Your Retirement Savings Plan Comes with Tax Benefits – Video Script

You're probably aware that your workplace retirement savings plan is one of the most convenient ways to save for retirement. But did you know that your plan can also help you manage your tax bill, both today and in the future?

As an example, we'll look at two types of 401(k) contributions: traditional and Roth.

Traditional pre-tax 401(k) contributions help you lower your tax bill today because contributions are deducted from your pay *before* taxes are assessed. Here's a look at how that works.

Let's start by assuming you earn $2,000 per pay period.

In Scenario A, you contribute nothing to your 401(k) plan and owe $440 in federal taxes.

In Scenario B, you contribute 6% of your pay, or $120, to your plan each pay period. Because those contributions are deducted from your pay before taxes are assessed, your tax obligation would be $26 lower than if you hadn't contributed at all.

But that's just the beginning of your plan's tax benefits.

Your contributions are invested in an account that grows on a tax-deferred basis. That means you don't have to pay taxes each year on any returns you earn in your retirement savings plan. Those returns are then reinvested into your account to buy more investment shares and potentially fuel more growth.

You *will* have to pay taxes on your contribution dollars and returns eventually, when you take distributions from your traditional 401(k) account. But ideally, that would be after years — and possibly decades — of potential growth.

Now let's shift gears and look at Roth 401(k) contributions. Unlike 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.

The main benefit of a Roth 401(k) is the promise of tax-free income in retirement.

Contributions and reinvested earnings grow without any current tax liability, just like in your traditional 401(k).

But unlike traditional 401(k) withdrawals, qualified distributions from Roth accounts are free of federal income tax, and possibly state and local taxes as well.

A qualified Roth 401(k) distribution is one made after a five-year holding period and after you reach age 59½, die, or become disabled.

The tax benefits are just one of the many reasons why it makes sense to participate in your workplace retirement plan. If you haven't 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 the contribution limits.

The hypothetical example used for the pre-tax benefits of 401(k) contributions assumes a 22% federal tax rate and has been simplified for illustrative purposes. Your results will differ based on your unique circumstances.

All investing involves risk, including the possible loss of principal, and there can be no assurance that any investment strategy will be successful.

Early distributions from traditional 401(k) plan accounts and nonqualified distributions from Roth 401(k) accounts will be subject to regular income taxes and a 10% penalty, unless an exception applies.

This information is not intended as tax, legal, investment, or retirement advice or recommendations.