Tax-Advantaged Investing

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Tax-advantaged investing opportunities are available to just about everyone...even you! Most of these government-authorized programs are designed as incentives to help people save for retirement and long-range goals. Features and qualifications for tax-advantaged programs vary, but all are designed to help you reach your financial goals faster. Read...think...and decide if you are taking full advantage of these powerful techniques for boosting your financial fitness and preparing for the years ahead.

Take Note: Tax-advantaged investment terms sound similar...but they differ

Tax-exempt
Taxes may not be due on investment contributions and earnings.
Examples: • No state taxes owed on EE and HH bonds.
• No federal taxes owed on municipal bonds.

Tax-deferred
Taxes are postponed until investment is sold or withdrawn.
Examples: • Most qualified retirement savings plans, IRAs, and deferred annuities.

Tax-deductible
Investment contributions are deducted from your income before taxes are calculated.
Examples: • Contributions to qualified 401(k) or 403(b) employer-sponsored retirement plans; some IRAs.

Tax-advantaged options for retirement savings

The government allows several types of tax-advantaged retirement savings programs. These include “tax-qualified” employer-sponsored retirement plans, programs for small businesses and those who are self-employed, individual retirement accounts (IRAs), and deferred annuities. Here is a summary of these options.

1. Qualified employer-sponsored retirement plans

You’ve probably heard of 401(k) plans. These are employer-sponsored retirement plans for employees of private corporations with more than 25 employees. Similar 403(b) plans are available to employees of schools, colleges, and charitable organizations as are Section 457 plans for state and

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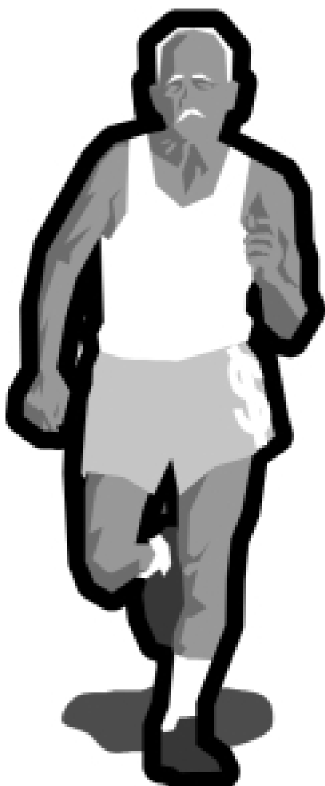
(Tax Advantaged Options for Retirement Savings, continued.)

local government employees. Highly desirable "matching" employer contributions are available through some of the plans. Employee contributions are deducted pre-tax from paychecks and invested in one of the options offered by the employer with earnings on the investments reinvested.

Taxes on the original contribution and the earnings are deferred until distributions begin in retirement. Each plan has contribution limits and withdrawal guidelines. Most are "self directed" which means that the final benefit is not the responsibility of the employer, but rather depends on investment decisions made by the employee and the return on the chosen investments.



2. Qualified retirement plans for employees of small businesses and those who are self-employed.

Keogh plans (similar in concept to the 401(k) and 403(b) plans described above) are available to anyone who has self-employed income or is employed by a small business. Individuals may make tax-deductible contributions of up to 25% of their net self-employment income — to a defined limit per year. As with employee-sponsored programs, pre-tax contributions are invested, investment earnings are reinvested, and taxes on the original contribution and subsequent earnings are deferred until distributions begin in retirement. Keogh plans can be complex and involve considerable paperwork and administrative time.

SEP (Simplified Employee Pensions) and ***SIMPLE*** (Savings Incentive Match Plan for Employees) are also available to those who are self-employed or work for a small business. They are easier and less costly to set up and administer than Keogh plans but have lower contribution limits. They provide for some matching funds by employers. Deductible (pre-tax) contributions and deferred taxes on investment earnings are features of both plans.

3. Individual Retirement Accounts (IRAs)

IRAs are personal retirement savings plans. For those who qualify, up to $3,000 in 2002 of earned income per person (increasing to $5,000 in 2008) may be invested each year in either a traditional or Roth IRA.

The major differences between traditional and Roth IRAs are 1) the timing of income tax payments (either at time of deposit or at withdrawal) and 2) withdrawal requirements.

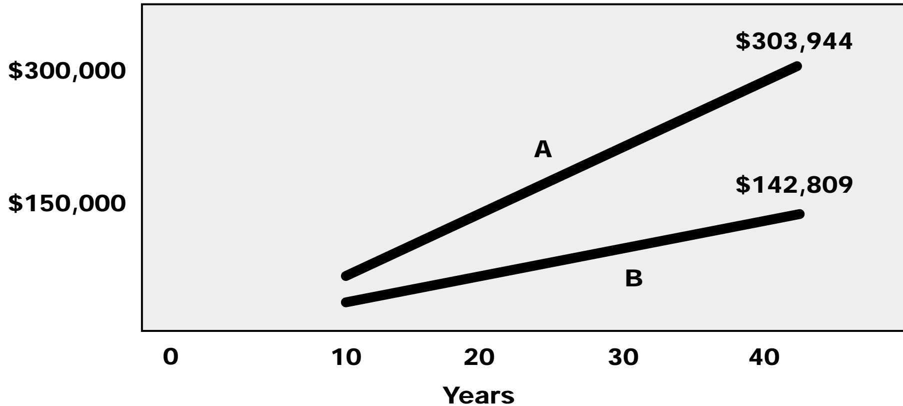
Traditional IRAs may or may not be tax-deductible. Deductible options are available for individuals who are not participating in an employer retirement plan and have incomes below defined levels. Individuals must begin to withdraw funds from a traditional IRA by age 70½. Income taxes are payable at the time of withdrawal.

Roth IRA contributions are not tax-deductible, but earnings grow tax deferred. Withdrawal of contributions can be made tax free at any time. Withdrawals of earnings are tax-free if made more than five years after the Roth IRA was established and the taxpayer has reached 59½, becomes disabled, or dies. Income limits are $160,000 for couples and $110,000 for a single person. There is no withdrawal requirement on Roth IRAs.

4. Deferred Annuities

Tax-deferred annuities are available from insurance companies and used by some individuals to accumulate retirement savings. Initial investments are made with after-tax dollars; however, taxes on earnings are deferred until payout at retirement, which could be a lump sum or a series of periodic payments.

Tax-advantaged investments grow faster



Assumptions

$5,000 investment @ 15% marginal tax rate and 10% annual return.
(A) Contributions to tax-advantaged investment made pre tax; taxes on contributions and earnings deferred.
(B) Contributions to investment made after tax; taxes on earnings not deferred.

Q: Why did account A perform better than account B?

A: There was more money in account A to grow.

This happened because:

1) pre-tax contributions to account A reduced the amount of income reported to the IRS and thus lowered incomes taxes due;
2) deferred taxes on investment A earnings reduced current income taxes;
3) the effects of compounding helped the larger amount of money in account A grow even faster.

Tax-advantaged programs for higher education

Another long-term financial goal for many families is accumulating dollars to help cover educational expenses for children. A number of tax-advantaged savings options for education are available.

1. Coverdell Educational Savings Accounts

Known formerly as education IRAs, these special education savings accounts permit parents, grandparents and others to invest up to $2,000 (starting in 2002) of after-tax dollars annually to use toward educational expenses of designated beneficiaries. Contributions and earnings grow tax-deferred and are not taxed upon withdrawal when used soley for the beneficiary's qualified education expenses.

In most cases, an educational savings account alone will not provide enough money to cover all educational expenses, but it can be a big help in combination with other sources of income. Keep in mind that money in an educational savings account may affect a beneficiary's ability to qualify for financial aid. Good news is that beginning in 2002, contributions can be made to both an educational savings account and a 529 plan in the same year for the same beneficiary.

2. State-sponsored college savings plans

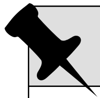
State-sponsored college savings plans — also known as 529 plans — allow families to save tax-deferred until the money is withdrawn for college, at which point it is taxed at the child's rate — usually 15%.

The newer variety of college savings plans permits the money to be used to pay the costs of any college or vocational school regardless of where you live or where your child wants to attend school. You can participate in 529 plans no matter what your household income and you can contribute far more than permitted in an educational savings account.

The Michigan 529 Educational Savings Plan (MESP) was initiated late in 2000. It offers three investment options and is managed by TIAA/CREF. Contributions are tax deductible and earnings are tax-deferred.

3. Roth and traditional IRAs

Both Roth and traditional IRAs can be a source of dollars for higher education. Tax-free and penalty-free withdrawals of up to $10,000 can be made from Roth IRAs after the account is five years old. Penalty-free withdrawals can be made from traditional IRA accounts for qualifying educational expenses. Keep in mind, however, that withdrawals from these accounts diminish the accumulation of retirement savings.



The facts about tax-advantaged dollars

1. The results of participation in most tax-advantaged options depend on the investor's investment choices, time until retirement and marginal tax bracket. For example, the higher a person's marginal tax rate (the rate paid on the last dollar of earnings) the greater the benefit from deductible contributions and tax-deferred earnings.
2. Employer "match" to employee contributions to 401(k) or 403(b) plans is like free money and greatly enhances the value of participating in an employer-sponsored retirement plan.
3. Many qualified tax-advantaged retirement programs involve automatic payroll deductions that help to make saving for retirement easier.
4. With some exceptions, there is a penalty for withdrawing money from a tax-deferred account before the age of 59½.
5. Deferring taxes allows money to accumulate and compound faster.

Investor query

Q. *What if an emergency arises and I need the money that I have invested in a tax-advantaged retirement plan?*

A. The IRS has set established rules and guidelines that limit access to funds for purposes other than those stated. Penalties are usually assessed for early withdrawals. However, some employee-sponsored plans have loan options or special withdrawal provisions to cover financial hardships, death, or disability. Familiarize yourself with the terms of your plan right from the beginning. Carefully weigh the impact of any withdrawal on your long-range goals and your current cash flow situation. Before taking action, take the time to explore alternative options for meeting your emergency needs. Invade your retirement savings only if ***absolutely necessary***.

Tax-advantaged dollars for first-time home buyers

There are two options. Tax-free and penalty-free withdrawals from *Roth IRAs* of up to $10,000 can be made after the account is five-years-old to help finance a first home. Penalty-free withdrawals can be made from *traditional IRAs*; however, income tax will be due on withdrawals if the original contributions were made pre-tax.

For further information, please contact your Michigan State University county Extension office found under local government in your telephone book, or on the Internet at: **http://www.msue.msu.edu**.

WWW Resources

www.collegesavings.org
(National Association of State Treasurers)
The official 529 College Savings Plans network site, where you can find links to plans in your state, frequently asked questions, etc.

www.misaves.com
A site with information about the Michigan Educational Savings Plan (MESP).

www.kiplinger.com
(Kiplingers Magazine)
Detailed descriptions of the college pre-paid and savings plans now available plus links to each state's website.

www.investing.rutgers.edu
(Cooperative Extension System)
See Unit 7 on tax-deferred investing.

www.rothira.com
A commercial website sponsored by Brentmark Software, Inc, a company that provides retirement planning software to professionals and consumers. It provides a wide range of articles and information on Roth IRAs.

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