Guard Against Five 401(k) Mistakes

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The 401(k) plan is the most popular retirement plan in the land. So there is a good chance that you, or your spouse if you are married—or maybe even both of you—are eligible to participate in this type of plan. If that's the case, you may want to avoid mistakes that have plagued individuals in the past. Here are five common examples:

Mistake #1: You sit on the sidelines. All too often people who are eligible to participate just say "no." But this is an opportunity to salt away money for the future without any current tax erosion. For 2010, the tax law allows you to defer up to $16,500 to your account, plus an extra $5,500 if you are 50 or older. What's more, your employer may "match" your contribution up to a stated percentage of salary. This matching contribution costs you zero out of pocket.

Mistake #2: You do not invest carefully. As with investments outside your plan, you should avoid too heavy a concentration in one particular offering. Other errors include over-diversification, such as scattering dollars in every possible mutual fund or other investment option. Try to find the proper balance. A logical approach is to allocate assets based on your current age, your expected retirement age, the amount you are contributing each year and your tolerance for risk. Of course, there are no absolute guarantees.

Mistake #3: You "rob" your plan early on. A 401(k) plan is meant to be a savings vehicle for retirement. However, participants often cannot resist taking out distributions, especially if they are changing jobs. As a general rule, a distribution made prior to age 59½ is subject to a 10% penalty tax on the taxable portion in addition to the regular income tax that is owed. If you switch jobs and roll over funds from your 401(k) to an IRA or another qualified plan, the rollover is exempt from current income tax if completed in a timely fashion.

Mistake #4: You borrow money from your plan. Along the same lines, you should be discouraged from taking a loan from your 401(k). Even though you will effectively be paying yourself back, it will be more difficult to meet your objectives for retirement. You will not have access to the funds you could have earned if the principal had remained intact. Borrowing may be necessary in an emergency, but in most cases it should be viewed as a last resort.

Mistake #5: You don't seek assistance. Recent law changes encourage 401(k) participants to obtain advice within certain parameters. There is no need to do it all on your own. With professional guidance, you can sidestep the common pitfalls outlined above.

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