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401(k) Withdrawal Mistakes to Avoid

These strategies will help you minimize the taxes and fees you pay on 401(k) distributions.

By Emily Brandon

Simply saving in a 401(k) plan isn't enough to ensure your retirement security. You also have to withdraw the money from your retirement account in a way that maintains as much of your spending power as possible. This typically involves taking steps to minimize taxes and avoid fees and penalties. Making these 401(k) withdrawal mistakes could cost you in retirement.

Leaving before you are vested.

While you always get to keep your personal 401(k) deposits, you don't get to keep your employer's contributions until you are vested in the plan. Retiring or leaving the company before you are fully vested means that you could forfeit some or all of your 401(k) match. If you are close to becoming vested in the plan, sticking around a few extra months could add hundreds or even thousands of dollars to your nest egg.

Not doing a direct rollover.

If you decide to transfer your retirement savings from a 401(k) to an IRA, ask your former employer to directly transfer the money to an IRA or different 401(k). If the company makes out the check to you, 20 percent of your account balance will be withheld for income tax. You will then have 60 days to deposit the cash, including the amount withheld, in a new tax-deferred retirement account before Uncle Sam keeps the 20 percent and you become responsible for any additional income tax due. If you're under age 55, you will also have to pay a 10 percent early withdrawal penalty on any amount not deposited in a new retirement account. "Make sure if you are going to roll over an old 401(k) that you always have the check made payable to the new custodian," says Jean Dorrell, an estate planner and founder of Senior Financial Security in Ocala, Fla. "As a general rule of thumb, don't ever have the check made payable to yourself."

Rolling over into higher-cost investments.

Transferring your retirement savings from a 401(k) to an IRA upon retirement or a job change often makes sense because IRAs typically offer more investment choices and lower expenses than 401(k) plans. However, if you have an especially good 401(k) plan where your former employer negotiated low investment fees on behalf of employees, you might want to leave the money in your old 401(k) plan. "If you have some really good investment options in your plan, that would be a good reason to keep your money in your 401(k)," says Laura Scharr-Bykowsky, a certified financial planner and principal of Ascend Financial Planning in Columbia, S.C. You don't want to roll your money into higher-cost investments that will eat away at your life savings.

Two required minimum distributions in the same year.

Withdrawals from retirement accounts generally become required after age 70½. Those who fail to withdraw the correct amount must pay a 50 percent excise tax on the amount that should have been withdrawn. You must take your first distribution by April 1 of the year after you reach age 70½. In subsequent years, annual distributions are required by December 31. If you delay your first distribution until April, you will need to take two withdrawals in the same year, which could impact your income tax rate. "I'm a fan of taking the first distribution in the year you turn 70½ because if you have to take two distributions in the same year, that could push you into the next tax bracket," says Dorrell.

Withdrawals before retirement.

If you take 401(k) withdrawals before age 55, you will generally have to pay income tax and a 10 percent early withdrawal penalty on the amount withdrawn. That means if you withdraw $5,000 from your 401(k) at age 50 and you are in the 25 percent tax bracket, you will only get to keep $3,250. Cracking into your nest egg early is expensive and should be avoided if you have other funds available. "In general, wait as long as you can until you withdraw from these accounts, and if you need the money, take out as little as possible and try to avoid the 10 percent penalty," says Rick Salmeron,

a certified financial planner and founder of Salmeron Financial in Dallas. If you roll the money over to an IRA, there are several government-approved ways to spend your nest egg that don't incur the early withdrawal penalty, including unreimbursed medical expenses that exceed 7.5 percent of your income, health insurance after a job loss, college costs, and a first home purchase up to $10,000.