

Should I contribute to my 401(k) plan at work?

Answer:

Yes. Unless you absolutely cannot afford to set aside any dollars whatsoever, you should contribute to your employer's 401(k) plan. A 401(k) plan is one of the most powerful tools you can use to save for your retirement.

The first benefit is that your contributions to a 401(k) plan are not taxed as current income. They come right off the top of your salary before taxes are withheld. This reduces your taxable income, allowing you to pay less in taxes each year. You'll eventually pay taxes on amounts contributed when you withdraw money from the plan, but you may be in a lower tax bracket by then. You may even qualify for a partial tax credit for amounts contributed.

Furthermore, money held in a 401(k) plan grows tax deferred. The investment earnings on plan assets are not taxed as long as they remain inside the plan. Only when you withdraw those earnings will you pay taxes on them (again, possibly at a lower rate). In the meantime, tax-deferred growth gives you the opportunity to build a substantial 401(k) balance over the long term, depending on investment performance.

If you're lucky, your employer will match your contributions up to a certain level (e.g., 50 cents on the dollar up to 6 percent of your salary). You typically become vested in your employer's contributions and related earnings through years of service (the details depend on the plan). Employer contributions are also pretax and are basically free money (once you're vested), so you should try to take full advantage of them. If you fail to make contributions and receive no match, you are actually walking away from money your employer is offering to you.

Another beneficial feature that many 401(k) plans offer is the ability to borrow against your vested balance at a reasonable interest rate. You can use a plan loan to pay off high-interest debts or meet other large expenses, like the purchase of a car. You typically won't be taxed or penalized on amounts you borrow as long as the loan is repaid within five years. Immediate repayment may be required, however, if you leave your employer. Loan payments are deducted from your paycheck with after-tax dollars.

Finally, 401(k)s are a very convenient and reliable way to save. You decide what percentage of your salary to contribute, up to allowable limits. Your contributions are deducted automatically from your salary each pay period. Because the money never passes through your hands, there's no temptation to spend it or skip a contribution here and there. Most plans allow for contributions as small as 1 percent of your paycheck.

Note: Employers can allow employees to contribute to separate IRA accounts inside the employer's retirement plan and can allow employees to make after-tax "Roth" contributions to a 401(k) plan. Under certain conditions, these contributions and related earnings may be tax free when paid out to you.