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GENERATING TAX-FREE INCOME

What is generating tax-free income?

Although income is usually taxable, there are a number of vehicles that can produce tax-free income. Examples of tax-free income can include:

- Roth IRA distributions
- Coverdell education savings account and 529 plan distributions
- Tax-exempt bond interest
- Interest on Series EE savings bonds used for education
- Life insurance (death benefit)
- Loans against and certain withdrawals from cash value insurance
- Certain gains from the sale of qualified small-business stock
- In certain situations, gain on sale of personal residence

How can IRA's be used to generate tax-free income?

Unlike contributions to a traditional individual retirement account (IRA), contributions to a Roth IRA are never tax deductible. Since you are taxed on your IRA contributions currently, that money will be returned to you tax free when withdrawn in the future. In addition, the earnings (interest) on Roth IRAs grow federal income tax deferred and are tax free when withdrawn (assuming your distribution is a "qualified" one--a distribution is qualified if you satisfy a five-year holding period and your distribution is made either after you've reached age 59½ or after you've become disabled). Because of these features, the Roth IRA is a useful tool for generating tax-free income.

Tip: Employers can allow employees to designate their contributions to a 401(k) or 403(b) plan as after-tax Roth contributions. Under certain conditions, these contribution amounts and related earnings will be tax free when distributed.

529 plans and Coverdell education savings accounts

529 plans (which include both 529 college savings plans and 529 prepaid tuition plans) allow individuals to save for college on a tax-advantaged basis. Any earnings on funds contributed to a 529 plan grow federal income tax deferred. Withdrawals are not subject to federal income tax if they are used to pay qualified higher education expenses. If used appropriately to save and pay for college expenses, then, a 529 plan can generate tax-free income.

The Coverdell ESA is another vehicle that allows individuals to save for a child's higher education on a tax-favored basis. Like a 529 plan, your contributions to a Coverdell ESA are not tax deductible. However, the earnings (interest) in the Coverdell ESA grow federal income tax deferred. Any money you withdraw from the Coverdell ESA will be tax free if used for qualified education expenses (including elementary and secondary school expenses). A Coverdell ESA, therefore, will generate tax-free income (if used properly).

Caution: Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans carefully before investing. More information about 529 plans is available in the issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits. The availability of the tax or other benefits mentioned above may be conditioned on meeting certain requirements. All investing involves risk, including the possible loss of principal, and there can be no assurance that any investment strategy will be successful.

How bonds can be used to generate tax-free income?

Tax-exempt bonds and Series EE savings bonds used for education are the two types of bonds that can be used to generate tax-free income.

Tax-exempt bonds

Interest on certain obligations of a state, territory, U.S. possession, or political subdivision can be excluded from your federal gross income. In addition, if you earn interest on tax-exempt bonds issued in your home state, generally, the interest will not be subject to state or local tax. Municipal bonds, therefore, can help generate tax-free income for you.

Caution: For investors who are subject to the alternative minimum tax (AMT), however, interest income from certain municipal securities must be included in income when calculating the tax. If purchased as part of a tax-exempt municipal money market or bond mutual fund, any capital gains earned by the fund are subject to tax, just as any capital gains from selling an individual bond are. Note also that tax-exempt interest is included in determining if a portion of any Social Security retirement benefit received is taxable.

Series EE savings bonds

The interest received on Series EE savings bonds is exempt from state and local income taxes. In addition, the interest on Series EE bonds purchased on or after January 1, 1990, may be exempt from federal income taxation if the bonds are used for certain educational purposes and if certain requirements (including adjusted gross income limitations) are met. Therefore, assuming you meet the requisite conditions, Series EE savings bonds can generate tax-free income.

How life insurance can be used to generate tax-free income?

Permanent life insurance can be used to generate tax-free income in two ways. The purchase of insurance should be considered because of its death benefit proceeds and its cash value buildup.

Death benefit

Generally, amounts you receive under a life insurance contract paid by reason of the death of the insured are not included in your gross income; the proceeds are tax free. Amounts payable on the death of the insured are excluded, whether these amounts represent the return of premiums paid, the increased value of the policy due to investments, or the death benefit feature. It is immaterial whether the life insurance proceeds are received in a single sum or otherwise. (However, any interest paid along with the life insurance proceeds is usually taxable.)

Cash value insurance transactions

The cash value in a universal life insurance policy can also be a useful tool for generating tax-free income. In general, amounts received under a life insurance contract (other than an annuity) are treated first as a recovery of basis; only after the entire basis has been recovered is there taxable income. Therefore, any withdrawal you make from your cash value life insurance policy (up to the amount of your basis or investment in the contract) can be taken tax free.

It is also possible for you to obtain a loan from your insurance company in an amount up to the cash value of the policy. For the most part, loans are not treated as taxable distributions (although interest will be charged by the insurer).

Caution: The above rules do not apply to modified endowment contracts (MECs).

Caution: Policy loans and withdrawals will reduce the policy's cash value and death benefit.

How can qualified small-business stock be used to generate tax-free income?

Qualified small-business stock is stock that meets requirements set forth in Internal Revenue Code Section 1202. Essentially, this is stock issued by domestic C corporations engaged in certain "active businesses" whose assets do not exceed $50 million. The stock must be issued after August 10, 1993, and must be acquired when originally issued by the corporation. Non-corporate taxpayers may exclude 50 percent of any capital gain from the sale or exchange of qualified small-business stock issued after August 10, 1993, and held for more than five years. The amount of gain eligible for the 50 percent exclusion in a tax year is limited to the greater of:

- Ten times the taxpayer's (aggregate) adjusted basis in the stock that is sold, or
- $10 million ($5 million if married filing separately) of gain from stock in that corporation, reduced by the amount of eligible gain you used to figure your exclusion in earlier years

For tax years 2005 and thereafter, you can generally exclude up to 60 percent of your gain if you meet the following additional requirements:

- You sell or trade stock in a corporation that qualifies as an empowerment zone business during substantially all of the time you held the stock
- You acquired the stock after December 21, 2000

For qualified small business stock issued after February 17, 2009, and before September 28, 2010, the amount that may be excluded upon sale or exchange of the shares is 75 percent. For qualified small business stock issued after September 27, 2010, the amount that may be excluded upon sale or exchange of the shares is 100 percent.

How can the gain on sale of your personal residence generate tax-free income?

If you sell your principal residence at a gain, you may be able to exclude from taxation all or part of the capital gain. If you meet the requirements, you can exclude up to $250,000 (up to $500,000 for married couples filing jointly) of the gain, regardless of your age.

You can generally exclude the gain only if you owned and used the home as your principal residence for at least two out of the five years preceding the sale (the two years do not have to be consecutive). An individual, or either spouse in a married couple, can generally use this exemption only once every two years. Even if you fail to meet these two tests, though, you may be eligible to claim a partial exemption.

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