



“ On T h e M o n e y R e p o r t ”

By Steve Pomeranz, CFP

Host, *On The Money!* WXEL 90.7 FM

A new tax break designed to encourage young, low-income wage earners save for retirement may also help savers closer to your golden years.

If you are semi-retired and a earning low income, there is good news: couples filing jointly with an adjusted gross income (AGI) of no more than \$30,000—or single filers with an AGI of no more than \$15,000—will receive a 50% credit on their contributions to a qualified retirement plan, such as a 401(k) or IRA. The maximum credit you can receive in a year is \$1,000 (filing single) or \$2,000 (couples filing jointly).

How the credit works

A credit, unlike a deduction, is a dollar-for-dollar reduction of any tax liabilities. In this case, the credit claimed is nonrefundable—that is, you won't receive any money back if you don't owe any taxes. For example, to receive a full \$1,000 credit, you'll need to have at least \$1,000 in income tax liabilities for the year. If your tax liability for the year is only \$500, for example, then \$500 is the maximum you can receive as a credit. (If you've already had \$500 withheld you're your paycheck, you will receive the \$500 back as a refund.)

Some taxpayers earning more than the limits cited above may qualify for smaller maximum credits. For example, couples with AGIs of \$30,001–\$32,500 can receive a 20% credit (\$400 maximum), and couples with AGIs of \$32,501–

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\$50,000 receive a 10% credit (\$200 maximum). There is no credit available for AGIs over \$50,000 (\$25,000 filing singly).

If you are just over one of these AGI thresholds, making a retirement contribution may drop you into a lower tax bracket, thus allowing for a larger credit. For example, say your AGI is \$32,000 (couple filing jointly). A \$2,000 contribution would drop your AGI to \$30,000—which means that you would qualify for a \$1,000 credit. In short, a \$2,000 contribution will cost you only \$1,000 (actually even less, because you would also receive a regular tax deduction of 15% in addition to the credit).

Drawbacks and limitations

Those not eligible for the credit include full-time students, dependents, and individuals who haven't reached age 18 by the end of the tax year. Also, taking money out of a tax-deferred retirement account—for the first-time purchase of a home, for example, or to pay for medical or education expenses—will reduce or even eliminate the credit for the current tax year, and possibly for future tax years as well.

Bear in mind that the credit is good only for a five-year window: tax years 2002 through 2006. But even if you don't contribute—or don't contribute the maximum—in calendar year 2002, you may be able to contribute retroactively as late as the filing date of your 2002 return. This applies to some retirement accounts, such as IRAs or simplified employee pension plans (SEPs), but not to all.

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Of course, many lower-income households find it difficult to scrape up the funds to contribute to retirement accounts, even with the credit. Taxpayers who are heading toward full retirement but still working part-time, however, may have income low enough to qualify for the credit, and may still be contributing toward retirement accounts. Semi-retirees who are already collecting some retirement benefits may have difficulty using this program. The law states that taxable distributions from a pension plan, Roth or regular IRA, 401(k), or similar plan (but not from Social Security payments) reduces or eliminates the credit.

For example, \$2,000 in pension plan income will offset \$2,000 in contributions a person might make to an IRA or other retirement plan, eliminating what's available for the credit. Moreover, this offset applies to distributions received not just during the current tax year, but also during the previous two tax years and the period following the current tax year up to the return's due date, including extensions.

Make sure you contact a qualified tax advisor before taking any action.

Steve

Steve Pomeranz, CFP
“The Investor’s Advocate”
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