departing employees will likely remove their assets from the company plan.

Financial Benefit

Administrative services for your 401(k) plan may have a per employee fixed cost. Thus, any employees departing with their assets will lower your administrative expenses.

Departing Employee Options For Their 401(k) Assets

Leaving one's employer can be an emotionally trying time and usually presents some mixed emotions. Of course, emotions and money decisions rarely mix well, so providing sound guidance during an emotionally charged time is very helpful. In general, your departing employees have four choices in what to do with their assets from your company's retirement plan:

- Rollover to an IRA
- Rollover to their new employer's plan

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- Keep the assets with your company's plan
- Take the assets in cash

OPTION #1: Rollover IRA

Our number one recommendation is usually to rollover retirement assets into an individual retirement account, known as a Rollover IRA. Why is this choice usually best? Well, a Rollover IRA keeps assets growing tax-deferred while also eliminating taxes, which could eat up to 50% of their retirement assets.

If a Rollover IRA is the right choice, it's essential to get it done properly. Your employee must arrange a rollover of their assets so that the money is transferred directly from your employer plan account to an IRA. If they receive the money directly - even if they subsequently put the money into an IRA within the 60 days allowed by the IRS - 20% of their assets will be withheld for federal income taxes. This equates to 20% less money in their account growing on a tax-deferred basis for their retirement! These monies may also be subject to a 10% penalty if they are under age 59 1/2.

The Pros of a Rollover IRA

- Continued Tax-Deferred Growth. Their assets grow tax-deferred until they begin making withdrawals, usually at retirement, when they may be in a lower tax bracket.
- No Immediate Taxes or Penalties. Your employee will not owe taxes or penalties when they roll over their assets to an IRA. Without a Rollover IRA, taxes could eat up to 50% of the assets, depending on your employees tax bracket
- A Wide Universe of Investment Choices. Your employee can invest their Rollover IRA in almost every type of mutual fund or individual security to properly diversify the retirement assets.

- Control. With a Rollover IRA, your employee controls the assets. This means they can access their money if they need it. Note that taxes and penalties may apply, however, if they need to withdraw their money before age 59 1/2.

- Roth IRA Conversion Option. If your employees are eligible and if it makes sense, they can convert to a Roth IRA after completing a Rollover IRA.

- Professional Guidance. When your employee establishes a Rollover IRA with our firm, they can then utilize the guidance, strategies and assistance of full-time professionals whose sole business is helping investors reach their retirement goals.

The Cons of a Rollover IRA

- No Loans. Your employee cannot borrow against their account balance.
- Required Minimum Distributions. All retirement accounts except Roth IRAs require them to start taking withdrawals beginning at age 70 1/2.
- Early Withdrawal Penalty. Withdrawals from any retirement account taken before age 59 1/2 are generally assessed a 10% penalty by the IRS.

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OPTION #2: Transferring Their Assets To Their New Employer's Plan

If your employee has already found a new job, their new employer's plan may allow them to move their plan assets into the current plan, where their assets will continue to grow tax-deferred. Your employee will need to find out from their new employer if they can do this immediately or if they have to wait until they are eligible.

If your employee has to wait until they are eligible, probably the best strategy is to move their assets into a Rollover IRA right away and then move money into the new employer plan later when they are eligible.

The Pros of Transferring Your Assets

- Continued Tax-Deferred Growth. As was the case with a Rollover IRA, your employees assets grow tax-deferred until they begin making withdrawals.
- No Immediate Taxes or Penalties. Your employee will owe no taxes or penalties when they transfer their assets to their new company's plan.
- Convenience. Retirement assets would be in one place.
- Loans. If their new plan allows, they can borrow against their account balance, which they cannot do with an IRA.

The Cons of Transferring Your Assets

- Restrictive Investment Options. Their investment choices are limited to those offered by their new employer's plan.
- Limited Flexibility. Their control and access to their assets will be subject to the rules governing their new plan, which may restrict their ability to move, exchange, or withdraw them.

- Required Minimum Distributions. All retirement accounts except Roth IRAs require them to start taking withdrawals beginning at age 70 1/2.

- Early Withdrawal Penalty. Withdrawals from any retirement account taken before age 59 1/2 are generally assessed a 10% penalty by the IRS.

- No Professional Guidance. If they rollover their assets to their new employer's plan, they may not have investment guidance on their investment choices, asset allocation and other strategies.

OPTION #3: Leaving Their Assets With Your Plan

When your employees change jobs, you being the former employer, may offer the option of leaving their assets with your 401(k) plan.

Although we generally do not make this recommendation (see the reasons above), the benefits of this option are essentially the same as if your employee transferred their assets to their new employer. Namely, your employee will enjoy tax-deferred growth and will not be faced with any immediate taxation of their assets. The cons of this option are also the same.

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OPTION #4: Taking Their Assets In Cash

One of the options your employees have when leaving your company is to take the assets in their retirement plan as cash. Generally speaking, this is our least favorite option because they may owe taxes immediately that could eat away up to 50% of their pretax distribution. Taking such a large tax hit could really undermine their retirement goals. Rolling over their entire plan balance to an individual retirement account is usually the best option if they don't have to use the money right away.

Being realistic, we know that in some cases there is a need for immediate cash to meet obligations. If your employee is in this situation, they should try borrowing from another source as their first source of cash. If they absolutely must dip into their retirement plan assets, they should take as little as they need, and rollover the rest to a Rollover IRA for the balance of their plan assets. If your employee takes this approach, the sum moved into the Rollover IRA will continue to grow tax-deferred. (Just note that you, as the previous employer, are not required to permit a split distribution if your direct rollover amount is \$500 or less.)

Pros of Taking Your Assets in Cash

- Flexibility. After your employee pays all the taxes due, they're in complete control of the money they have left.

The Cons of Taking Your Assets in Cash

- Income Taxes. You, as the employer will be required to withhold 20% in federal taxes and your employee could also owe additional federal, state, and local taxes. And because your employees cash distribution must be added to their ordinary income when they report their taxes, your employees actual marginal tax rate could increase. Taxes could eat up to 50% of their assets.

- Early Withdrawal Penalty. If your employee is under age 59 1/2, they usually owe an additional 10% federal penalty for early withdrawal.

- Loss of Retirement Income. Since your employee has less money to invest after-taxes, they lose the advantage of tax-deferred growth on the money lost to taxes. This could leave them with less income when they're ready to retire.

In conclusion, we believe 401(k) education and services for departing employees is a valuable employee benefit. These services, when properly provided by a third-party, are of no cost to the employer. These services, if offered, should be available and accessible by employees through the web, an 800 number, print collateral and company-sponsored meetings.

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