The Tax Benefits of Retirement Plan Participation – Video Transcript

Your employer-sponsored retirement savings plan is one of the most convenient ways to help build a nest egg for your retirement. But did you know that your plan also offers tax benefits?

Depending on the type of contributions you make to your plan – pre-tax or after-tax -- you could receive tax benefits now, as well as down the road. To provide an example, we'll look at two types of 401(k) plan contributions: traditional and Roth.

Your contributions to a traditional 401(k) account are deducted from your pay *before* taxes are assessed. So participating in a traditional 401(k) helps reduce your income tax bill today.

Your contributions are then invested in an account that grows on a "tax-deferred" basis. Tax deferral means that you don't have to pay taxes each year on any returns you earn. And since those returns are automatically reinvested back into your account, more of your money may go to work for you.

You *will* have to pay taxes on your contribution dollars and returns when you withdraw the money. But ideally, that would be after years--and possibly decades-- of potential tax-deferred growth.

Keep in mind however, that a retirement savings account is meant to benefit you *in retirement*. For that reason, the IRS generally penalizes account withdrawals taken prior to age 59½. If you do not qualify for one of the few exceptions, you may have to pay a 10% penalty tax on the withdrawn amount, in addition to the regular income taxes that will apply.

Now let's shift gears and look at Roth 401(k) contributions. Unlike contributions to a traditional 401(k) plan, contributions to a Roth 401(k) are made with after-tax dollars, so there's no up-front tax benefit.

Contributions to your Roth account can grow without any current tax liability, just like contributions to your traditional 401(k). But unlike traditional 401(k) withdrawals, qualified withdrawals from Roth accounts are free of federal tax, and possibly state and local taxes as well.

In order for a Roth 401(k) withdrawal to be qualified, it must be made after a five-year holding period and after you reach age 59½, die, or become disabled.

What happens if you make a nonqualified withdrawal? In that case, the earnings portion of your withdrawal is subject to regular income taxes and the 10% early-withdrawal tax penalty.

The tax benefits offered by your employer-sponsored retirement plan represent just one of the many reasons why it makes sense to participate. If you have not already done so, consider enrolling in your plan today and contributing as much as you can. And on the road to retirement, consider increasing your contributions whenever possible, up to plan limits.