3 Key Reasons to Contribute to Your Employer's 401(k) Plan

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If you would like to save for retirement, 401(k) plans can offer you significant tax savings through tax-deferral, additional employer pay in the form of matching contributions, and certain legal protections for your savings. However, the extent to which you will receive these benefits, and the value they represent to you, will depend upon your individual financial circumstances and the specific attributes of your employer's plan.

Conventional wisdom states that you should be contributing to your company's 401(k) plan each year. But should you really? Why? What are the benefits of doing so?

Tax-Deferred Growth

401(k) plans are a form of investment account. Unlike other investment accounts, however, neither the money contributed into the account, nor the income earned on the investments made inside of the account, are taxed at the time it is earned. Instead the taxation of contributions and income earned in these accounts occurs in the future, when the money is withdrawn. Hence the term "tax-deferred growth". By deferring the taxation of investment income in these accounts into the future, your money is allowed to stay in the account which maximizes the power of compound growth.

It is important to be aware, however, that when you do withdraw money from these accounts in the future, some of the income may be taxed at a higher rate than it otherwise would have been if it had been held inside of a taxable brokerage account. This is because all distributions from a 401(k) account are taxed as "ordinary income". Although for federal tax purposes ordinary income is taxed at a higher rate than certain forms of investment income which are taxed at "capital gains" tax rates, in most cases the power of the tax-deferral far outpaces the potentially higher tax rate paid on the investment income.

It is also important to know that you must meet certain requirements in order to avoid paying an additional 10% income tax penalty on your 401(k) account withdrawals. One of these requirements is that you must be at least 59 ½ years old at the time you withdraw money from your account, with certain exceptions.

Employer Matching Contributions

In order to satisfy certain tax rules, and to lower per-employee costs for the plan, companies often try to encourage their employees to contribute to their 401(k) plan. One of the ways in which companies do this is by offering to "match" contributions that an employee makes into his/her account. Company matching basically means that the company pays you to contribute to your 401(k) account. The amount of matching contributions (if any) that your employer makes into the plan, and how those contributions are calculated, are an important detail which you should fully understand.

It is important to note that you do not always immediately own the matching contributions made by your employer into your account. Your ownership of these contributions depends on something called "vesting" which is fancy word for ownership. Some employer plans provide that you own the matching contributions they make immediately (immediate vesting). Other employers provide that your percentage ownership in matching contributions increases over some specific set of years, as defined in the plan's "vesting schedule".

This means that depending upon the details of your employer's 401(k) vesting schedule, if you contributed to the plan, received matching contributions, and then left the company within a certain amount of time, you could forfeit some, or all, of those employer matching contributions. However, you do always maintain 100% ownership of the amount you contributed.

Protection from Creditors

One other potential benefit that many people aren't aware of is that as an employer retirement plan 401(k) accounts receive certain protections from creditors and bankruptcy.

These protections are of legal nature, but are an important characteristic of these plans to be aware of. If it is something you would like to learn more about, we recommend you speak with a qualified attorney.

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