

Avoid These Errors on the Path to 401(k) Success

Last week's column drew a comment from a 401(k) millionaire, having started his 401(k) participation right away -- "from day one."

He offered some advice to those who aren't convinced about the benefits of impactful participation: "Sacrifice if necessary but just do it. The future passes at warp speed, and before you know it, retirement ... is upon you." Thank you, J.H. This is good advice indeed.

With that advice in mind, let's look at mistakes that can keep you from achieving millionaire status, starting with the biggest mistake we touched on last week.

Most 401(k)s do provide matching contributions. If your plan is in the minority, use these data points from Plan Sponsor Council of America's 66th annual survey to ask for a change. The survey of 687 plans confirmed that only 20.6% of plans did NOT offer matching contributions. Instead, 13.8% offered non-matching contributions, and 6.8% offered no contributions of any type (tinyurl.com/yhucastw).

Not getting your full share of the company match is Mistake No. 1. Say your 401(k) is set up to match your contribution dollar for dollar up to 6% of compensation, but you are only contributing enough to trigger a 1% match. Explore your reasons. Sometimes, it's just something you haven't thought of checking on after you signed up for the 401(k). Get your contribution up to 6%.

Mistake No. 2: Cashing out of your 401(k) when you change jobs.

The U.S. Treasury would love for you to take every penny out of your 401(k) when you change jobs for one very good reason: more tax revenue. It's surprising but true that some 401(k) participants who cash out are not aware that withdrawals are taxed as income. Not only do you pay taxes on the withdrawal, but you may also

pay a penalty for early withdrawals (before age 55 for a 401(k)).

What should you do instead of cashing out? Generally, you can leave the 401(k) with your old employer, move it to your new employer's plan (if transfers are permitted) or set up a rollover IRA working with your financial adviser. If you don't have an adviser, try your local bank or a national firm such as Vanguard or Fidelity. (I have no connection with either firm.)

Mistake No. 3: Borrowing from the 401(k) to make consumer purchases.

This is a biggie. Just about every 401(k) plan has a loan feature (82.9%, according to the Plan Sponsor Council of America survey).

While loan provisions may be a blessing in the case of emergencies, they should not be used for consumer purchases. "Should you borrow or take an early distribution from 401(k)?" an article by Merrill, discusses the considerations and risks involved (tinyurl.com/ytdm44dd).

Mistake No. 4: Defaulting on a loan

If you do have to take out a loan, you need to know about timing, repayment and default.

Timing: According to an IRS resource (tinyurl.com/44z6wx7e), most loans have to be repaid within five years, unless the loan is used to buy a primary residence. Check your plan. What happens if you can't meet the timing?

Repayment: How do you repay the loan (usually payroll deductions), and what happens if you quit?

Default: Before you borrow, find out how a default is handled (for example, if you quit while a loan is outstanding). Usually, your 401(k) balance is used to pay the outstanding loan. When that happens, you will need to pay taxes on the withdrawal, along with a potential tax penalty.

Do your homework before taking out a loan, and include your tax adviser in the conversation.

These common mistakes highlight the importance of being informed. As part of my advocacy for financial literacy education, I created and fund the 401(k) Champion® Competition. (Full disclosure: I am NOT in the 401(k) business.) This year's competition launched Sept. 9, and I encourage all 401(k) participants to apply now. Champions have the ability to help others learn about how 401(k)s work and contribute to retirement security. Visit 401kchampion.com.

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