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Avoid Cashing Out Your 401(k)

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When prices are rising and bills are pressing, any available cash may seem like the perfect solution to a short-term crunch. And that means people switching jobs these days may be more tempted than ever to cash out their 401(k)s.

That is a mistake, financial advisers say. Even if your account balance seems too small now to represent significant retirement savings, the power of compounding over time is a saver's best friend. And if you compare compounding growth to the downsides of taking the cash -- the penalties and taxes assessed on early distributions -- your best bet is to roll the money into an IRA or 401(k), if offered by your new employer, advisers say.

"It's hard to save," said Linda Lubitz, president of the Lubitz Financial Group in Miami, "so don't blow it by destroying the foundation of a good savings plan."

Still, about 40% of workers in their 20s and 30s said they had cashed out their 401(k)s or 403(b)s when they switched jobs, according to an online survey of about 1,200 people conducted in January for Fidelity Investments by CMI, a research firm.

In the land of retirement savings, every little bit helps. Even if your 401(k) balance is small, it will grow: $800 earning 8% for 45 years grows to almost $26,000. And rolling the money over into another retirement account means you avoid the 10% penalty for early withdrawal (assessed if you are younger than 59½), plus ordinary income tax levied on the money.

"You're paying a heavy tax load. You're losing the tax-deferred compounding on those monies over time. What seems like a nice chunk of change right now will cost you much more over a 20- or 30-year period," said Andrew McIlhenny, executive vice president of Firstrust Financial Resources in Philadelphia.

Also, workers who opt to take the cash don't always realize their employers will only pay out 80% of the account balance. The IRS requires the employer to withhold 20% for taxes.

"If the check is made payable to you, they are going to withhold a mandatory 20%," Mr. McIlhenny said. If that is more than you will ultimately owe in penalty and income tax on the distribution, you will have to wait until tax time to get your refund.

An IRA can offer more investment options than a 401(k), depending on the employer's plan. How to decide where to send the money?

"You have to look at the situation," Mr. McIlhenny said. "If your new 401(k) offers a very broad spectrum of funds that achieve the goals you're trying to achieve, then by all means I think the 401(k) is a great solution. If it doesn't and you feel there are better opportunities out there in a self-directed or managed account, then by all means utilize the IRA."

Mr. McIlhenny cautioned people to watch for fees when choosing a spot to park funds. For instance, he said, "if you're using a commission-driven representative, you may incur a front-end sales fee, a back-end sales fee or some type of a level fee to have that money managed by an IRA custodian."