

ICI VIEWPOINTS

April 14, 2020

Investing Basics: Tax Benefits to Encourage Saving

As part of the ICI Education Foundation's [30th anniversary celebration](#), we are sharing a [series of ICI Viewpoints](#) explaining basic investing concepts, drawn from the ICI Education Foundation's Investing Road Trip.

Would you rather have \$100 tomorrow or \$1,000 a year from now? Most people, according to research, would take the \$100, even though waiting a year increases the amount of the reward tenfold. Social scientists, who have been puzzling over questions on present bias and temporal discounting for decades, have found that people often discount a future reward for a timelier (albeit smaller) windfall. This tendency to prioritize a payoff that's closer to *now*, coupled with the difficulty of imagining one's future needs, makes saving for long-term financial goals—a future need, indeed—challenging.

Unfortunately, temporal discounting wastes one of the greatest assets that a saver has—time. For young workers saving for a secure retirement, [compound returns can do a lot of the heavy lifting](#) toward achieving this financial goal—but time is an essential ingredient.

To encourage people to save and make time work for them, federal and state governments offer special tax treatment for savings plans for specific goals, such as retirement and education. Here's how it works, in general: savers who contribute to such a savings plan in any given year can deduct that contribution from their taxable income for that year.

(Beyond that basic structure, each savings plan is subject to its own specific rules, governing federal versus state deductibility, contribution limits, income limits, and timing.)

By increasing the benefit savers receive in the *short term*, the government nudges savers to take a positive action that will provide a benefit in the *long term*.

The 401(k) plan, a workplace retirement account and the most common tax-advantaged savings account used by [more than 58 million active participants](#), offers a relatively simple example of how this tax treatment works: A worker chooses the percentage of her pay she'd like to contribute, up to a limit set by the Internal Revenue Service (IRS). Contributions can be automatically taken from her paycheck and added to her 401(k) account. She can then deduct those contributions from her taxable income for the year, lowering her tax bill.

It's important to understand that, while Uncle Sam encourages people to save by offering tax deductions on contributions to individual retirement accounts (IRAs), 401(k)s, and

similar workplace retirement plans, these contributions are not a tax credit, nor are they tax-free. Instead, they are tax-deferred. (Another form of the 401(k), the Roth 401(k), [offers a different tax treatment](#) but, ultimately, a similar incentive to save.)

Federal Income Tax Return Filing and Payment Deadline Postponed in Response to Novel Coronavirus Emergency

The IRS has announced that the tax return filing and payment date has been postponed to July 15, 2020. Because IRA contributions must be made by the tax return due date for that year, savers have more time to contribute to their IRA and have it count for 2019—until July 15, 2020.

[Learn More >>](#)

To understand tax deferral, consider our 401(k) saver: she contributes to her 401(k) paycheck-by-paycheck, takes the tax deduction on her contributions each year, and eventually retires. When she starts to take money out of her 401(k) in retirement, those withdrawals will be counted as income—and that income will be taxed.

To her credit, she took action to start saving, took advantage of beneficial tax treatment, and realized a significant—albeit delayed—reward in retirement.

Next month's installment in this series, in honor of "529 Day," or May 29, will explore another savings plan with favorable tax treatment—the 529 savings plan.

Other Posts in This Series

- [Investing Basics: What Is Investing?](#)
- [Investing Basics: What Is Risk?](#)
- [Investing Basics: Types of Investments](#)
- [Investing Basics: Diversification](#)
- [Investing Basics: Dollar-Cost Averaging](#)
- [Investing Basics: Benefits of Mutual Funds](#)
- Investing Basics: Tax Benefits to Encourage Saving
- [Investing Basics: 529 Savings Plans](#)
- [Investing Basics: Compound Returns and the Power of Reinvestment](#)