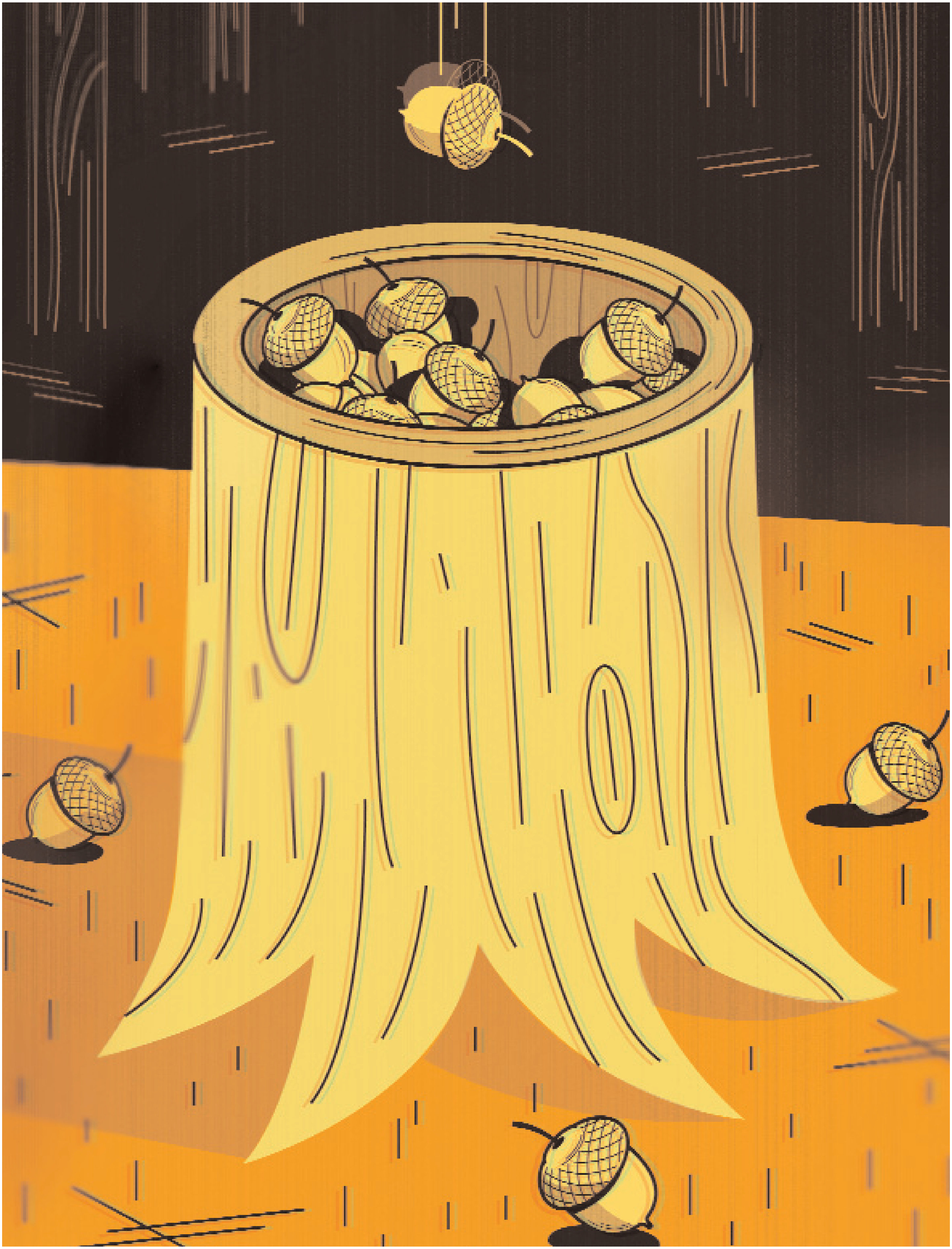

Taxpayer

SAVINGS TIME

Tax Laws Contain Incentives to Put Money Away for Retirement and College, but Some May Disappear After 2010

SAMUEL L. BRAUNSTEIN AND CAROL F. BURGER

WE ALL KNOW THAT SAVING MONEY IS ESSENTIAL TO A sound financial plan. But alas, when it comes to saving, as with so many other endeavors, knowing the right thing to do is often a lot easier than actually doing it.

And so it is with many individuals and families in the United States.

Most estimates put the personal savings rate in the United States at no more than 1 percent of income, a level that dismays most economists. That trend is occurring at a time when many people are facing the double demands on their financial resources of sending children to college while trying to save up for their retirements.

For most people, accomplishing just one of those tasks is daunting, especially in light of the debt loads that many families carry. Accomplishing both goals is a truly monumental challenge. Families need all the help they can get.

The federal tax system might seem to be an unlikely source of relief. But the tax laws actually encourage savings through a number of measures that make it possible for individuals to defer taxes on some savings income, receive credits for using certain savings vehicles and, in a few cases, avoid taxes altogether on income earned through savings.

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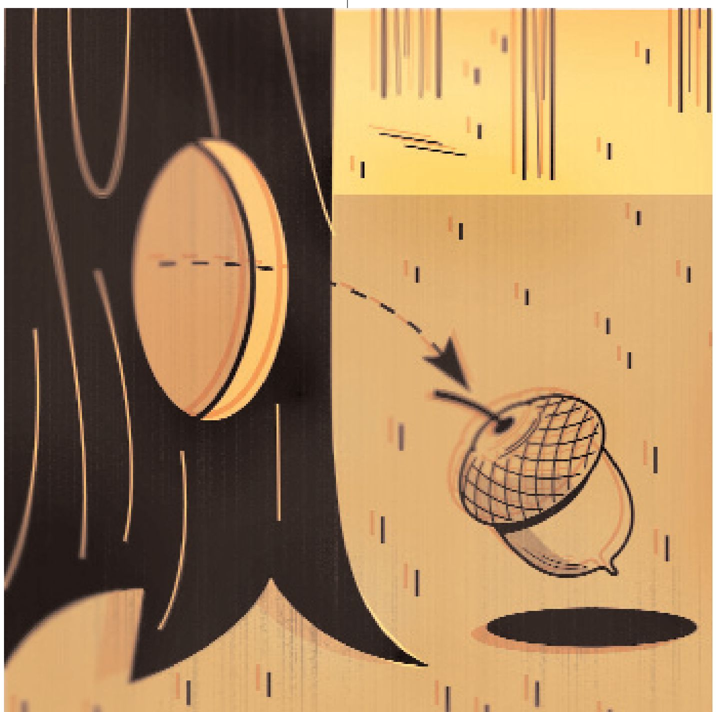
ILLUSTRATIONS BY HARRY CAMPBELL

But some of the current savings incentives—the ones introduced by the Economic Growth and Tax Relief Reconciliation Act of 2001—may not be around that long. The act is scheduled to sunset in 2011, at which time federal tax law will revert back to what it was before 2001, unless Congress decides to make at least some of the law's provisions permanent. Until the status of the 2001 law is resolved, tax lawyers and their clients will face some difficult long-term tax planning issues.

It's up to the individual

FAVORABLE TAX LAWS IN recent years have helped spur the growth of savings plans in which individuals, rather than employers, make the bulk of the contributions. These arrangements often coexist with traditional employer-funded vehicles, such as pension and profit-sharing plans, but in some cases they're the only retirement plans available to workers.



Individual retirement accounts have been opened by millions of people in the United States, subject to certain eligibility requirements and limits on annual contributions. Subject to certain limitations, an individual may deduct at least some of his or her IRA contributions every year, and the earnings in the account are not taxed as they accumulate.

For tax years 2005 through 2007, an individual with earned income who has not reached the age of 70½ by the end of a tax year may contribute up to $4,000 per year to an IRA. An individual who is at least 50 also may make catch-up contributions of up to $1,000. If the individual participates in an employer-sponsored retirement plan, however, deductions for IRA contributions may be limited, depending on the type of retirement plan.

IRA withdrawals are taxed as ordinary income for the year in which they are made. Beyond that, rules governing withdrawals are linked to the age of the account owner.

Generally, if a taxpayer withdraws money from an IRA before reaching the age of 59½, he or she must pay tax on the amount withdrawn as ordinary income plus a penalty tax of 10 percent of the amount withdrawn.

For taxpayers between the ages of 59½ and 70½, amounts withdrawn are subject to taxes only as ordinary income. As a financial planning matter, most people try to refrain from making IRA withdrawals in order to maximize the tax-deferred growth of their accounts.

But upon turning 70½, taxpayers must begin making withdrawals from their IRAs. At this point, effective planning usually involves determining the minimum amount that must be withdrawn in order to maintain as much flexibility as possible.

Roth IRAs are an invention of the Taxpayer Relief Act of 1997. Roth IRAs differ significantly from other individual retirement accounts in that contributions to a Roth account are not deductible for income tax purposes. At the same time, qualified distributions from a Roth IRA are neither taxable as ordinary income nor subject to the 10 percent penalty tax for early withdrawals.

Unlike regular IRAs, there are no minimum distribution requirements for Roth IRAs. Accordingly, they provide another vehicle for passing savings to the next generation and provide another source of nontaxable income to taxpayers during their lifetimes.

The Internal Revenue Code permits taxpayers to convert an existing standard IRA to a Roth IRA. But the amount in the IRA being converted must be included as ordinary income for the year in which it is converted.

Roth IRAs are unavailable to many taxpayers due to income restrictions. The amount that may be contributed is phased out as the taxpayer's modified adjusted gross income increases. The amount is phased out ratably between $95,000 and $110,000 for single taxpayers; between $150,000 and $160,000 for married couples filing joint returns; and up to $10,000 for married people filing separate returns.

Keogh plans (also referred to as HR 10 plans) give self-employed individuals the capability to create a retirement savings vehicle similar to corporate retirement plans available to many employees. Contributions to Keogh plans are deductible from income taxes. While Keogh plans exist primarily for the benefit of self-employed individuals, they also may include employees of people who create them.

Early on, Keogh plans were subject to many special rules, but most were eliminated by the Tax Equity and Fiscal Responsibility Act of 1982. Now, Keogh plans generally provide the same benefits and have the same requirements as other qualified plans (in other words, those that allow deductions for employer contributions and don't tax contributions until they are distributed).

401(k) plans (referring to the IRC section that governs them) are the most common example of a qualified cash or deferred arrangement, which allows employees to defer portions of their salaries as current compensation and instead elect to have them paid to a savings plan sponsored by the employer. The deferred amounts are not included in an employee's gross income. The amounts that build up in each employee's account (including earnings on contributions) are not taxable until distributed to the employee. An employer also may contribute to the plan, and those amounts also are not included in the employee's gross income.

403(b) plans allow public schools and tax-exempt organizations under IRC § 501(c)(3) to purchase annuity contracts or contribute to custodial accounts for their employees.

In effect, 403(b) plans are similar to 401(k) plans. Employee contributions to 403(b) plans may consist of salary reductions (elective deferrals) and/or after-tax contributions. Employers also may contribute to these plans. And, as with 401(k) plans, those contributions are excluded from the employee's gross income (to the extent they do not exceed defined limits). Distributions are taxable for the year in which they are received by the employee.

457 plans allow state and local government bodies and tax-exempt organizations to adopt nonqualified deferred compensation plans under which some contributions to an employee's account may be deferred as income for tax purposes until distributed. Unlike other types of deferral plans, however, 457 plans are subject to strict statutory limits on the amount a participant can defer each year.

Roth 401(k) and 403(b) plans will be introduced in 2006 under provisions in the Economic Growth and Tax Relief Reconciliation Act allowing employers to offer more options in their 401(k) and 403(b) plans.

As they are now formulated, standard IRAs, 401(k) plans and 403(b) plans are effective savings vehicles for employees who expect to drop into lower tax brackets when they retire. But some retirees move into higher tax brackets or remain where they are, particularly when they face the loss of significant itemized deductions. In such instances, the Roth approach may be a favorable alternative to the standard plans.

Under this approach, 401(k) plans that are amended appropriately may allow employees to designate portions of their elective contributions as Roth contributions. Roth contributions will be taxable to the employee at the time they are made. This will be offset, however, by two other factors: First, there are no income limitations on who can participate in a Roth plan; and second, as with Roth IRAs, any qualified distributions from designated Roth contributions (including earnings) will not be subject to federal income taxes.

The Roth option also will be available starting next year to employees under amended 403(b) plans.

All is not "pure gold," however, with the new Roth-type plans. Employer matching contributions and plan forfeiture allocations will not be allowed—only an employee's after-tax contributions and earnings on them may be in the Roth account. Moreover, employers will have to consider the costs of additional accounting requirements for the Roth plans before adopting them.

And, as with many other provisions of the 2001 act, the Roth-type plans are scheduled to sunset at the end of 2010 unless extended by Congress.

Meanwhile, there is a proposal in Congress to reduce the complexities of retirement savings plans by essentially replacing them with a single type of individual savings account—the employer retirement savings account, which would be similar to a Roth IRA.

Sticker-shock absorbers

JUST AS IT ENCOURAGES SAVINGS FOR RETIREMENT, THE Internal Revenue Code offers various incentives to put money away to pay college costs. It's a good thing, too, since estimates put the increase in college costs since 1975 at more than 700 percent.

Qualified tuition plans are commonly known as 529 plans for the IRC section that governs them. These programs are maintained at the state level to allow taxpayers to purchase tuition credits on their federal taxes for a designated beneficiary (a 529 prepaid tuition plan) or contribute to an account used to pay the qualified higher education expenses of a designated beneficiary (a 529 savings account).

For purposes of 529 plans, qualified higher education expenses include tuition, fees, books, supplies and equipment, expenses for special needs and, if the student is enrolled at least half-time, room and board. While some education incentive programs restrict eligibility based on income, taxpayers at all income levels may participate in 529 plans.

Before 2002, distributions from qualified tuition programs constituted taxable income to the beneficiary, except for distribution amounts offset by credits under other programs (see below).

But under the 2001 act, distributions made in 2002 and later years to pay for qualified higher education expenses are excludable from the beneficiary's income. This exclusion provides an incentive to "pre-fund" contributions to a 529 plan to the extent allowable and accelerate tax-free growth of the account. Contributions to a 529 plan are considered gifts that qualify for the annual gift tax exclusion ($11,000 per donee for single taxpayers making gifts and $22,000 per donee for spouses filing jointly).

An especially favorable rule allows a donor to treat contributions made during one year that exceed those maximums as having been made ratably over a five-year period beginning in the year they were actually made. Accordingly, a donor may contribute as much as $55,000 for each named beneficiary ($110,000 for married donors) in a given year and treat the contributions as being made ratably over five years.

The fact that qualifying distributions from 529 plans are tax-free is obviously an important consideration when evaluating whether to use them. Unfortunately, the possibility that this benefit will disappear if the 2001 act sunsets in 2010 makes planning somewhat difficult. In many cases, parents or grandparents now are making con-

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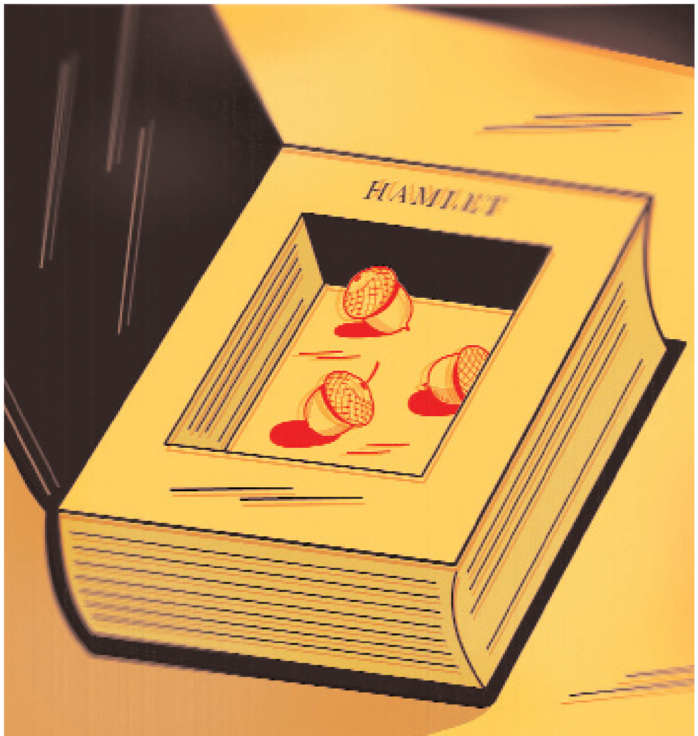
tributions for children who would not use the funds until after 2010. If the act does sunset, distributions made after 2010 will be taxable.

Amounts withdrawn from a 529 plan that are not used for qualified higher education expenses are includable in the gross income of the beneficiary or other distributee and subject to a 10 percent penalty tax.

A change in designated beneficiaries is not treated as a withdrawal from the plan if the new beneficiary is a family member (broadly defined) of the prior beneficiary. But if the new beneficiary is assigned by tax rules to a younger generation than the prior beneficiary, then the prior beneficiary will be considered to have made a gift to the new beneficiary. (If the beneficiaries are at least two generations apart, the generation-skipping transfer tax might also apply.)



Alternatives to weigh

ONE DOWNSIDE TO 529 PLANS IS THAT THE PERSON ESTABlishing an account may not direct how the funds are invested; those decisions are made by the manager of the overall program fund, usually an investment institution selected by the state. The individual donor may, however, be able to select among different investment strategies when opening the account.

There is no requirement that an individual contribute to the program maintained by the state in which he or she resides, though some states provide an incentive to do so, such as a state income tax deduction. It is generally advisable to compare the plans offered by different states before deciding which one to use, both as to the precise terms of the plan and the investment performance of the money managers used.

Coverdell education savings accounts (formerly known as education IRAs) are more limited than qualified tuition plans (see IRC § 530). The maximum annual contribution to a Coverdell ESA is $2,000 per beneficiary for taxpayers below a certain income threshold. The allowed contribution amount begins to phase out for individual taxpayers with modified adjusted gross income of $95,000 ($190,000 for married couples filing joint returns) and disappears when modified adjusted gross income reaches $110,000 ($220,000 on a joint return).

A Coverdell ESA may be established for a beneficiary for whom a qualified tuition plan also has been established, but no contributions may be made to a Coverdell ESA once the beneficiary reaches age 18 (except in the case of a beneficiary with special needs). As with 529 plans, contributions are eligible for the gift tax exclusion.

The tax treatment of distributions from Coverdell ESAs also is similar to 529 plans, but the same expense may not be claimed under both plans. Distributions from Coverdell ESAs are tax-free if used for qualified higher education expenses, but are taxable to the distributee and generally subject to a 10 percent penalty if withdrawn for any noneducational expense.

Funds may be transferred from a Coverdell ESA to a 529 plan for the same beneficiary, making it possible to consolidate accounts.

Unlike 529 plans, Coverdell ESAs may be used for qualified elementary and secondary education expenses —again, at least through 2010, subject to the fate of the 2001 act. Another difference is that the contributor to a Coverdell ESA may direct how the funds are invested.

Except in the case of special needs beneficiaries, amounts remaining in a Coverdell ESA will be deemed distributed 30 days after the designated beneficiary reaches age 30 or dies unless rolled into an account for another beneficiary from the same family who is younger than 30.

The education expense exception to the IRA early withdrawal penalty is not actually a savings vehicle, but it does give IRA owners some flexibility in making withdrawals.

As noted above, distributions from IRAs are includable in income. But the 10 percent penalty tax for distributions before the owner has reached 59½ is waived under IRC § 72 for qualified higher education expenses. For this purpose, qualified higher education expenses include tuition, fees, books, supplies and equipment; room and board also may qualify, to a limited extent, for students carrying at least a half-time workload. The expenses must be incurred for the education of the taxpayer, the taxpayer's spouse, or any child or grandchild of the taxpayer or spouse.

Exclusion of income from U.S. savings bonds also is possible in a limited number of circumstances if the income is used for higher education expenses incurred by the taxpayer, a spouse or dependent during the year in which the bonds were redeemed. Under IRC § 135, the exclusion is only available for bonds issued after Dec. 31, 1989, to individuals age 24 or older who own the bonds individually or jointly with a spouse. Accordingly, the exclusion is not available for bonds purchased by a parent in the child's name.

For purposes of this exclusion, contributions to a qualified tuition plan or Coverdell ESA for the taxpayer, spouse or dependent are considered qualified higher education expenses. In that case, a taxpayer may redeem bonds in advance of the year in which payments are made to an educational institution. But education expenses taken into account for purposes of a qualified tuition plan or Coverdell ESA may not also be counted as qualified education expenses for purposes of excluding income from savings bonds.

The exclusion of income from savings bonds phases out at inflation-adjusted income levels. For 2005, the phase-out begins at modified adjusted gross income of more than $61,200 ($91,850 for joint returns), and the exclusion is completely phased out when modified adjusted gross income reaches $76,200 ($121,850 for joint returns). Married people filing separate returns for the year may not claim the exclusion regardless of income level.

Sunset looms on the horizon

ALTHOUGH NOT TECHNICALLY SAVINGS VEHICLES, SEVERAL credits and deductions for education costs bolster the savings incentives in the federal tax laws.

The Hope Scholarship credit is a nonrefundable credit equal to 100 percent of the first $1,000 of qualified tuition and related expenses paid by the taxpayer in a particular year for an eligible student carrying at least half a normal full-time workload in a degree program, plus 50 percent of the next $1,000 of eligible expenses, up to a maximum total credit of $1,500. (These limits apply for 2005; the dollar limits are indexed for inflation.) The credit may only be applied to the first two years of each student's post-secondary education.

The lifetime learning credit is a nonrefundable credit equal to 20 percent of qualified tuition and related expenses paid by a taxpayer during the year up to a maximum of $10,000. This credit is available even if the student is not enrolled on at least a half-time basis, and may be claimed for more than two years.

A taxpayer cannot claim both credits with respect to the same student in the same tax year. Both credits phase out for taxpayers with modified adjusted gross income of at least $43,000 for 2005 ($87,000 on a joint return) and are fully phased out when modified adjusted gross income reaches $53,000 ($107,000 on a joint return). Neither credit is available for married taxpayers filing separate returns.

(2005 is the last year in which a deduction will be allowed under IRC § 222 for certain higher education expenses incurred during the year, ranging up to $4,000 depending on the taxpayer's income and filing status. This deduction may not be claimed in conjunction with either a Hope Scholarship or lifetime learning credit with respect to the same student.)

Scholarship grants received by a college-level degree candidate are excludable from income under IRC §117 to the extent the student establishes that they were used to pay qualified tuition and expenses. Qualified tuition reductions offered to employees of educational institutions and their families also are excludable from income.

Interest on education loans may be deducted in an amount up to $2,500, depending on income and filing status.

There is no time like the present to incorporate savings incentives from the tax laws into personal financial plans. But it's important to keep in mind that in some cases the clock is counting down to their possible disappearance after 2010. ■