What Is Tax Deferral?

"Tax deferral" is a method of postponing the payment of income tax on currently earned investment income until the investor withdraws funds from the account. Tax deferral is encouraged by the government to stimulate long-term saving and investment, especially for retirement.

Only investment vehicles designated as "tax deferred," such as IRAs, plans covering self-employed persons, and 401(k)s, allow taxes to be deferred. In addition, many insurance-related vehicles, such as deferred annuities and certain life insurance contracts, provide tax-deferred benefits.

There is a substantial benefit to deferring taxes as long as possible, because this allows the entire principal and any accumulated earnings to compound tax deferred. The compounding effect can be dramatic over an extended period of time and can make a big difference in the accumulation of a retirement nest egg.

Additionally, investments in tax-deferred vehicles are often made when you are earning a higher income and subject to a higher tax rate. When you reach retirement and begin taking distributions from your tax-deferred accounts, it is possible that your tax bracket will be lower.

One note of caution: When formulating your tax plan, recognize that all withdrawals from tax-deferred plans are taxed as ordinary income. Early withdrawals (prior to age 59½) may be subject to a 10% federal income tax penalty. Once again, the government is encouraging a long-term outlook.