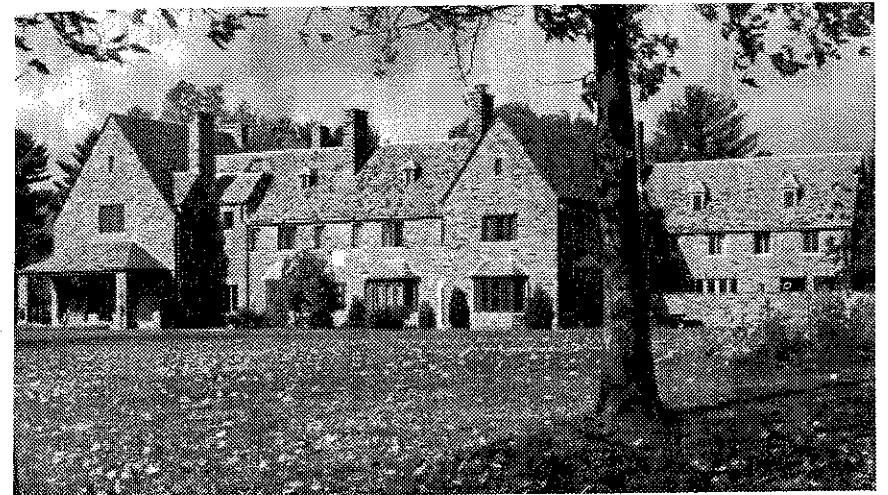


How to Build Wealth With Tax-Sheltered Investments

By
Kerry A. Lynch



ECONOMIC EDUCATION BULLETIN

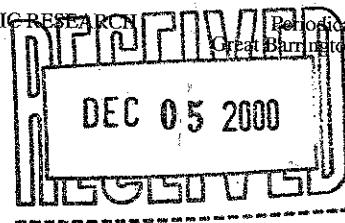
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"We do not commonly see in a tax a diminution of freedom, and yet it clearly is one. The money taken represents so much labor gone through, and the product of that labor being taken away, either leaves the individual to go without such benefit as was achieved by it or else to go through more labor."

— Herbert Spencer
English philosopher
(1820-1903)

INTRODUCTION

THE purpose of this booklet is to help the reader achieve the basic goal of every investor, building wealth, by taking advantage of tax-saving investment opportunities. With many people facing larger tax burdens every year, it is becoming all the more important for investors to protect their wealth from being eaten away by taxes that, with prudent planning, could be postponed or entirely avoided.

Too many people separate their investment planning from their tax planning. They save money in certificates of deposit or mutual funds during the year — then discover in April that their investment returns have been eaten away by income taxes. "Running in place" financially is discouraging, to say the least. Over the long term, it can lead to postponing or losing goals: early retirement, a quality education for yourself or your children, adequate savings for travel, entertainment, charitable efforts, and so on. In short, a lower standard of living than you had hoped.

You are far more likely to achieve your financial goals if you make informed investment decisions. This includes taking advantage of tax-sheltered investments. By doing so, you can increase your wealth in two ways: first, by immediately cutting your taxes and, second, by increasing the long-term return on your savings, possibly many times over what you could earn in taxable investments.

Moreover, you can do this without taking big risks. By "tax-sheltered investments," we do not mean complicated and often very risky investments that serve little purpose other than tax avoidance and creating jobs for tax lawyers. You should avoid investments that you do not understand or that are attractive solely for their tax benefits.

The investments discussed in this booklet are familiar to most people. They include such "safe" investments as U.S. Government savings bonds free of default risk. Indeed, if you are a conservative investor, tax-savvy investing offers virtually the least risky way to increase the return on your savings. Of course, the more investment risk you are willing to shoulder, the more your potential gains from tax-sheltered investing will be. But virtually anyone who pays taxes can build their wealth faster by acting on the information that follows.

I.

HOW TAXES REDUCE YOUR WEALTH

THE more money you pay in taxes, the less you have left to spend and invest. The effect of taxes on your ability to spend may be obvious, but the impact on your investing (and, therefore, on your future spending) is more subtle. Taxes hit investors with a "triple whammy." First, income taxes leave you with less to invest initially. Second, you don't earn a return on what you don't invest. Third, the return on what you do invest may be reduced by additional taxes. Over the years, the impact of taxes on your wealth can be enormous. Fortunately, there is another side to this coin, namely, that if you can postpone or avoid altogether paying taxes on your investments, the benefits can be enormous.

For example, if you invest \$1,000 in an account earning an 8 percent rate of return each year, after 10 years you will have \$2,160. However, if the annual investment earnings are taxed as income, and if your marginal tax rate is 28 percent, the after-tax return will be reduced to 5.76 percent each year. After 10 years you will have only \$1,750 — 20 percent less than the tax-free account. After 20 years, the difference will be even greater. The tax-free account will be worth \$4,660 and the taxable account worth \$3,065, only two-thirds as much.

The gap between taxable and nontaxable investments is even greater if the initial investment is subject to tax. In the 28 percent tax bracket, one would owe \$280 in Federal income taxes on taxable wages of \$1,000, leaving only \$720 to invest. After 20 years in an account earning an 8 percent taxable return, \$720 would grow to only \$2,205 — less than half of what would accumulate if the \$1,000 were not initially taxed and were fully invested in an account earning a tax-free return.

Looking at it another way, at a marginal tax rate of 28 percent an investor would need \$1,390 in pre-tax income to make a \$1,000 investment. To match the growth of an account earning a tax-free return of 8 percent, he would have to earn a return of 11.1 percent in a taxable investment.

The "Miracle" of Compound Interest

The longer the investment period, the greater the benefits of tax-deferred or tax-exempt treatment of principal and/or investment earnings. Over 40 years, the one-time \$1,000 investment in the tax-favored account described above would grow to \$21,725. By comparison, the after-tax investment of \$720 in a taxable account earning the same pre-tax return would have a value of just \$6,765. Even if the initial investments were the

full \$1,000 and only the interest were taxed, the taxable account would grow to just \$9,395, far less than the tax-favored account.

Small differences early on in the value of taxable versus tax-favored accounts snowball into much larger ones later, because of what has been called the "miracle" of compound interest. In our example of investing \$1,000 for 40 years, a difference of just \$280 in the initial investment, combined with a 2.4 percentage point tax-related difference in the rate of return, balloons to a difference of nearly \$15,000. If the initial investments are equal, the 2.4 percentage point difference in return grows to a dollar difference of \$12,300.

Just as investment earnings in a savings account compound every year, the extra savings attributable to favorable tax treatment compound. As a result, the dollar gap between a tax-sheltered investment and an equivalent taxable investment widens every year the investment is held. The wedge that taxes drive between the returns on tax-sheltered vs. taxable investments is greater, in dollar terms, the higher the rate of return on the investment. However, even at relatively low rates of return it is still significant. For example, if the rate of return is 5 percent per year, a tax-free investment of \$1,000 will increase to \$4,300 over 30 years. If the initial investment and subsequent interest earnings are subject to a 28 percent tax, it will increase to just \$2,100. In other words, even "conservative" investments can provide a much higher effective yield if they enjoy favorable tax treatment over a long period.

Your Marginal Tax Rate

A key consideration in a tax-sheltered investment is the investor's marginal tax rate, or tax bracket. This rate is not simply the average rate, or the amount of tax due divided by the amount of reported income; it is the amount by which one's tax changes in relation to an increase or decrease in taxable income. One's marginal rate is not as easy to figure out as it once was, because the official brackets can be increased by factors such as "phase-outs" and surcharges, and because the impact of state and local income taxes on Federal taxable income varies.

Estimating one's marginal tax rate is the first step in any consideration of tax-sheltered investments. Obviously, if your marginal tax bracket is 15 percent, tax-sheltered investments will save you less than if your marginal rate is 40 percent.

Because a given investment will pay the same amount to all its holders, it is to be expected that the price of a given tax-sheltered investment will be bid up to levels that bring its pre-tax rate of return well below that of an equivalent fully taxable investment. For example, if corporate bonds are

yielding 6.5 percent, municipal bonds paying tax-exempt interest will yield less, perhaps 6 percent. But imbalances in the markets can occur that create tax saving opportunities for a wider or narrower spectrum of taxpayers. In addition, if it is the account rather than the investment *per se* that is tax-favored, an investor can take full advantage of the higher return on taxable investments by holding them in tax-favored accounts (such as IRAs or company retirement plans).

Other Considerations

In our simplified examples of taxable versus tax-favored investments, we left out some important considerations. In particular, there is a distinction between investments that are *tax-exempt* and those that are *tax-deferred*. Taxes eventually must be paid on the latter. For example, the investment earnings in an IRA account are more properly termed tax-deferred rather than tax-free, since they are usually taxed when they are withdrawn as income. Eventually, taxes must be paid on many tax-sheltered investments, such as those used for retirement planning.

If one takes into account deferred taxes, the net gain from tax-sheltered investments will be less than suggested by our earlier illustrations. *But in most cases it is still higher, sometimes much higher, than a comparable investment that receives no favorable tax treatment.* Once again, the advantage will be greater the longer the investment period, the higher the rate of return, and the higher the marginal tax rate while the funds are invested. The benefits will be that much larger if your marginal tax rate is lower when funds are eventually taxed as income, for example, after you retire.

We also have not touched on the restrictions that make some tax-favored investments illiquid, such as penalties for early withdrawals from retirement accounts. These restrictions, and the question of whether it makes sense to put funds in a tax-favored investment even if you think you may face a penalty for early withdrawal, will be discussed in greater detail later.

Our main point here is to emphasize that *taxes matter*. If you are a taxpayer, you can almost certainly cut your taxes and build your wealth faster by taking advantage of tax-favored investments.

II.

REAL SHELTER: YOUR HOME

BY far the most common tax-favored investment, one's home, is not generally thought of as such. Approximately 65 percent of U.S. households are owner-occupiers. A homeowner's periodic outlays for items such as real estate taxes, insurance, and maintenance usually are significantly less than the market rental value of his dwelling, and the difference is the income earned on the homeowner's investment, in effect, from renting to himself. This income is not taxed, and because no cash actually changes hands it is unlikely that such income ever will be taxed.

In a major deviation from the principles of income taxation, the interest on the loan or mortgage used to make this investment is deductible from taxable income, even though the income generated from the use of the funds (the value of the occupancy cited above) is not taxed. Interest on mortgage debt on a second residence, such as a summer home, also is deductible in most cases. Up to \$1 million of mortgage debt qualifies for the mortgage interest deduction.

There are other tax benefits to homeownership, but the deduction of interest alone makes it financially attractive for many people. Interest is deductible, of course, only if you itemize your tax return. If the annual interest payments, plus any other deductions you are entitled to claim, are larger than your standard deduction, you will find it to your advantage to itemize.

Home Equity Loans

Mortgage interest is deductible regardless of whether the debt is used to buy, build, or improve a home, or for purposes unrelated to homeownership. For example, interest paid on a home equity line-of-credit that is used to buy a car or pay off other debt is fully deductible. This provision is especially valuable nowadays, because, as a result of the 1986 tax reform, interest on nonmortgage, personal loans is no longer tax deductible. If you use a home equity loan to finance the purchases usually paid for with consumer loans, you can still take advantage of deductible interest. It is important to realize, however, that home equity loans are secured by your home, and if you default it is the home, not the car or groceries you bought with the loan proceeds, that is subject to seizure by creditors. Also, the interest deduction is limited to home equity loans or lines-of-credit totaling less than \$100,000, not counting your original mortgage debt.

Tax Treatment of Gains

You may enjoy additional tax savings when you sell your principal

residence. The Taxpayer Relief Act of 1997 eliminated for most homeowners the federal income tax on the gain from the sale of a principal residence. If a seller owned and occupied the home for a total of at least 2 years out of 5 years prior to the sale, up to \$250,000 (\$500,000 for married couples filing joint returns) of any gain is excluded from income tax. Even home sellers who do not meet these ownership and residency requirements may be eligible for a *pro rata* amount of the exclusion, if the sale is due to a change in place of employment, health, or to "unforeseen circumstances" (as defined by the IRS). If there is any taxable gain, it will be taxed at the capital gains rate, which is lower than the rate on ordinary income. The tax rate on capital gains is 20 percent if an individual's tax bracket is 28 percent or higher, and 10 percent if his tax bracket is 15 percent. Beginning in 2001, the maximum capital gains rates for assets held more than 5 years will be 18 percent and 8 percent (instead of 20 and 10 percent, respectively). To qualify for the capital gains rate, the home seller must have owned the home for at least 18 months.

The special tax treatment of the capital gain from selling a home is partly intended to relieve home sellers of taxes on appreciation of their property as a result of inflating; however, it also makes "do it yourself" projects more attractive. Any work that homeowners may do to improve their property may add substantially to the value of the house. The tax on that, or any other increase in value, is not payable until the house is sold, and even then the gain will probably be tax-free. Moreover, in contrast to what the homeowner may do for a living, any work that he performs to maintain or improve his property is not taxed as income. The absence of income taxes on one's own work efforts and on the increase in the home's value from such "sweat equity" renders do-it-yourself projects attractive to all but the most inept or highly remunerated.

The only adverse tax aspect of investing in one's residence is that any losses upon resale are not deductible against income or against gains on other investments. (Congress has debated whether to allow such deductions, but as of this writing the law had not changed.)

Other Advantages

Official policy has been to encourage homeownership via a broad panoply of regulations and subsidies that enable those who cannot afford to buy homes outright to borrow on favorable terms (favorable, at least, in relation to the terms that would be offered to individuals to borrow for most other purposes). Because home buyers can borrow 90 percent, or more, of the purchase price, and because there are no continuous price "quotes" on houses, the "leverage" available to investors on owner-occupied housing is far greater and less risky than it is, say, for investment securities. In other

words, the financial benefits are large relative to the out-of-pocket investment (the down payment), and as long as the monthly payments are made, a homeowner will not be "sold out" if the market weakens temporarily.

In addition, land and buildings are tangible items that are likely to retain long-term value in an era of depreciating currencies.

There are also nonfinancial reasons to own one's home (security and pride, for example). It may not be advisable to buy a home solely for the tax benefits, but these should always be considered when making the decision to rent or buy. The tax savings will be larger the higher your marginal tax rate, the larger the mortgage interest payments, the smaller the down payment in relation to the purchase price, and the longer you live in the house.

III.

COMPANY RETIREMENT PLANS

PRIVATE businesses are not required to offer pension plans, but many of them do. The Federal Government, state governments, and many local governments provide them. If you are covered by a pension plan it can provide an important source of retirement income and, in many cases, one of the best opportunities for tax-sheltered investing during your working years.

Our focus here is on "defined-contribution" pension plans, which provide a separate retirement account for each employee. The pension benefit received from these plans upon retirement (or when the employee leaves the job) is not a fixed amount based on the employee's earnings, years of service, or age, as is the case with more traditional "defined-benefit" plans. Instead, it depends on the value of the retirement account. This value is based on contributions that the employee, and sometimes the employer, make to the account during the employee's working years, and the investment earnings or appreciation in asset value of those contributions. If the plan meets certain reporting and fiduciary requirements, it is a "qualified" plan and receives special tax treatment, namely, the deferral of income taxes on contributions and investment earnings until funds are withdrawn.

There are various types of defined-contribution plans, but the ones that give employees the most investment control are the "salary deferral" plans such as 401(k)s and 403(b)s (for tax-exempt and educational organizations).

Three Tax Advantages

If a defined-contribution plan offers the option of salary reduction, or "elective deferral" of salary, the employee can choose to contribute part of his salary or wages to a retirement fund rather than take it as cash salary. If salary deferral is available, you generally are well-advised to take advantage of it. Earnings that you contribute are not counted in your taxable income (although they are subject to Social Security tax); the investment earnings on your contribution are tax-deferred; and employers may match your contribution, in full or in part (although they are not required to do so). As a result, you can earn a much higher return on your pension investment than you could in comparable investments outside of a pension plan.

To illustrate, suppose you have the option of contributing to a pension plan in which your employer contributes one dollar for every two dollars

of salary you elect to contribute. If you contribute \$2,000, you immediately reduce your taxable income by \$2,000. If your marginal tax rate is 28 percent, you would save \$560 in Federal income taxes. In addition, your employer makes a matching \$1,000 contribution — giving you an instant “return” of 50 percent! If the total \$3,000 investment earns a tax-free return of 7 percent, in 20 years it will grow to \$11,600 — a cumulative return of 480 percent on your initial \$2,000 investment!

On the other hand, suppose you choose not to contribute to your pension plan. The \$2,000 in earnings is taxed as income, leaving you with \$1,440 to invest (assuming your tax rate is 28 percent). If you put this money in a conventional account where investment earnings are taxed as income, the annual 7 percent return would be reduced to a 5.04 percent after-tax return. After 20 years your investment would grow to \$3,850, or only one-third the value of the tax-favored investment, which would be worth nearly \$8,000 more.

What If Your Employer Contributes Nothing?

Matching contributions from your employer make salary-reduction pension plans an all but unbeatable investment. But even if your employer does not match your contribution, the favorable tax treatment of your initial investment and future earnings on it still make it more attractive than most other methods of saving.

In the above example, if your tax-deductible salary deferral of \$2,000 (with nothing extra from your employer) were invested tax free at 7 percent for 20 years, it would increase to roughly \$7,700. In other words, it would be worth twice what could be earned if your wages were initially taxed at 28 percent and the remainder were invested in a taxable account.

Making the Most of Your Pension Plan

The investment benefits of a salary-reduction pension plan are greatest if you make a habit of contributing part of your earnings every month, every year. (In most cases, you can arrange to do this simply by asking your employer to withhold a portion of your paycheck.)

For example, if you were to defer \$1,000 of earnings every year toward a plan providing a matching employer contribution of \$500, and if these contributions earned a tax-free return of 7 percent each year, after 20 years your account would have a value of \$65,800. Even if there are no matching contributions, your own deferrals would appreciate to \$43,900. By comparison, if you did not defer the \$1,000 in wages each year but instead took it as taxable income and put the \$720 left after taxes into a comparable taxable investment, your investment would grow to just \$25,100 (assum-

ing your marginal tax rate is 28 percent).

Of course, if your marginal tax rate were higher, the value of the taxable account would be even smaller, because both your take-home wages and the after-tax investment earnings would be lower. The higher your marginal tax rate, the more you stand to gain by electing to defer part of your earnings into a qualified pension plan.

The more earnings you defer, the greater your potential tax-related investment gains will be. There are legal limits on how much salary or wages can be deferred each year. The maximum tax-deductible employee contribution depends on the type of plan and in some cases is adjusted periodically for price inflation. For example, in 1999 it was \$10,000 for 401(k) plans and 403(b) plans. These general limits may differ for specific plans, due to the complicated tax rules used to calculate contribution limits. Your employer or a tax advisor can tell you the limit for your plan.

As explained in Chapter IV, if you (or your spouse) contribute to a company plan you may, depending on your level of income, lose the opportunity to deduct a separate contribution to an Individual Retirement Account (IRA) from your taxable income. If this is your situation, you should consider the tax consequences of both types of contributions before making either. If you decide to contribute to the company plan, you should put at least as much in it as you would have put in an IRA. This will avoid a situation where you contribute a small amount in your employer's plan (\$1,000, say) at the expense of losing the tax benefit of the larger contribution (perhaps \$2,000) that you planned to make to your IRA.

Elective deferrals provide employees with the same tax-saving opportunity as a deductible IRA, without being subject to the \$2,000 limit on tax-deductible IRA contributions. The possibility of matching employer contributions also makes deferrals a potentially more rewarding way to invest. The restrictions on early withdrawals and their tax treatment differ somewhat from IRAs, which may influence your decision to contribute to one or the other.

If you are planning to invest less than \$2,000 per year, however, an IRA may be preferable, especially if your employer's pension plan does *not* make matching contributions. An IRA offers more investment options, allowing you to invest in any of the hundreds of mutual funds now available or to buy stocks directly. In contrast, a 401(k) plan is limited to the investments offered by your employer — typically a handful of mutual funds. In addition, it usually is easier to get your money out of an IRA. You are free to withdraw funds from an IRA at any time (although you may pay a tax penalty for an early withdrawal), but you usually cannot touch your

401(k) until you reach age 59 1/2, leave the company, or qualify for special status, such as financial hardship.

Managing Your Pension Fund

Many companies give their employees a voice in managing individual pension accounts. An employee typically is allowed to allocate his fund among several types of investments, which may range from Treasury bonds to volatile "growth" stocks.

Given a choice of investments, many employees reportedly pick the "safest" investment offered. This is somewhat unfortunate, since low-risk investments usually do not perform as well over the long run as a diversified portfolio. (For this reason, professional pension fund managers, who bear a legal responsibility for prudent fiduciary management of funds, allocate their funds among a mixture of high- and low-risk investments.) If you expect to keep your pension money invested for a long time, you should consider some of the riskier investments available to you. Presumably, you will not need the money until you retire, and short-term fluctuations in investment returns will be of less concern than the long-term rate of return. In general, the younger you are, the more investment risk you can afford to take. A pension fund invested for the long term probably should include stocks, since the stock market has, on average, earned higher returns than other investments over long periods.

Of course, you should not gamble recklessly with your retirement fund, especially if you plan to retire within a few years (or withdraw funds for some other reason). More generally, it is important to keep in mind that the first goal of every investor is preservation of principal. The generous tax treatment of pension funds is wasted if your investment becomes worthless; even the most generous tax laws in the world cannot make zero grow to anything more than zero. Investors are well-advised to seek a prudent balance of risk and return, one that suits their age, financial situation, and personal tolerance for risk. The special tax treatment of pension funds will help make up for a lower return on the most conservative investments, but also will magnify the usually higher returns on "middle of the road" investments.

Your employer determines the kinds of investments from which you can choose. Your options may be broad or quite limited. Whatever the case, do not assume that since your employer is offering the investments, they will automatically earn a respectable return given their level of investment risk. It is up to *you* to track their performance, and if it is sub-par you might ask your employer to consider offering alternative investments. There is also no guarantee that an investment is "safe" because your employer

makes it available to you. For example, the "guaranteed investment contracts" offered by some pension plans are actually policies sold by insurance companies. It is the insurer, not the employer, that is responsible for paying the "guaranteed" return, and the guarantee is only as good as the insurer behind it. You should invest in such contracts only if the insurer is highly rated by A. M. Best and other financial ratings services. Whatever investments you choose, you should regularly review your pension account holdings and make changes as warranted.

A word on employee stock ownership plans: pension plans that are entirely invested in the stock of your employer's company can be dangerously lacking in diversification. If the fortunes of your employer take a turn for the worse, your retirement fund (and a large chunk of your wealth) could go up in smoke. If your pension is invested in a single stock, it is advisable to adjust your other investments so that your overall holdings are broadly diversified.

Cash Withdrawals

The tax laws are designed to encourage workers to save their pension benefits until retirement and then draw down any savings during retirement. Consequently, the laws tend to penalize those who receive pension payments at a very early or a very late age. Tax treatment of pension withdrawals depends on the type of pension plan, the form of benefit payment (annuity or lump-sum), the amount of the benefit, and the beneficiary's age.

Withdrawals from most qualified company pension plans are usually not permitted until you reach age 59 1/2. Exceptions to this rule vary, so you should check with your employer. In most cases you can receive payments before 59 1/2 if you leave your job, are laid off or disabled. You may also be allowed to take an early withdrawal in the form of a loan (see below).

Early withdrawals are also permitted if you can claim "financial hardship" based on the IRS's rather strict definition. To qualify for a hardship withdrawal, the IRS requires you to show an immediate and heavy financial need that you cannot meet with other financial resources. Qualified needs include the following expenses: the purchase of a home (but not mortgage payments); tuition, related fees, and room and board for college studies for yourself, your spouse, or dependents; medical expenses previously incurred for yourself, your spouse, or dependents; preventing your eviction or mortgage foreclosure; and paying funeral expenses for a family member. It is not enough to show need; you also must tell your employer that you cannot pay the expenses by other means, such as borrowing from a bank, selling off assets, or (as discussed below) borrowing funds the pension plan itself.

If an early withdrawal is permitted, generally you will owe a 10 percent penalty tax on the distribution, in addition to regular income tax. Thus, if you withdrew your entire pension fund in a lump sum of, say, \$50,000, you would owe \$14,000 in regular Federal income taxes and \$5,000 in penalty taxes (assuming you are in the 28 percent tax bracket).

Exceptions to the penalty include payments made on account of your death or disability, for certain medical expenses, if you leave your job or retire at age 55 or over, or as part of a series of substantially equal periodic payments made over your life expectancy after you leave your job. Early distributions that are rolled over to another pension plan or an IRA within 60 days of your receiving them generally are exempt from both the penalty and regular income tax, although mandatory withholding complicates the process of making tax-free rollovers (see box on p. 18).

After age 59 1/2 there is no legal restriction on making withdrawals from most pension plans. You will owe income tax on withdrawals that represent either a return of contributions that were not previously taxed, or investment earnings. Thus payouts from most salary-deferral pensions, such as 401(k)s, will be fully taxed. Again, rollovers are excluded from this tax (see box).

Lump-Sum Payments

When you leave your job or retire your employer may offer you the option of taking your pension in a series of annuity payments or in a single lump sum. A lump-sum payment gives you control over the entire account balance, and you are free to invest it or spend it as you choose. Employers are not always required to offer a lump-sum option, and the employee's choice of it may be subject to the employer's approval.

If you do receive a lump-sum payment, special tax treatment may be available. If you were born before 1936 and you participated in your employer's pension plan for at least 5 years, you are eligible for special 5 or 10 year averaging tax treatment. Under this method, the income tax on the lump sum is calculated as if you received the money in equal parts over 5 or 10 years (you pay the entire tax up front, however). If you participated in the plan before 1974 a portion of the distribution may be eligible for a lower tax rate. Whether income averaging will reduce your taxes depends on your regular tax bracket and the special tax rates applied to averaged income; you are well-advised to consult a tax advisor. For those born after 1935, lump-sum distributions received after 1999 are not eligible for averaging.

In deciding whether to apply income averaging, remember that you can elect the option only once in your lifetime. If you receive a small distribu-

tion but expect to receive a larger one in the future, it may be better simply to roll over the money into another retirement account, thus deferring taxes on it. If you roll it over into an IRA, bear in mind that withdrawals from IRAs are not eligible for income averaging.

Loans

Some pension plans allow employees to borrow from their retirement accounts. Such loans are not subject to income tax if they meet certain conditions. The plan must be a qualified pension plan, and the maximum tax-free loan may be limited. In addition, the loan must be repaid within 5 years, with the notable exception of a loan used to buy a principal home, which may be repaid over a much longer period.

Required Distributions

After age 59 1/2 there is no legal restriction on making withdrawals from most pension plans. There also is no penalty for leaving the funds fully invested, until you reach age 70 1/2 or retire, whichever comes later. The law requires that you begin taking distributions by the later of 1) April 1 of the calendar year following the year in which you turn 70 1/2 or 2) April 1 following the year in which you retire. (If you own more than a 5 percent interest in the business, however, you must start taking distributions following the year in which you reach age 70 1/2, even if you are still working.) The minimum required distribution is based on your life expectancy (and that of a designated beneficiary, if any). If you fail to take at least this minimum, you face a tax penalty of 50 percent on the gap between it and what you received.

If you are over 59 1/2 but not yet required to take distributions, consider the tax and investment consequences of taking voluntary withdrawals. The less you withdraw, the longer you avoid paying taxes on the income and the longer you earn tax-free interest. But the larger the account is when you turn 70 1/2 or retire, the larger will be the required distributions after that. They might be large enough to push you into a higher tax bracket. In that case, you might be able to reduce your total taxes by taking taxable withdrawals earlier, even though you will sacrifice some tax-free investment earnings.

Balancing Tax Benefits vs. Tax Penalties

The legal restrictions on withdrawing money from company pension plans, plus the tax penalties for many withdrawals, make them illiquid investments. Any salary or wages that you defer are essentially locked up until you retire or leave your job. Even if you can get permission for a withdrawal under other circumstances, you will probably owe a tax pen-

A Special Tax on Pension Distributions

In 1992, in an effort to raise revenue to pay for extended unemployment benefits, Congress enacted a new withholding tax on pension distributions. The tax applies to any distribution that is eligible for rollover treatment, such as a lump-sum payment received when you retire, change your job, or lose your job.

The law provides that 20 percent of the distribution will be withheld against future Federal income taxes unless you transfer the distribution *directly* into an IRA or another employer's pension. Previously, an employee could have the full distribution paid directly to himself, and he had a 60-day grace period to decide whether to roll it over into a tax-sheltered retirement account. Now, 20 percent is automatically withheld unless the distribution is immediately transferred directly to another qualified account.

If the 20 percent is withheld, you still have 60 days to make a "tax-free" rollover. In that case, the 20 percent withholding will be refunded when you file your income tax (in the meantime, you lose the chance to earn interest on it). However, the full 20 percent will be refunded only if you roll over the *entire* amount of the distribution — including the amount that was withheld! If you roll over less, the 20 percent will be subject to income tax, plus a 10 percent tax penalty if you are under age 59 1/2.

For example, if you were entitled to a \$100,000 distribution, you would initially receive only \$80,000. To get a full refund of the \$20,000 withheld, you must deposit \$100,000 into an IRA or another employer's pension (within 60 days of taking your distribution). If you deposit only \$80,000, then you will owe income tax on the \$20,000, plus a 10 percent penalty if it is an early distribution. If you are under age 59 1/2 and your marginal tax rate is 28 percent, you would pay \$5,600 in Federal income tax and \$2,000 in penalties. Your \$20,000 refund would be reduced by \$7,600. (If you do not deposit anything in another qualified retirement account, you will owe taxes on the full \$100,000 distribution, amounting to \$38,000 with penalties.)

This law was passed with virtually no public debate, and reportedly with heavy support from lobbyists for the financial industry, who saw the tax as a neat way to keep pension payouts from "leaking out" of the investment industry. Assuming the law is not repealed by Congress (a fading hope), the best ways to avoid the withholding tax are to leave your pension money with your old employer until you decide where to invest it, or immediately transfer it directly into an IRA. *If you have time get financial advice*, since either choice has future tax consequences. (For example, funds in an employer's pension plan can sometimes be borrowed tax free, but money borrowed from an IRA is usually taxed as income; withdrawals from a company plan may qualify for "forward averaging" tax treatment, while IRA withdrawals do not.) If you do transfer your distribution into an IRA, the account should be separate from any other IRAs, to preserve the option of switching it into another employer's pension plan at a later date.

alty if you are young. The option to borrow provides a large "loophole," but in general you should avoid deferring salary that you will want in a few years for school, a down payment on a home, or whatever.

That said, the enormous tax advantages given to company pension plans make them a highly attractive long-term investment. Even if you contribute for only a few years, the money can reap an enormous return by the time you retire, particularly if you invest early.

For instance, if you were to contribute \$1,000 of salary into a 401(k) plan each year from age 20 through age 29 *and nothing more after that*, and if you left the funds invested at a return of 8 percent, at age 60 you would have over \$157,000. By comparison, if you waited *until* age 30 to begin contributing to your retirement account, and then deferred \$1,000 of salary *every year after that* until you reached 60, you would have only \$122,000. In other words, 10 years of investing early on would outgrow 30 years of investing later on. The earlier you set aside funds, the more you gain.

When do the benefits of tax-free treatment outweigh the penalties you may owe for an early distribution? The answer depends on your marginal tax rate, the difference between the rates of return available on taxable and nontaxable investments, and the length of time you hold the investment. In most cases, you would have to hold the tax-deferred investment for at least 5 years before the benefits offset the penalties.

For example, if you were to defer \$1,000 of untaxed wages into a pension plan earning 8 percent tax-free annual interest, and take the entire account as a taxable distribution upon leaving your job 5 years from now, you would be entitled to a gross payment of \$1,470. You would owe \$410 in income taxes (assuming a 28 percent tax rate) and, if applicable, an early withdrawal penalty of \$147, leaving an after-tax distribution of \$913. In contrast, if you had initially taken the \$1,000 as cash wages and invested the \$720 left after taxes in an equivalent investment subject to taxation of the 8 percent investment earnings, after 5 years you would have \$950. In this case, the taxable account would be the better investment. After 8 years, however, the tax-favored investment would provide more.

Planning is the key to making the most of opportunities to build wealth through your employer's pension fund. Think twice before putting money into it, and think even harder before taking it out.

Looking Ahead

Our discussion covers the tax laws most commonly applied to pensions. Exemptions and exceptions abound, and to understand all your legal options, avoid tax penalties, and minimize your tax bill, you should study the

laws or consult a competent financial planner. This is especially important if you are faced with financial decisions involving large sums of money (a lump-sum distribution, for example). It is better to invest in good advice than risk paying higher taxes and possibly tax penalties later on.

If you do not plan to retire or change jobs in the near future, the specific tax laws discussed here may change by the time you do retire. There is no way to anticipate what future laws concerning pension contributions and benefits will be. You should keep abreast of tax and regulatory developments, to help ensure that you use these tax-sheltered investments to your best possible advantage.

IV. IRAS

IN recent years Congress has expanded Individual Retirement Accounts (IRAs). Eligibility rules have been eased, allowing more Americans to take advantage of these accounts. In addition, there are now several types of plans available: traditional IRAs, Roth IRAs, SIMPLE IRAs, and Keoghs. Each offers unique tax benefits.

A. Traditional IRAs

A traditional IRA may be established by anyone under age 70 1/2 with earnings. These accounts offer two important tax advantages. The investment income on an IRA contribution accumulates tax-free until the funds are withdrawn. Second, depending on your income and whether you participate in a company pension plan, your IRA contribution may be tax-deductible on Federal and many state income tax returns.

The maximum contribution each year is \$2,000 or, if earnings are less than \$2,000, 100 percent of earned income. If you file a joint tax return, you and your spouse may each contribute up to \$2,000 as long as your combined earnings cover the contributions. Thus, if one spouse is not working but the other earns at least \$4,000, each may contribute \$2,000. (The \$2,000 limit on IRA contributions has not been adjusted for price inflation since it was introduced in 1981. Had it been, the maximum contributions would now be about \$3,700. As of this writing, Congress was considering an increase.)

If you are eligible and financially able to make a tax-deductible contribution to a traditional IRA, the tax benefits are substantial, provided you can leave the fund invested for a few years. A tax-free investment in an account earning tax-free interest will grow much larger than a taxable investment in the same account with taxable interest. For example, annual tax-deductible contributions of \$2,000 invested in an IRA account earning 8 percent each year will grow to \$31,000 after 10 years. By comparison, if the \$2,000 in earnings are subject to tax each year and invested in the same account but with taxable interest, the yearly investment would be only \$1,440 and the after-tax return only 5.76 (assuming your marginal tax rate is 28 percent). After 10 years, the taxable investment would grow to \$19,900, just 65 percent of the tax-favored investment.

Eligibility for Deductible Contributions

The amount of a contribution to a traditional IRA that you may deduct from your taxable income depends on your income and whether you are

actively participating in an employer's pension plan. If you are not married and are not covered by a pension plan, or if you are married and neither of you has coverage, you may claim the full \$2,000 deduction regardless of your income (assuming your earnings are at least \$2,000). Otherwise, individuals may deduct the full \$2,000 only if their "modified adjusted gross income" (MAGI) is below a certain limit. (MAGI can be calculated from your tax return, using the guidelines described in IRS Publication 17. It equals wages, investment earnings, and other income, *minus* most adjustments to income other than for IRA deductions, *plus* a few other items, such as deductions for the interest on student loans.) In 1999 you could deduct up to \$2,000 if your MAGI was below the following thresholds:

- \$31,000 if you are single, head of household, or married filing separately and treated as single because you lived apart from your spouse the entire year;
- \$51,000 if you are married filing jointly and both you and your spouse are active participants in an employer's pension plan during the year, *or* you are a qualifying widower;
- \$51,000 if you are married filing jointly and you are an active participant but your spouse is not. You use the \$51,000 threshold, your spouse uses a \$150,000 threshold;
- \$150,000 if you are married filing jointly and you are not an active participant in a pension plan but your spouse is. You use the \$150,000 threshold, your spouse uses the \$51,000 limit;
- \$0 if you are married filing separately and you lived with your spouse for any part of the year.

If your income exceeds these limits, the maximum deduction you may claim for an IRA contribution is gradually phased out, so that above a certain income threshold you are not allowed any deduction. If your income threshold is \$31,000 (see above), the deduction limit is phased out for MAGI income of \$31,001-\$40,999 and there is no deduction for income of \$41,000 or more. If your threshold is \$51,000, the phase-out range is \$51,001-\$60,999 with no deduction for income of \$61,000 or more. If your threshold is \$150,000, the deduction limit is phased out for income of \$150,001-\$159,999 and eliminated for income of \$160,000 or more. If your threshold is \$0 the deduction is phased out for income of \$0-\$9,999 and eliminated for income of \$10,000 or more.

These income thresholds are scheduled to increase by \$1,000 a year from 2000 through 2002. After that larger increases are scheduled, so that by 2005 the phaseout range for single filers, for example, will be \$50,000-\$60,000.

Deductible and nondeductible contributions for any given tax year may

be made up until income tax day (usually April 15) of the following year. Of course, you will benefit most from the tax-free buildup of investment earnings if you invest early rather than waiting until the last minute.

Setting Up an IRA

Mutual fund investment companies, banks, savings and loans, brokerage firms, and credit unions offer IRA investment programs. These are technically "trust" or "custodial" accounts with the bank (or broker, etc.) serving as the trustee or custodian. Insurance companies offer deferred annuities that qualify as IRAs. The total contribution may be split among any number of separate accounts. Before establishing any account, the investor should carefully review the terms of the agreement, including any management fees and restrictions on investments or transfers of the funds. Annual management fees should be paid separately so that they will not be deducted from the IRA contribution itself.

IRA funds may be invested by their trustee or custodian in a wide range of vehicles, from long- and short-term fixed-return investments such as Government bonds or bank certificates of deposit, to common stocks, money market funds, and mutual funds. The individual may have greater or lesser control over the type of investment depending on the terms of the account. Tax laws do not restrict the *direct* transfer of funds from one IRA to another, and thus they allow the investor considerable flexibility in switching accounts. If done properly (competent advice should be obtained beforehand), such a transfer is not considered a "rollover," and the legal limit of one tax-free rollover per year does not apply. However, transfers may be limited by a trustee, depending on the term of the agreement, so it is important to review these terms beforehand.

If you put your IRA in an investment company that offers a family of mutual funds, you will be able to allocate your investment among these funds and switch easily from one fund to another according to your investment objectives. If you prefer to manage your investments even more closely, for example by choosing specific stocks instead of relying on a mutual fund manager to do so, you can bypass the traditional IRA and set up a "self-directed" IRA. Both investment brokerages and banks offer these, but brokerages usually are less expensive and more convenient. This type of account retains the brokerage as trustee or custodian, but allows the investor to select the investments. Agreements set up using IRS model trust Form 5305 and model custodial account Form 5305-A satisfy all IRS requirements for such accounts. It is up to you to find a bank (or broker) that will agree to serve as trustee. IRA accounts currently held in other forms can be converted to self-directed accounts with no tax penalty. Such conversions must meet certain requirements to es-

cape taxation and should be done with care.

A Pitfall to Avoid

"Safe" investments, such as certificates of deposit, typically provide lower yields over the long run than a diversified portfolio that includes stocks, even though the latter may be subject to more short-term volatility. How you invest your IRA will be influenced by your other investment holdings and your overall investment strategy.

The fact that capital gains are not immediately taxed in tax-deferred pension accounts can create the temptation to take a "flyer" with such funds, say, by investing in high-risk "growth stocks" paying little or no dividends. While the prospect of not paying gains taxes on a stock that increases markedly in price might seem to appear sound, all too often such stocks decline toward worthlessness. In that event, the investor is often chagrined to find he cannot deduct the loss (conveniently forgetting that the original investment was not counted as taxable income when funds were paid in to the account) and holds on to "losers" in the account in hopes of recovery.

The problem is that even the "miracle" of compound interest cannot make zero increase to more than zero. For this reason, investments in self-directed tax-deferred pension accounts should be concentrated in conservative holdings that offer generous current yields, which can compound and accumulate free of tax.

Rollovers

You can make a tax-free rollover of funds from another IRA or from a qualified pension plan into an IRA, in which case there is no limit on the amount transferred. To avoid income taxes or penalties you should get competent advice before doing this. If the funds are paid to you before being redeposited, there is a limit of one tax-free rollover per year, and to qualify the rollover must be made within 60 days. If the funds are directly transferred from one account to another, there is no restriction on the number of times you can make tax-free switches.

In regard to rollovers from employer-sponsored plans to IRAs, it is especially important to roll funds directly into the IRA rather than having them paid to you first, in order to avoid a 20 percent withholding tax (see page 18).

Nondeductible Contributions

If you are not eligible to deduct your contribution, you can still make a nondeductible contribution. If a deduction of less than \$2,000 is allowed,

you may make a nondeductible contribution, provided that your total IRA contributions do not exceed \$2,000. However, if your income level makes you eligible to contribute to a Roth IRA (discussed below), you almost certainly are better off doing that. Investment earnings in both types of accounts accumulate free of tax. The earnings in a traditional IRA are taxed upon withdrawal, however, while withdrawals from a Roth IRA, if certain conditions are met, are completely tax-free. In addition, you are not required to take minimum distributions from a Roth IRA after you reach age 70 1/2, as you are with traditional IRAs. In short, greater tax benefits and more lenient withdrawal rules make Roth IRAs a better alternative to traditional but nondeductible IRAs.

However, if your income level is high enough to bar you from contributing to a Roth IRA, a traditional but nondeductible IRA still offers the tax-free buildup of investment earnings. You must weigh this advantage against the tax restrictions on withdrawals made before you reach age 59 1/2 (discussed later in this chapter). If your marginal tax rate is relatively high, the tax benefits may more than offset the penalty after only a few years. Generally it takes about 5 years before this happens.

For most investors age 59 1/2 or older, there is little downside to making nondeductible contributions, since there is no penalty for withdrawals. You can make contributions through age 70 1/2, after which you must begin drawing down your account.

For investors who expect to be in relatively high tax brackets when they withdraw funds from a nondeductible IRA account, there is another consideration. The investment buildup in an IRA is taxed, upon withdrawal, as ordinary income at rates as high as 39.6 percent. In contrast, capital gains on non-IRA investments are subject to a maximum tax of 28 percent. If you expect the buildup of your investment to come primarily from unrealized capital gains rather than interest or dividends (a relatively high-risk strategy, as discussed on page 24), you may be better off placing your funds in a conventional account rather than a nondeductible IRA. The gains will not be taxed until they are realized, at which time they will be subject to the lower tax on capital gains rather than the higher tax on ordinary income. In addition, you will be able to deduct capital losses, which you cannot do within a nondeductible IRA. A conventional account is most likely to be more advantageous than a nondeductible IRA if you (or your mutual fund manager) follow a "buy and hold" strategy. If, in contrast, your account will have a high rate of portfolio turnover, a nondeductible IRA may be a better choice, because it allows capital gains to compound tax deferred.

If you do make nondeductible contributions, it is up to you to keep a

record of them. Most banks, brokers, and other IRA trustees report withdrawals as if they are taxable. It is your responsibility to show otherwise and thus avoid paying a double tax when nondeductible contributions are withdrawn. For some people, the more complicated bookkeeping involved when one has nondeductible IRAs may outweigh the benefits (see "Record Keeping," below).

Restrictions and Penalties

Deferred taxes on contributions and investment earnings make traditional IRAs a very attractive investment. To encourage their use for retirement planning rather than short-term investing, and to insure that IRA funds actually are drawn upon for retirement income and not simply used to build up tax-sheltered legacies, certain restrictions apply to the use of IRA funds.

Before you reach age 59 1/2 there are no legal restrictions on withdrawals from IRAs. This is in contrast to 401(k)s and other company pension plans, where early withdrawals are generally prohibited. However, early IRA withdrawals almost always are subject to a 10 percent penalty tax, plus regular income tax on the portion that reflects the return of tax-deductible contributions and investment earnings.

The only exception to both the income tax and the penalty is for a payment that is repaid or rolled over into another tax-sheltered account within 60 days. This includes loans that are repaid within 60 days. (Longer "loans" are treated as taxable distributions.)

There are six other exceptions to the penalty for early IRA withdrawals. The penalty is waived if you are totally disabled; if you pay deductible medical expenses that exceed 7.5 percent of your adjusted gross income, in which case the IRA penalty does not apply to distributions that exceed the 7.5 percent threshold; or you received unemployment benefits for at least 12 consecutive weeks and you paid medical insurance premiums for yourself or your family (withdrawals up to the amount paid for insurance are not penalized). If you are a first-time home buyer, up to \$10,000 may be withdrawn without penalty to cover qualifying home-buyer expenses. Distributions are also free of penalty if they are used to pay for the expenses of a higher education, including tuition, room, and board for yourself or your family. Finally, the IRA penalty is waived for an early distribution that is part of a series of roughly equal payments received yearly over your life expectancy (or the joint life expectancy of you and a beneficiary). In other words, an annuity.

As with many "targeted tax breaks," there are many rules and regulations governing these exemptions. If you think you may be eligible for one,

Giving Your Children a Head Start

If you have children who are earning income but who are not in a financial position to contribute to an IRA (or to a company pension plan by making voluntary salary deferrals), consider giving them the money to do so. This will enable them to take full advantage of the tax deduction for such contributions and the tax-deferred buildup on the investment. These tax benefits offer an all but unbeatable head start to long-term investors. Indeed, depending on the rate of return, an individual who contributes for just a few years early in his working life can accumulate *more* upon retirement than someone who contributes more but starts later.

For example, if the rate of investment return were 6.5 percent each year, a young adult who contributed \$2,000 of tax-deductible income to an IRA each year from age 20 through 29 and nothing after that would have a fund worth \$190,100 upon reaching age 60. If he postponed his contributions until age 30, and invested \$2,000 each year after that, by age 60 he would have \$184,000. In other words, 10 years of early contributions would accumulate to a larger amount than 30 years of later contributions. The reason is that the smaller investment compounds for a longer period. If the level of interest rates were higher, the difference would be even larger. At 8 percent, the "early bird" account would accumulate to roughly \$315,000, compared to "only" \$245,000 for the larger investment made later on — a difference of \$70,000!

Your children can contribute to IRAs only if they have wages, salary, or self-employment earnings. Obviously they can contribute to a company pension only if their employer offers a plan with that option. Moreover, you cannot make direct contributions for them; it is up to them to invest money you give them in an IRA or use it to offset the salary that they defer into a retirement plan.

check the tax laws first to make sure you cover all the bases. Congress is considering adding other exceptions but, as of this writing, has not yet enacted any legislation. Readers should consult a reliable source for the latest information.

The expanding list of penalty exemptions makes IRAs a more liquid investment than they used to be for people under age 59 1/2. However, just because you qualify to make a penalty-free withdrawal does not mean you should do so. Every withdrawal reduces your potential to build wealth using these tax-favored accounts. In general, early withdrawals should be avoided.

Between ages 59 1/2 and 70 1/2 there is no tax penalty for withdrawals. Payments are taxed as ordinary income. If you made both deductible and nondeductible IRA contributions, part of any distribution will be tax free (see "Record Keeping," below). Until you reach age 70 1/2 you are not required to withdraw funds, and the longer you leave your investments

intact the longer you will enjoy the tax-free buildup of interest. However, if the distributions you will eventually be required to take will be so large as to push you into a higher tax bracket, consider withdrawing funds before age 70 1/2 even if you do not "need" the money; in this way, you may smooth your tax bill.

After age 70 1/2 you must begin drawing down your IRA account. After April 1 following the end of the year in which you turn 70 1/2, no further contributions may be made (except for lump-sum distributions from company pension plans) and you must begin receiving minimum annual distributions, based on IRS actuarial schedules. Failure to take the minimum distribution may result in a 50 percent penalty tax on the required amount not actually distributed.

When you take your first mandatory distribution you must choose one of the methods recognized by the IRS for calculating the required minimum withdrawal. Once the choice is made it is difficult to revoke. Each method carries important implications for your taxes, your beneficiaries, and your estate. Do not rely on your account's trustee (brokerage firm, bank, etc.) to choose the method, as their choice may be based on what is convenient for them rather than what is most advantageous for you. You are well advised to get professional advice before making this key decision. To familiarize yourself with the major rules, one very useful book is *IRAs, 401(k)s & Other Retirement Plans: Taking Your Money Out* by Twila Slesnick and John C. Suttle (Nolo Press, \$24.95).

Record Keeping

Because IRAs receive special tax treatment, and because this treatment is subject to change over the years, it is important to keep a record of all contributions and withdrawals. To minimize tax complications, IRAs based on your own contributions should be kept separate from an IRA based on a lump-sum distribution from a pension plan. Accounts based on deductible contributions should be kept separate from accounts based on nondeductible contributions.

In the eyes of the IRS, all traditional IRA accounts are treated as a single account, and withdrawals in a given year from any and all IRAs are treated as a single withdrawal. Therefore, if you have IRAs based on both deductible and nondeductible contributions, a portion of any withdrawal will be taxable and another portion will be tax-free. The tax-free portion is calculated using IRS Form 8606; basically, it is the ratio of your nondeductible contributions to the total balance of all your IRA accounts. This "ratio tax" applies even to a withdrawal from a separate IRA based wholly on nondeductible contributions. IRA trustees (such as banks or mutual fund admin-

istrators) will report all withdrawals to the IRS as if they are taxable. The burden of proving that they are not is upon you. According to the IRS, you should keep extensive tax records from the time you make contributions until all IRA savings are withdrawn.

B. Roth IRAs

Roth IRAs became available in 1998. Unlike traditional IRAs, contributions to Roth IRAs are not deductible. But the investment earnings grow tax-free and, subject to certain conditions, withdrawals may be completely tax-free. Thus, an owner of a Roth IRA will never have to pay tax on the IRA's earnings, unless he or she makes premature withdrawals, as discussed below. In addition, Roth IRAs do not require minimum distributions at age 70 1/2, thus providing investors the option of continuing to let the full balance of the IRA compound tax-free. Moreover, Roth IRAs may still be funded after the taxpayer reaches age 70 1/2, unlike traditional IRAs. The income caps that govern contribution limits are also higher than for regular IRAs.

Contributions

An individual may make nondeductible contributions to a Roth IRA of up to \$2,000 per year or, if earnings are less than that, 100 percent of earned income. Couples filing a joint return may contribute up to \$2,000 each providing their combined income is at least \$4,000. The \$2,000 limit is reduced by any deductible or nondeductible contributions made to a traditional IRA. In other words, combined contributions to traditional and Roth IRAs may not exceed \$2,000 per year. Roth IRAs may still be funded after you reach age 70 1/2, so long as you have the required compensation.

Depending on your income, your maximum contribution may be less than \$2,000 or even zero. "Income" here refers to "modified adjusted gross income" (MAGI) as defined by the IRS specifically for figuring Roth eligibility. In 1999, for single and head of household filers or married couples filing separately who lived apart the entire year, permissible contributions are phased out for MAGIs between \$95,000 and \$110,000. For married couples filing jointly, contributions are phased out for MAGIs between \$150,000 and \$160,000. For a married couple filing separately who lived with each other for any part of the year, the phaseout range is \$0 to \$10,000. Above the higher thresholds, no Roth contributions are permitted. Unlike traditional IRAs, these income phaseouts apply regardless of whether you (or your spouse) are covered by an employer's pension plan.

Contributions for a given tax year may be made up until income tax day (usually April 15) of the following year. There is a 6 percent penalty tax each year for contributions that exceed the limit, unless the excess plus any

related investment earnings are withdrawn by the time you file your tax return. As of this writing, Congress was considering raising both the \$2,000 contribution limit and the income phaseouts; check IRS Publication 17 for the latest rules.

Converting a Traditional IRA to a Roth IRA

Converting a traditional IRA to a Roth IRA, in order to take advantage of the tax-free withdrawal provision, is also possible. You may do this if your modified adjusted gross income is \$100,000 or less and you are not married filing separately. (For this purpose, MAGI does not include the amount of the conversion.) However, income taxes must be paid on the amount converted, except to the extent that the account was allocable to nondeductible contributions.

Converting could appeal to taxpayers who plan to leave their IRAs to their heirs, since distributions to beneficiaries often will be tax-free. However, the conversion tax should be carefully considered. The additional income from the conversion can boost taxpayers into a higher tax bracket, or make Social Security benefits taxable as a result of the increase in income. If you do make a conversion, you should try to pay the tax from sources outside the IRA.

To make a conversion, the account holder can direct the trustee of the traditional IRA to transfer the funds to a new Roth IRA trustee, or simply register the account with the same trustee. Funds can also be transferred by taking a distribution from the IRA and rolling it over to the Roth IRA. Such rollovers must be done within 60 days of receiving the distribution to avoid tax.

SEP (Simplified Employee Pensions) are also eligible for conversion to Roth IRAs, as are SIMPLE IRAs (discussed below), provided you have held the SIMPLE IRA account for at least 2 years.

If you are over age 70 1/2 and required to take minimum distributions from a traditional IRA, you may not convert such a distribution into a Roth IRA. However, you can convert any of the remaining portion of the IRA. Through 2004, required minimum distributions are counted toward the \$100,000 income limit that determines whether you are eligible to convert to a Roth IRA. Beginning in 2005, they will not be counted.

If you are under age 59 1/2, a conversion from a traditional IRA to a Roth IRA is not subject to the 10 percent tax penalty for early distributions.

Recharacterizations

If you convert a traditional IRA to a Roth IRA and decide you want to

“undo” it (perhaps because you discover that your income is more than the \$100,000 ceiling), you can transfer the funds back into a regular IRA by doing a “recharacterization.” You can also do this if, for example, you contributed to a Roth and later decide you would like to switch your contribution to a regular IRA in order to claim a deduction. Recharacterizations may be done until the due date for your taxes (usually April 15, plus any extensions).

A traditional IRA that is converted to a Roth IRA then recharacterized back to a traditional IRA may be “reconverted” back into a Roth. The main reason to do this is to save on taxes in the event the value of the converted funds declines. Instead of paying taxes on the higher value of the funds as of the first conversion to a Roth, you can pay the tax based on their lower value when you reconvert. However, the IRS has placed limits on the number and timing of reconversions.

Improper switches between IRA funds can trigger taxes and penalties for early withdrawals and excess contributions. To avoid unpleasant surprises, consult IRS Publications 17 and 590.

Withdrawals

The investment earnings on your Roth contributions accumulate free of tax. Withdrawals are completely tax-free *if* they are “qualified.” To be considered qualified, they must be made after the account has been held for at least 5 years *and* the taxpayer is older than 59 1/2, disabled, a beneficiary receiving distributions following the death of the account owner, or using the distribution to pay up to \$10,000 for the expenses of buying a first home.

The 5-year holding period begins with January 1 of the first tax-year you contribute to a Roth IRA. If you subsequently open other Roth accounts, you do not have to meet separate 5-year tests for them. For example, if you opened your first Roth IRA by making a \$500 contribution in March 2000 for the 1999 tax year, and in 2001 you converted a traditional IRA into another Roth IRA, the 5-year holding period for both accounts would begin January 1, 1999 and end December 31, 2003.

Even if a distribution is not qualified, the first withdrawals from the account are treated as a return of the investor’s contribution and are tax-free. After amounts equal to the entire contribution have been withdrawn, additional withdrawals are taxable. All of your Roth accounts are treated as one account for purposes of figuring whether any withdrawal is a tax-free return of your contributions.

If a withdrawal is taxable *and* you are under age 59 1/2, it is also subject

to a 10 percent penalty. The exceptions to this early-withdrawal penalty are the same as for traditional IRAs. Namely, it is waived if you are disabled, have medical expenses exceeding 7.5 percent of adjusted gross income, received unemployment benefits for at least 12 weeks and paid medical insurance premiums, or you paid first-time home expenses up to \$10,000.

If you have a Roth IRA that was created by converting a traditional IRA, the rules on the taxation of withdrawals are somewhat different. For example, a distribution taken before age 59 1/2 may qualify as a tax-free return of your contribution but still be subject to the 10 percent penalty. See IRS Publication 590 for further details.

Distributions to Beneficiaries

If you inherit a Roth IRA, you must begin taking minimum distributions each year, unless you are a surviving spouse. They may or may not be taxable, as discussed below.

You must take distributions according to your life expectancy or else withdraw the entire account by the end of the fifth year following the owner's death. However, if you are a surviving spouse and you are the account's sole beneficiary, you may avoid this requirement by electing to treat the account as your own, in which case you are not required to take any distributions during your lifetime. Surviving spouses who choose to take distributions over their life expectancy can delay the first withdrawal until the date the original account owner would have turned 70 1/2. The choice of distribution method may not be up to the beneficiary, as the original owner of the account or the terms of the plan may specify which method is to be used (check this before opening a Roth IRA).

Distributions to surviving beneficiaries are tax-free if they are received five years or more after the original account owner opened his first Roth account. Before that 5-year period, distributions are tax-free to the extent they represent a return of contributions. After amounts equal to the entire contribution have been withdrawn, additional withdrawals are taxable.

There is no 10 percent penalty for early withdrawals from a Roth IRA if you receive them as a beneficiary, even if you are under age 59 1/2.

Roth IRA vs. Traditional IRA

The confusing rules for IRAs and Roth IRAs can be overwhelming when you are trying to decide which is the best way to save for retirement. Before putting funds in either, consider putting money into a 401(k) or other employer-sponsored plan. If your employer makes matching contribution these plans are an all but unbeatable investment, and you should

fund them at least up to the amount the employer matches.

Next, determine your eligibility for IRA contributions. Factors to consider are your income, marital status, and whether you or your spouse is active in a pension plan. High earners who are barred from making deductible contributions to a traditional IRA may still be eligible to open a Roth account, because the income caps are higher. On the other hand, a non-working spouse of a high earner may be barred from contributing to a Roth IRA but be eligible to deduct a contribution to a standard IRA. In short, the eligibility rules may make your choice clearer.

If you are eligible to contribute to both a deductible traditional IRA and a Roth IRA, your decision is more difficult. Is it better to pay taxes now (on a Roth contribution) or later (on withdrawals from a traditional IRA)? As a rule of thumb, if your rate will be higher when you withdraw the money, a Roth IRA is generally a better bet. If your rate will be lower, a traditional IRA will provide a higher return. The problem, of course, is that nobody knows what tax rates will be in the future.

As noted, you are not required to take distributions from a Roth IRA at any age. This makes them more flexible than standard IRAs and also makes them an attractive tool for estate planning. It also means that you do not have to worry about selecting a minimum distribution method — a decision that is crucial for owners of standard IRAs but so complicated in terms of its effects on taxes and estate planning that they are invariably told to "consult an expert" for advice. Of course, Roth owners also do not have to deal with tedious calculations of required minimum distributions every year, either.

Investors reportedly have shied away from Roth IRAs in favor of the up-front deduction of traditional IRAs, because they are afraid that Congress will someday change the rules and make future withdrawals taxable. This is always a risk with any tax-sheltered account. Tax laws change often. However, the recent trend has been toward creating more tax breaks, not eliminating them. We expect this to continue as long as the federal budget remains in surplus. Congress also may create more retirement tax breaks in hopes of reducing the looming fiscal burden of aging baby boomers on Social Security, Medicare, and other age-based government programs.

C. SIMPLE IRAs and SEP Plans

Small businesses and the self-employed often cannot afford the expense of setting up and maintaining a traditional pension plan. Two alternatives are the SIMPLE IRA and the simplified employee pension (SEP). These are hybrids of a company pension plan and an IRA. Essentially they are IRAs for the employee, financed with contributions made by the employer

or the employee or both. SIMPLE IRAs have been available since 1997 and have replaced salary-reduction SEPs, which now may be offered only if they were established before 1997.

The maximum amount that can be contributed by employees each year to a SIMPLE IRA is \$6,000 per year (this limit is subject to future adjustments for price inflation). Employers are obligated to match the contribution up to a limit of 3 percent of the employee's wages or to make a fixed contribution of 2 percent for every employee. The tax laws regarding withdrawals are generally the same as those that apply to IRAs, with one notable exception. For the first 2 years of an employee's participation, any withdrawal before age 59 1/2 that is subject to an early withdrawal penalty is penalized at a rate of 25 percent (in addition to regular income taxes) rather than 10 percent. After this two-year period the penalty is 10 percent.

The maximum amount of salary that may be contributed by an employee to an SEP is \$10,000 per year (subject to adjustments for price inflation). Employers may contribute additional amounts, provided total employer-employee contributions do not exceed 15 of earnings or \$24,000, whichever is less. The tax laws regarding withdrawals are generally the same as those that apply to standard IRAs.

D. Keoghs

Keogh retirement accounts may be set up by a sole proprietor or a partnership. These plans allow the self-employed, and in some cases those working for them, to make tax-deductible contributions, up to maximum limits that vary depending on the plan but generally may not exceed \$30,000. As with SEPs and other qualified plans, investment earnings on all contributions accrue tax-free until withdrawals are made. Keoghs can be created as defined-benefit plans, but most are defined-contribution plans, with the funds invested however the self-employed individual (or the employer, in the case of a small business) chooses, much like an IRA.

Withdrawals from Keogh accounts are subject to restrictions, taxes, and early withdrawal penalties similar to those that apply to other qualified company retirement plans; for specific guidelines, consult a tax advisor.

If you are self-employed in a small business, your choices for tax-favored retirement planning using tax-free contributions come down to IRAs, SIMPLE IRAs, SEPs, and Keoghs. IRAs generally are least advantageous since the contribution limits are small. A competent advisor can help you decide whether a SIMPLE IRA, an SEP (other than salary-reduction types, which have been replaced by SIMPLE IRAs) or a more complicated Keogh would be more suitable, based on a number of differences. SEP accounts may be opened and funded as late as the due date of your

return (usually April 15th) following the end of the tax year, whereas Keoghs must be opened by December 31st, although funding can be postponed until April. Taxable lump-sum distributions from Keoghs may qualify for special income-averaging tax treatment, while SEP and SIMPLE IRA (and IRA) distributions do not. For more information see IRS Publication 560 *Retirement Plans for Small Business*.

Caution: Congress at Work

Congress has made a number of changes to the tax treatment of self-directed retirement accounts, especially IRAs, in recent years. There are more proposals in the pipeline, including raising the cap on contributions from the current \$2,000 limit. To keep abreast of changes, consult IRS Publication 17 *Your Federal Income Tax* and publications such as *J.K. Lasser's* annual tax guide.

V.

EDUCATION IRAS

THE Education IRA (or Ed IRA) is really a misnomer. These are tax-deferred educational savings accounts with no retirement implications. Through an Ed IRA an individual may make contributions up to \$500 per year per beneficiary to a trust or custodial account established on behalf of any child under the age of 18. The contributions are not deductible but the amounts deposited accumulate free of tax, and qualified withdrawals are tax-free.

Contributions

Anyone may contribute to an Ed IRA, including the designated beneficiary, so long as modified adjusted gross income is below \$110,000 (\$160,000 on joint returns). (For most taxpayers, modified adjusted gross income is simply adjusted gross income, unless they have income from abroad.) However, the \$500 contribution limit is phased out for income between \$95,000 and \$110,000 (\$150,000-\$160,000 on joint returns). Unlike regular IRAs, you can contribute to an Ed IRA even if you have no earnings for the year. Thus, children can use gifts from parents or grandparents to establish their own accounts.

You may contribute up to \$500 per child per year to as many children as you like. However, the total contributions to all Ed IRAs set up for a given child may not exceed \$500 per year, regardless of the sources. In other words, a grandparent may contribute up to \$500 annually for each grandchild, but each grandchild may receive no more than a total of \$500 in Ed IRA contributions from the grandparent and any other donors. Excess contributions are subject to a 6 percent tax penalty, levied each year on the beneficiary. In addition, this penalty is applied to *all* contributions made to a beneficiary if *any* money was also paid during the year to a qualified state tuition program on his or her behalf. (As of this writing, Congress was considering eliminating this provision.)

The deadline for annual contributions is December 31.

Withdrawals

Withdrawals from Ed IRAs are tax-free to the beneficiary if they are used to cover qualified education expenses at an eligible school. Most colleges and vocational schools are eligible but elementary and high schools are not. Qualified expenses include tuition, fees, books, and supplies. Room and board qualifies if the beneficiary is at least a half-time student, and is limited to the school's posted room and board charge for students living on

campus or \$2,500 for students living off-campus (but not at home).

If annual withdrawals are more than expenses, a portion of the total withdrawal is taxable as income to the beneficiary. The taxable portion is the amount that represents a withdrawal of tax-free investment earnings. If a withdrawal is taxable, it usually is also subject to a 10 percent penalty tax. However, this penalty is waived if the distribution is due to the beneficiary's death or disability, or if the distribution is taxable only because the beneficiary waived tax-free treatment in order to qualify for an education credit (as discussed below).

Any amount withdrawn from an Ed IRA can be rolled over tax-free to another Ed IRA account naming a new beneficiary. The rollover must be done within 60 days after funds are withdrawn, and the new beneficiary must be under age 30 on the date of the rollover *and* be a member of the previous beneficiary's family. For this purpose Congress defines "member of the family" broadly enough to include the following individuals (and their spouses): the beneficiary's siblings, stepsiblings, children, stepchildren, parents, stepparents, cousins, uncles, aunts, in-laws, grandchildren, and even grandparents. (Of course, to meet the age requirement the grandparent would also have to be under age 30!) Spouses are also eligible. An alternative to such rollovers is to simply change the designated beneficiary on the existing account to a qualified family member.

These options give donors some flexibility: they can set up accounts for a number of young children, and the accounts can be redesignated or rolled over later on when financial needs become clearer. For example, one child might win a scholarship and not need the funds, while another might decide to attend medical school and need extra support.

The funds in an Ed IRA must be completely distributed within 30 days after the beneficiary turns 30 (or within 30 days after his death, if that happens sooner). Otherwise they are subject to income tax. However, tax-deferral on unused funds can be maintained by rolling them over to another account for a different beneficiary, who must be a member of the family or, in the case of death, a surviving spouse.

Important Considerations

The tax-deferred build-up of Ed IRAs makes them an attractive way to save for education expenses. The benefits of tax-free withdrawals are less clear, however, at least for some individuals. Mainly this is due to one drawback of Ed IRAs: if a student receives a tax-free distribution, none of the student's education expenses for the year may be used as the basis for claiming an education credit on a tax return. Thus, the potential cost of losing these credits must be considered when a beneficiary takes withdrawals from an Ed IRA.

Two such credits are currently available to taxpayers paying education expenses for themselves or their dependents. A Hope credit can reduce one's taxes by as much as \$1,500. A Lifetime Learning credit may reduce taxes by as much as \$1,000. Eligibility requirements vary, but many students qualify. Like most of the tax breaks Congress has recently created, income affects eligibility and the amount of the credit. Both types of credits are phased out if your modified adjusted gross income is between \$40,000 and \$50,000 (\$80,000-\$100,000 on joint returns).

Depending on various factors, an education credit might be more valuable than a tax-free distribution from an Ed IRA. A tax-free distribution is "worth" the amount of the withdrawal times the taxpayer's marginal tax rate. The lower your tax bracket, the less it is worth. For example, if a taxpayer in the 15 percent tax bracket withdrew \$1,500 tax-free, he would save \$225 in taxes. Those in the 28 percent bracket would save \$420, and those in the top bracket of 39.6 percent would save \$594. In contrast, a credit is "worth" the amount of the credit. For the taxpayer in the lowest bracket, it would make more sense to forego the Ed-IRA withdrawal and instead claim a \$1,500 Hope credit, thus saving \$1,500 in taxes (assuming he is eligible to claim the full credit). The Ed IRA funds would continue to grow tax-free. But suppose the student had no other source of funds to pay for these expenses. In that case, he could withdraw the \$1,500 from the Ed IRA and waive the tax-free treatment in order to qualify for the HOPE credit. (To waive tax-free treatment, beneficiaries must file IRS Form 8606.) He would still save money — his net tax savings would be \$1,500 less the \$225 paid in taxes, or \$1,275.

The lower one's tax bracket, the more likely that a credit would provide more tax savings than a tax-free Ed IRA withdrawal. Taxpayers in higher brackets may find the exemption is preferable — and indeed, that may be their only option if their education credits are phased out due to high income. The trade-off also depends on the amount of qualified education expenses to be paid for with the Ed IRA. If they are high enough, the tax savings from an Ed IRA withdrawal may surpass the \$1,500 cap on the tax credit, even for those in low tax brackets.

Comparing these options is complicated by the fact that the exemption of Ed IRA distributions from income tax applies to the beneficiary of the account, *not* the contributor. For students with low incomes (in the 15 percent or zero tax bracket) the tax savings on Ed IRAs may be smaller than the savings their parents could realize by claiming a HOPE or Lifetime Learning credit for their child's education.

What is best will depend on the student's eligibility for the various tax benefits, the amount of eligible expenses, the tax status of the Ed IRA

beneficiary and (if different) the taxpayer claiming the credit, the availability of funds outside the Ed IRA to pay for school, and whether there are other family members who might benefit, now or later, from any unused funds in the Ed IRA. In short, it depends on personal and financial circumstances at the time education expenses are incurred, and these are not easily generalized.

In sum, Ed IRAs provide the maximum benefit when you allow the contributions to grow tax-free for a long time — the longer, the better. If you expect to keep the funds invested only a short time, the tax benefits will be smaller and might be offset if withdrawals fail to qualify for tax-free treatment. For most people, the tax benefits and flexibility of Ed IRAs outweigh their restrictions.

VI.

U.S. SAVINGS BONDS

UNITED States Series EE and I savings bonds, the only kind available for direct purchase, offer distinct tax advantages. First, the interest is exempt from state and local taxes. Second, bondholders have the option of deferring Federal income tax on the interest until the bonds are redeemed. Third, if the bonds are used to pay for college expenses, the interest may be exempt from Federal tax.

In addition to these tax advantages, savings bonds can never decrease in dollar value, in contrast to marketable bonds. Series EE bonds pay a market-based rate of interest that varies and will increase if the general level of interest rates turns upward; thus, they provide bondholders some protection against an acceleration in price inflation. Series I bonds provide even more protection because they are indexed for price inflation. U.S. savings bonds may be purchased for as little as \$25, which makes them a very affordable investment, and they can be purchased free of commission. All these features make savings bonds an attractive investment for many people.

EE Bonds

The Federal government began selling savings bonds in the 1930s. In the decades since, the Treasury has periodically changed the rules for calculating the interest on the bonds, most recently with an eye toward making the bonds earn a variable, market-based rate much like other savings products. The information below applies to the EE bonds currently available for purchase. Bonds issued prior to May 1997 are subject to different rules.

Series EE savings bonds are sold at a 50 percent discount to their face value. Thus, a \$50 bond costs \$25. They do not pay cash interest; rather, their rate of return is reflected in a periodic increase in their redemption value, and accrued interest is paid when the bonds are redeemed. The rate of interest is adjusted by the Treasury every 6 months (in May and November), so the dollar increase in the redemption value may vary from one semiannual period to the next.

This means that the number of years it takes until the bonds can be redeemed for their full face value is not fixed, but depends on the rate of interest they earn, which varies with market interest rates. At a rate of 6 percent, for example, it would take 12 years for a savings bond to mature. If a bond earned 4 percent interest, it would take almost 18 years to mature. The lower the rate, the longer it takes the bonds to reach their face value. However, if the market-based rates are not sufficient for a bond to reach

face value in 17 years, the Treasury will make a one-time adjustment to increase it to face value at that time.

Bonds earn a variable rate of return equal to 90 percent of the average of 5-year Treasury security yields for the 6 months before the rate announcement. This rate currently is 5.54 percent, effective through April 30, 2001. The Treasury announces a new rate each May 1 and November 1. The announced rate applies to every bond for a 6-month period and is adjusted on the 6-month anniversary of the bond's purchase. For example, the rate on an EE bond purchased in December will change at the beginning of every December and June. From December through May it will earn the rate announced by the Treasury the previous November, because at the time of purchase that was the most recently announced rate. From June through November it will earn the rate announced the previous May.

Interest is compounded semiannually but credited monthly. This is in contrast to older savings bonds on which interest usually is credited every six months. Under the semiannual schedule, holders of old bonds need to prudently time their redemptions to avoid losing a half year's interest. With new bonds increasing in value every month, however, the timing of redemptions of bonds purchased after May 1997 is less of a concern. To take advantage of the monthly schedule, investors should redeem bonds at the beginning of the month. If a bond were cashed in on the last day of the month, an entire month's interest would be lost.

Series EE bonds continue to earn interest long after they reach face value. Current issues earn interest for 30 years. During the period of extended maturity — after the bonds reach face value but before they reach the 30-year final maturity — bonds earn market-based variable rates according to whatever rules are in place at the time. After 30 years the bonds reach "final" maturity, and any deferred tax must be paid, unless the bonds are exchanged for series HH bonds (discussed below).

Bonds can be cashed in any time after 6 months after the date of issue. However, if a bond is cashed in before it is 5 years old there is a penalty equal to 3 months' worth of interest.

The interest on EE bonds is exempt from state and local income tax. Unless the bondholder chooses to report the interest annually, Federal income tax on the interest is deferred until the bond is redeemed or it stops earning interest, whichever happens first. (Thus, if a bond reached final maturity (stopped earning interest) in 1999, taxes were due in 1999 even if the bondholder failed to redeem the bond.) If a bond is used to pay for college expenses, the interest may be exempt from Federal tax, as discussed below.

Because the method of interest accrual on savings bonds depends on the date of purchase and the market level of interest rates, it can be very confusing for investors to figure out what their bonds are worth. Fortunately, the Treasury publishes a table of savings-bond redemption values. To find the redemption value of a specific bond, ask your local bank or financial advisor to check their copy of the table; you will have to provide the month and year the bond was issued. You can obtain a free copy of the table, Form PD 3600, by writing to the Savings Bond Operations Office, Parkersburg, WV 26106-1328. You can get the same information from the government website, www.savingsbonds.gov.

Individuals may purchase up to \$30,000 face value (\$15,000 purchase price) of EE savings bonds in any calendar year. The bonds are available in denominations ranging from \$50 to \$10,000. They are sold at most banks.

The table on page 45 summarizes the features of EE bonds purchased in May 1997 or later.

Series I Bonds

The variable market-based rate earned by EE bonds provides bondholders some protection against price inflation, because interest rates usually increase when price inflation accelerates. However, the link between interest rates and price inflation is not rigid, especially over short periods. Interest rates are affected by other factors, and sometimes they fall during periods of accelerating price inflation. Thus the new generation of EE bonds, while it is a great improvement over older savings bonds, still leaves bondholders exposed to some risk of price inflation.

In September 1998 the Treasury began offering a new type of savings bond that provides explicit protection against price inflation. Series I bonds earn interest at a rate that is pegged to the Consumer Price Index. If price inflation increases, the rate on I bonds increases, thus compensating bondholders for the dollar's loss of purchasing power.

Like EE bonds, I Bonds earn interest for 30 years. They do not pay cash interest; rather their rate of return is reflected in a monthly increase in their redemption value, and accrued interest is paid when the bonds are redeemed. The interest is exempt from state and local income tax, and bondholders have the option of deferring federal income tax until the bonds are redeemed or they stop earning interest after 30 years, whichever comes first. If the bonds are used to pay for college expenses, the interest may be exempt from Federal tax.

The interest rate for I Bonds is a combination of a fixed rate plus a rate of price inflation. The fixed rate is selected by the Treasury and remains

the same for the 30-year life of the bond. The rate of price inflation is based on the six-month change in the Consumer Price Index (for All Urban Consumers, not seasonally adjusted). The Treasury adjusts the interest rate on I bonds at the beginning of each May and November. The bond rate announced in May reflects price inflation from the previous September through March; the rate announced in November is based on price inflation from March through September.

For example, I bonds purchased from November 2000 through April 2001 will earn a 6.49 percent annual rate for the first six months after purchase. This composite rate combines a 3.4 percent fixed rate, which will remain in effect for the life of the bond, and a 3.04 percent price inflation rate, which was the annualized rate of change in the CPI from March through September 2000. Next May, the Treasury will announce a new price inflation rate based on the September-to-March change in the CPI. That will be combined with the fixed rate to set a new composite rate that each bond will earn for another six months. Next November the rate will change again, and so on.

(Sharp readers will have noticed that in the above example, the 6.49 bond rate is slightly larger than the sum of the 3.4 percent fixed rate and the 3.04 price inflation rate. This is because the formula used to calculate the bond rate adjusts both the principal and the fixed rate of interest for price inflation. This ensures that investors receive a guaranteed *real* return of 3.4 percent on their savings bonds.)

Although the Treasury announces new rates in May and November, the rates on individual bonds are adjusted on the six-month anniversary of their purchase. For example, the rate on an I Bond purchased in April will change at the beginning of every April and October. From April through September, it will earn the rate announced by the Treasury the previous November, because at the time of purchase that was the most recently announced rate. From October through March it will earn the rate announced the previous May.

Thus, the protection I bonds provide against price inflation does not perfectly mirror current price trends. There can be a significant time lag between the end of the six-month period over which price inflation is measured and the date at a bond is affected by this measurement. In the above example, the interest credited to the bond on April 1, 2001 will reflect the bond rate announced in November 2000, which will be based on the rate of price inflation from March through September 2000. Eventually, the bond will be fully adjusted for more recent price inflation, but there will be a lag of six months.

Although the fixed real rate of interest on a given I bond never changes,

different bonds can have different fixed rates. The Treasury announces a new fixed rate twice a year, in May and November, and the rate applies only to bonds purchased in the six months after the announcement. For example, the 3.4 percent fixed rate currently in effect applies only to bonds purchased between November 2000 and May 2001. Bonds purchased after

Comparison of EE Bonds and I Bonds

	EE Bond	I Bond
Features	<p>Issued at 50% of face value. (A \$100 EE Bond costs \$50.)</p> <p>Offered in 8 denominations (\$50, \$75, \$100, \$200, \$500, \$1,000, \$5,000, and \$10,000).</p> <p>\$15,000 issue price (\$30,000 face value) annual purchase limit per person.</p>	<p>Issued at face value. (A \$100 I Bond costs \$100.)</p> <p>Offered in 8 denominations (\$50, \$75, \$100, \$200, \$500, \$1,000, \$5,000, and \$10,000).</p> <p>\$30,000 annual purchase limit per Social Security Number.</p>
Interest	<p>Calculated as 90% of 6-month averages of 5-year Treasury Securities yields.</p> <p>Rates announced every May 1 and November 1.</p> <p>Guaranteed to reach face value in 17 years.</p> <p>Increases in value monthly and compounds semiannually. Interest is paid when the bond is redeemed.</p>	<p>Calculated as an earning of a fixed rate of return and a semiannual inflation rate based on CPI-U.</p> <p>Rate Announcement: Same as EE.</p> <p>No guaranteed level of earnings.</p> <p>Generally increases in value monthly and interest compounds semiannually (except in periods of deflation when the bond value could remain unchanged). Interest is paid when the bond is redeemed.</p>
Exchange	<p>Earn interest for up to 30 years.</p> <p>Can be exchanged for Series HH savings bonds.</p>	<p>Life span: Same as EE.</p> <p>Cannot be exchanged for any other series of savings bonds.</p>
Cashing	<p>Can be redeemed after first 6 months.</p> <p>A 3-month interest penalty applies to bonds redeemed during the first 5 years.</p> <p>Financial institution reports interest earnings (difference between redemption value and purchase price) on IRS form 1099-INT. Savings bonds are exempt from state and local income taxes.</p> <p>Eligible for tax benefits upon redemption when used for qualified education expenses.</p>	<p>Same as EE.</p> <p>Same as EE.</p> <p>Same as EE.</p>

Source: Treasury Department.

May 1, 2001 might earn a different rate.

Since introducing I bonds in 1998, the Treasury has changed the fixed rate. For example, bonds purchased between November 1998 through October 1999 earn a real return of 3.3 percent for their 30-year lifetime, and those purchased from May 2000 through October 2000 earn 3.6 percent. These different fixed rates mean that investors will earn different real returns on their I bonds, depending on when they purchased them. Inflation-indexing guarantees a real return; what the real return will be depends on what fixed rate is in effect when a bond is purchased.

It is not clear what basis the Treasury uses to select the fixed rate on I bonds. So far, the announced rates have roughly corresponded with the real return on 5-year Treasury securities. Time will tell if the Treasury will continue to pay a competitive real rate on future issues of I bonds.

In the rare event that the price level falls — i.e., the rate of price inflation is negative — an I bond will earn less than the fixed rate. For example, if the CPI fell at an annual rate of 1.0 percent, the annual rate on a bond with a 3.6 percent fixed rate would fall to 1.56 percent. Thus, price deflation will cause a bond to earn interest more slowly or not at all. However, even if the rate of price decrease were high enough to reduce the bond rate below zero, the Treasury's rules provide that I bonds will never lose value. At worst their redemption value will remain the same until the earnings rate becomes positive.

Series I Bonds are sold at face value in denominations of \$50, \$75, \$100, \$200, \$500, \$1,000, \$5,000, and \$10,000. The eight denominations feature portraits of Americans who, according to the Department of Treasury, represent "the diversity that built this country, made it what it is today, and will take it into the future." They are: Helen Keller (\$50), Dr. Hector P. Garcia (\$75), Dr. Martin Luther King, Jr. (\$100), Chief Joseph (\$200), General George C. Marshall (\$500), Albert Einstein (\$1,000), Marian Anderson (\$5,000), and Spark Matsunaga (\$10,000). Investors may buy up to \$30,000 of I bonds per year.

I bonds must be held for at least 6 months before they can be cashed in. To encourage long-term investing, the Treasury imposes a 3-month interest penalty on bonds that are redeemed less than 5 years after purchase. Interest is compounded semi-annually but is credited monthly, on the first day of each month. To take advantage of this schedule, investors should redeem bonds at the beginning of the month. If a bond were cashed in on the last day of the month, an entire month's interest would be lost.

I bonds and EE bonds are the only two bonds currently offered for sale by the Treasury. They share many features but there are key differences.

These are described in the table on page 45.

Are They a Good Deal?

Clearly the new EE and I savings bonds are a better deal for investors than the low-fixed-rate bonds issued prior to the 1990s.

Investors in EE bonds are guaranteed to earn a market-based interest rate that will vary with the rate on 5-year Treasury securities. Although they will earn only 90 percent of the Treasury rate, they are immune from the market risk that affects other Treasury securities — that is, the risk that the price of an outstanding note or bond will decline in response to an increase in market interest rates. The redemption value of EE bonds never declines.

Investors in I bonds are guaranteed to earn a fixed real yield. Unlike investors in EE bonds and other conventional bonds, I bond investors are protected against the risk that their investment's real return will be eaten away by unexpected price inflation. In return for this certainty, they give up the chance to earn potentially higher but uncertain real returns on EE bonds or other investments such as stocks and corporate bonds.

Since I bonds have only been available since September 1998, the historical data for comparing their performance with EE bonds are limited, but they are revealing. Thus far, I bonds have consistently outperformed EE bonds. EE bonds purchased anytime since 1997 currently are earning 5.54 percent. The rate currently paid on I bonds depends on when they were purchased but it ranges from 6.49 percent to 7.49 percent. (All these rates are subject to change when the Treasury announces new rates.) In dollar terms, an I bond purchased for \$100 in September 1998 is now worth \$110.80, compared to \$109.44 for an EE bond. So far, at least, I bonds have been the better bet.

This could change. Suppose that over the next six months the rate of price inflation decreases but the interest rate on 5-year Treasury notes increases. Then the yield on I bonds will fall but the yield on EE bonds will rise. Any number of other scenarios can be imagined, and the difference in returns on both types of bonds is likely to vary from one six-month period to the next, for the life of the bonds. The point to remember is that EE bond rates vary with the market level of rates, and this variability can work for or against investors. For conservative investors who prefer the certainty of a guaranteed real return to the risk that their real returns on EE bonds or other investments may be higher or lower than expected, I bonds are a welcome alternative.

At bottom, of course, the greatest risk that holders of any of the Treasury's indexed debt face is the possibility that the government might renege on its

promise to pay a positive real return in the event of rapidly accelerating price inflation or a hyperinflation. In this respect, the historical record is not reassuring: throughout history, whenever governments actually have faced a currency collapse (presumably the times when investors would most benefit from holding such indexed debt), they have defaulted on their promises. The new I bonds would appear to be a useful alternative only so long as confidence in the dollar remains strong. Any expectation that they would provide protection in the event of a monetary meltdown would seem exceedingly naïve.

Special Advantages

Another potential benefit of EE and I savings bonds is that if the bond owner pays education expenses for the higher education of a child, a spouse, or himself in the same year he cashed in bonds, the interest may be tax exempt (not merely tax deferrable). To qualify, a number of conditions must be met: the bonds must have been purchased by a person age 24 or older; if they are used for a child's education, they must be issued in a parent's name; and the expenses must be at a college or vocational school that meets Federal financial aid standards. The costs of books and room and board do not qualify as eligible expenses, but payments to qualified state tuition plans do. Expenses must be incurred during the same year in which the bonds are redeemed. Series EE bonds issued after 1989, and all I bonds, are eligible.

The percent of interest that is tax-free depends on the taxpayer's income in the year the bonds are redeemed. A full exclusion is available in 2000 if modified adjusted gross income is below \$54,100 for a single person or \$81,100 for married couples filing joint returns. Above these income levels the tax exemption is phased out, and it is eliminated for incomes above \$69,100 for singles and \$111,100 for couples filing jointly. These amounts are adjusted annually for price inflation.

Savings bonds also can be used to reduce or avoid the "kiddie tax." Under current law, any investment income above \$1,400 (in 2000) that children under 14 receive each year is taxed at their parents' tax rate. However, since income tax on savings bonds may be deferred until they are cashed in, the interest on savings bonds held in the child's name (perhaps as a gift from a parent or grandparents) can escape the kiddie tax by deferring the income tax until the child is 14 or older. At that time the bonds can be redeemed and the interest will be taxed at the child's tax rate, which presumably is lower than the parents' rate.

HH Bonds

Series HH bonds, the only other type of savings bonds currently offered

by the Treasury, cannot be purchased directly. They can be acquired only by exchanging Series EE or E bonds or Savings Notes (also called "freedom shares"), or by reinvesting the proceeds of matured H bonds. There is no upper limit on the amount of HH bonds that can be obtained by exchanging other bonds, but the minimum denomination is \$500. The exchange forms that must be submitted to acquire HH bonds are available at most banks.

HH bonds pay cash interest that is subject to Federal income tax in the year it is paid (although it is exempt from state and local income taxes). The chief advantage of exchanging EE or E bonds or Savings Notes for HH bonds is that the investor can continue to defer Federal taxes on the accumulated interest on the EE or E bonds or Savings Notes. This can be done for a maximum of 20 years after the HH bonds are issued, at which time the bonds reach full maturity and earn no more interest. Taken to the extreme, it is possible to defer taxes on savings bond interest for as long as 50 years: one could buy EE bonds and hold them until they reach final maturity after 30 years, then exchange them for HH bonds and hold these another 20 years.

HH bonds pay interest semiannually, at a fixed rate (currently 4 percent). The rate is fixed for 10 years after purchase, and is then reset at a new rate that remains fixed for another 10 years.

Tax Treatment

There are two ways to report the interest on Series EE and I bonds. The first method, which most taxpayers choose, is to postpone reporting (and paying tax on) the interest until you cash in the bonds or they reach final maturity, whichever happens first. The second method is to report the increase in redemption value as interest each year and pay any tax due immediately. You must use the same method for all series EE, E, and I bonds you own.

You may change your method of reporting interest at any time. If you have been deferring tax on your bonds, you can change to annual payment simply by reporting all interest accrued to date on your bonds. Or, if you have been reporting interest every year you can change to postponing the tax on future interest. To make the latter switch, you must send the IRS a letter that meets certain requirements, as described in IRS Publication 17.

The issue of who pays tax on savings bond interest and how much they pay can be confusing, because of the different tax treatment options and because bonds may be issued in more than one name, purchased as gifts, or inherited. When a bond is redeemed, the bank will give you a Form 1099-INT indicating the amount of interest you received. However, this amount

may overstate the amount you owe taxes on, depending on whether ownership of the bond ever changed and whether any of the interest was previously taxed.

For further details on the tax treatment of savings bonds, see IRS Publication 17, *Your Federal Income Tax — for Individuals* and Publication 550, *Investment Income and Expenses*.

Lost Bonds

Savings bonds have a tendency to get lost, especially the small-denomination bonds that often are given as gifts. If you misplace your savings bonds, or they are stolen or destroyed, the Government will replace them free of charge if you can provide sufficient proof of your claim. You must fill out a claims form, PDF 1048, which you can request from a bank or by calling the Savings Bond Customer Service office at 304-480-6112, writing to the Bureau of Public Debt, Savings Bond Operations Office, Parkersburg, WV 26106-1328, or downloading it from www.savingsbonds.gov. The process can take 6 weeks or longer, depending on how much of the following information you can provide: the serial number of the bond, the month and year of purchase, the denomination, the bond owner's name and Social Security number, and the bond owner's address at the time of purchase. Obviously it is a good idea to add this information to your financial records whenever you buy a bond.

Additional Information

To find out what interest rate is currently being paid on series EE and I bonds, call 1-800-4US-BONDS (1-800-487-2663). This automated line will also tell you which older bonds have stopped earning interest. For other information, call the Savings Bond Customer Service office at 304-480-6112. Extensive information is also available at their website, www.savingsbonds.gov.

VII. MUNICIPAL BONDS

MUNICIPAL bonds are issued by state and local government agencies. They offer one important advantage over other types of bonds: the interest on them is exempt from Federal income tax. If you buy a "muni" bond issued within your own state, the interest also may be exempt from state and local income tax.

Because of their special tax status, the rate of return on munis is lower than the return available on comparable taxable bonds. Whether the tax benefits are large enough to compensate for this lower yield depends on your marginal tax rate. The table below shows the equivalent taxable yields for various tax-free yields and for several marginal tax rates:

<i>Tax</i>	<i>Tax-Exempt Yield</i>								
<i>Bracket</i>	2%	3%	4%	5%	6%	7%	8%	9%	10%
15	2.4	3.5	4.7	5.9	7.1	8.2	9.4	10.6	11.8
28	2.8	4.2	5.6	6.9	8.3	9.7	11.1	12.5	13.9
31	2.9	4.3	5.8	7.2	8.7	10.1	11.6	13.0	14.5
36	3.1	4.7	6.3	7.8	9.4	10.9	12.5	14.1	15.6
39.6	3.3	5.0	6.6	8.3	9.9	11.6	13.2	14.9	16.6

Note: For other tax-free yields and tax brackets, the equivalent taxable yield can be computed as follows: equivalent taxable yield = tax-free yield ÷ (1 - marginal tax rate). For example, if your marginal tax rate is 28 percent and the yield on a tax-exempt muni bond is 6.1 percent, the equivalent taxable yield is: $6.1 \div (1 - 0.28) = 8.47$ percent.

You are most likely to find that municipal bonds provide returns that are competitive with the yields on taxable bonds if you are in a high tax bracket. However, even if your tax rate is high enough to make their yield attractive, there are other factors to consider. Municipal bonds vary in quality. Unlike Treasury bonds, there is no guarantee that the interest and principal on state and local bonds will be paid in full and on time. Moody's and Standard and Poor's assign quality ratings to bonds based on what these rating agencies think about the ability of the state or city to meet its obligations for a particular bond. Top-rated bonds pay a lower interest rate than lower-rated bonds.

In addition, intermediate-term and long-term municipal bonds face the same major risks as any long-term fixed-dollar claim, namely, that their market value will decrease when interest rates increase and that the purchasing power of the principal will be greatly diminished when the bond matures. The longer the maturity of the bond, the greater will be the impact of rising interest rates and price inflation on the value of the bond. Conversely, bondholders benefit from falling interest rates.

Investors who are willing to accept these risks can buy municipal bonds in a variety of ways. The bonds can be purchased and sold directly in almost any amount and are widely available, although "odd lots" below \$25,000 may be costly to trade. There are mutual funds that invest exclusively in municipal bonds, and unit investment trusts that sell shares in a fixed portfolio of munis.

Before investing in a fund or trust, check its performance record, how it works, and what it is invested in. Some municipal bond fund managers invest in bonds carrying low quality ratings, or bond derivatives, in hopes of earning a higher return, but these funds carry a greater risk of loss. Some fund managers try to time their trading to take advantage of interest rate trends. When they are successful, their funds can earn substantial capital gains, which can account for a substantial portion of a fund's annual return. Capital gains distributed to shareholders as dividends are taxable as such, so there may be less of a difference between the total returns of aggressive and conservative municipal bond funds on an after-tax basis than there is on a pre-tax basis.

Some bond funds may be entirely invested in bonds issued within your state, and although the interest income from these funds is free of state income tax, their lack of diversification could be a problem if the state's fiscal outlook deteriorates. Finally, take into account the ease of withdrawing your investment, as well as commission expenses and management fees, which can significantly cut into your rate of return.

VIII. DEFERRED ANNUITIES

THERE are two basic types of annuities. Immediate annuities pay a stream of income to the investor beginning within a year of the date the policy is purchased or "annuitized." Deferred annuities do not provide income until at least a year, and usually many years, after the investment is made. Deferred annuities are discussed in this chapter; immediate annuities are discussed in Chapter IX.

Deferred annuities are attractive primarily as a means of accumulating savings for retirement. Their chief advantage is that income taxes on investment earnings are deferred until the investor takes money out of the contract. However, as with most tax-favored accounts there are tax penalties for early withdrawals. In addition, most deferred annuities are subject to surrender fees if a policy is canceled after only a few years. These potential taxes and fees make deferred annuities suitable mainly for funds that an individual can afford to leave invested for the long term.

How They Work

Deferred annuities may be purchased with a single (often large) premium or multiple premiums paid over a number of years. Multi-premium deferred annuities may have fixed or, more commonly, flexible premiums, *i.e.*, the investor contributes as much as he wants whenever he wants, much like investing in a mutual fund.

Flexible-premium annuities can, if they meet certain legal requirements, qualify as "individual retirement annuities" that are eligible for IRA contributions of up to \$2,000 per year. "Qualified" IRA annuities offer the additional advantage that premiums may be deductible from taxable income, depending on your income level and participation in company pension plans. However, it generally is not advisable to put IRA funds in an annuity. Like a belt worn with suspenders, the tax-deferral advantage of an annuity becomes redundant when the policy is held as an IRA, which provides the same tax-deferral opportunity on its own (without any of the surrender fees that most annuities carry, discussed below).

A good rule of thumb is to consider investing in a deferred annuity only after you have contributed as much as you can to a separate IRA and other tax-favored retirement plans such as 401(k), 403(b), and Keoghs. In this way, you will take full advantage of the deferral of income taxes on both contributions and investment earnings. If you have additional capital to invest for the long term, an annuity will provide tax-deferred investment buildup. You will not be allowed to deduct your contribution, but there is

no ceiling on how much you can contribute. If your employer does not offer a pension plan, deferred annuities are an especially useful vehicle to accumulate savings for retirement.

The investment gains in a deferred annuity accumulate tax free until the investor either takes withdrawals or until he "annuitizes" (converts the policy into a stream of income payments payable over his lifetime). During this accumulation period, the policyholder may elect to cancel the policy (surrender it) and receive a cash-surrender value as stipulated in the contract. Most contracts also allow partial withdrawals. In either instance, surrender charges will be levied, typically ranging from 5 to 10 percent of the policy's cash value. These charges usually are highest during the first year of the contract and typically are phased out over 5 to 7 years, although this varies widely and a few policies levy charges as long as 12 years. Some multi-premium policies start the surrender-charge schedule over again each time you make a new payment. These policies, and policies with steep charges, should be avoided. Investors should avoid deferred annuities altogether unless they expect to leave their funds invested long enough to avoid surrender charges.

Deferred annuities provide for a refund to a designated beneficiary in the event the policyholder dies during the accumulation period. The refund usually is the cash value of the contract or the net sum of total contributions less withdrawals and charges, whichever is higher. It may be payable to the beneficiary in a lump sum or a series of annuity income payments payable over a few years or over the beneficiary's lifetime. The beneficiary also may have the option of leaving the money invested, where it will continue to grow tax free until it is withdrawn. The options specified in the contract should be read with care, as they will vary depending on whether the contract is jointly owned, who is named as the owner, who the owner designates as a beneficiary, and whether the beneficiary is a spouse.

When the Contract Matures

The accumulation period ends when the stipulated annuity date arrives, and the policyholder may then take the cash value of the contract (and pay taxes on the investment buildup) or use it to purchase an annuity income. The dollar amount of this income may be fixed or variable, depending on the options offered by the contract (see next chapter). If you decide to annuitize, it pays to shop around for the most favorable terms and options. Policies that perform well during the accumulation phase do not always offer the highest income rates, and if you find another policy that offers a better deal, you can transfer your funds directly into it without incurring any income tax.

The policyholder may elect to postpone the annuity date he originally selected. By doing so, the value of the contract can be greatly increased, as additional investment returns on previous contributions plus any additional premium payments increase the total fund. Moreover, with each passing year the annuity income obtainable for a given sum increases because the annuitant's age increases and his expected future lifetime is thereby shortened. However, the policyholder may only postpone the annuity date until a maximum age specified in the contract (typically age 80 or 85), after which income payments must be taken.

Variable Annuities

Variable annuities combine the investment opportunities of mutual funds with the tax-favored treatment of annuities. Like a mutual fund, the premiums paid into a variable annuity are invested in a fund chosen by the investor, and the investment return depends on how well the selected assets perform. Unlike regular mutual funds, the investment gains in a variable annuity accumulate tax free until income payments begin or withdrawals are taken. Thus, variable annuities offer a potentially larger after-tax return than a comparable mutual fund. In recent years, mutual fund companies have aggressively marketed these policies as a tax-sheltered investment, and sales have soared.

The policyholder is given a selection of funds to choose from, similar to a family of mutual funds. These so-called "subaccounts" typically might include a bond fund, an income fund, a growth-oriented stock fund, an international stock or bond fund, and a money market fund. Many policies also offer one or more "fixed-rate" subaccounts that are similar to a traditional fixed-rate annuity (discussed in the next section). Once the investor allocates his funds among the available subaccounts, he can switch from one subaccount to another without incurring taxes.

The tax-sheltering advantage of a variable annuity must be weighed against some disadvantages. The fees charged to cover fund management expenses, administrative costs and the like run higher than on regular mutual funds. Add to this a separate charge for mortality risk, and total expenses can easily top 2 percent per year. There also may be an annual maintenance charge as high as \$30. In addition, a few states levy a tax of as much as 3.5 percent on your premium payments. There may also be transfer fees when you switch from one subaccount to another, and restrictions on the number of switches you can make each year.

Unlike regular mutual funds, variable annuities also carry surrender charges if you withdraw all or part of your investment in the early years of the contract. As noted earlier, these charges vary widely; on one policy we

have seen they run as high as 12 percent and apply as long as 12 years. In addition, withdrawals taken before age 59 1/2 also are subject to tax penalties similar to those levied on IRAs. In contrast, withdrawals from regular (non-IRA) mutual funds face no such penalty.

Taking these costs and lack of liquidity into account, some investors might be better off with a regular mutual fund. If you do not expect to leave your funds invested for at least 5 years, you almost surely should avoid variable annuities with surrender charges. If you do decide to invest, look for policies with annual expenses under 1.5 percent and a low annual contract charge (under \$25). Annuities sold through discount brokerages and investment companies usually are less expensive than those sold by insurance agents and full-service stockbrokers, because their commission costs are lower. Companies that offer low-cost mutual funds, such as Vanguard and T. Rowe Price, usually sell variable annuities with comparably low expenses.

If you do invest, a variable annuity offers the greatest investment potential if you put your funds in a stock fund subaccount, since stocks historically have outperformed bonds over the long run. Many policyholders reportedly invest in money market subaccounts, or in fixed-rate subaccounts earning a return that is fixed at a specific rate for 6 months, a year, or a few years. These fixed-rate subaccounts are less volatile, but their low yields are eaten away by management fees. In addition, the potential gains from tax-deferred compounding are smaller in a low-yielding subaccount. It is preferable to invest in a conservative stock fund comprised of stocks paying generous current yields.

Variable annuities provide investors with a way to earn higher returns than those provided by fixed-rate annuities. However, the higher potential returns from stocks carry higher risks. To attract investors who are averse to investment risk, insurers offer various guarantees on variable annuities. The most common is a guaranteed minimum death benefit, which promises that the death benefit will never be less than a certain amount, such as the total premiums paid, or the value of the account on a selected "anniversary date," or the premiums plus a guaranteed return of 5 percent, etc. This guarantee is not free, however. Its cost is reflected in the policy's expense charges or, if the benefit is optional, it is charged as an additional expense equal to perhaps 0.15 percent of the account's value each year.

Some variable annuities guarantee "living benefits" as well. They may guarantee that the investor will never lose more than a given percentage of his premiums, or that he will get back at least his premiums or his premiums plus a fixed return. The cost of this benefit ranges from 0.75 to 1.5 percent of the account value each year. Other contracts charge 0.25 to 0.5 percent of the

account to guarantee that the annuity will be convertible in the future to a minimum amount of annuity income payments. As a rule, the more generous these and other guarantees are, the more expensive they are — and their total cost can quickly add up. The combined cost of purchasing all the available guaranteed benefits could cut the return on your variable annuity investment by more than 2 percentage points annually.

As with a mutual fund investment, it is essential to check the performance record of the funds offered within a variable annuity. In this regard, some policies offer subaccounts that are "clones" of regular mutual funds, and it might be expected that these subaccounts would match the returns of their sister mutual funds. This is not always so. Studies indicate that sometimes the subaccounts do better, sometimes worse, due to differences in fund management and expenses. Thus, it is advisable to check directly the historical record of the subaccounts. Information on the historical performance and costs of variable annuities is available from many of the same publications that publish data on mutual funds. The *Wall Street Journal* publishes weekly data showing the latest one-week and year-to-date rates of return, as well as expense ratios, for each of the subaccounts of dozens of variable annuities. *Barron's*, the weekly financial paper, publishes data showing the rate of return during the latest 4-week and 52-week periods.

Another source of information is *Morningstar Variable Annuity Performance Report*. This publication is similar in format to Morningstar's mutual fund survey and provides timely information on the performance, asset holdings, investment strategies, and fund expenses of subaccount funds. It also includes analyst reviews. The *VARDS Report*, published by Variable Annuity Research and Data Service, also provides information on investment performance. Since the fees for both of these publications are substantial, check with your local library for availability.

Since variable annuities are a relatively new innovation, 5- and 10-year performance records are not always available, but investors should focus their research on long-term returns because deferred annuities are inappropriate for short-term investing.

Fixed Annuities

Until a few years ago, deferred annuities were marketed primarily as fixed-rate annuities. Although these now have been eclipsed in popularity by variable annuities, they still are available, primarily through insurance agents.

Unlike a variable annuity, the rate of return on a fixed-rate annuity depends on the interest rate credited to the invested funds by the insurance company. This interest rate is fixed for a period of time, usually a year,

after which the company may readjust the rate and fix it for another limited period. This "current" rate, so called because it varies with the market level of interest rates and the company's financial position, is guaranteed by the company not to fall below a minimum rate, usually 3.5 to 4.5 percent, during the life of the policy. Each company has its own method for setting the current rate. Some offer very high rates for an initial "guarantee period," which may last several years, but there is no guarantee that their "renewal" rate credited after the guarantee period expires will be equally attractive.

Fixed annuities appeal to conservative investors because their rate of return is less volatile than that on variable annuities. However, the potential return also is lower, because the premiums for fixed annuities are invested conservatively by insurance companies in fixed-dollar claims, usually bonds. Most policies currently pay about 6 to 7 percent. Taking into consideration mortality charges and other ongoing expenses, the net rate of return is likely to be no more than the rate of price inflation plus a couple of percentage points, at best.

A more flexible alternative to the traditional fixed-rate annuity is the fixed-rate subaccount available as an option in many variable annuities. The rate of return usually is similar and is fixed by some companies for as long as 3 years, but the investor has the added advantage of being able to switch funds out of the fixed-rate subaccount into other, less conservative, subaccounts. In contrast, the only way to shift funds out of a traditional fixed-rate annuity is to surrender the policy, which can be done without incurring taxes but may trigger surrender charges.

Some fixed-rate annuities offer the option of taking a loan against the value of the contract, which enables the policyholder to access his funds without cancelling the contract. This feature is less common on new policies, which usually allow partial withdrawals instead. As with any withdrawal, a loan will have tax consequences, possibly including penalties for early withdrawal. In addition, most companies will charge interest.

Tax Treatment

The investment earnings on deferred annuities, whether fixed-rate or variable, are not taxed as income until the policyholder withdraws money or surrenders the contract. Withdrawals and surrenders before the annuity starting date are subject to income tax. The portion of any payment that counts as taxable income depends on whether the policy is an IRA and when the investment was made. If it is an IRA financed with deductible contributions, the full amount of any withdrawal is taxed. If it is a non-deductible IRA or simply a non-IRA annuity, the portion that represents

investment earnings rather than a return of principal is taxed. (For more on the tax treatment of IRAs, see Chapter IV.)

If you invested in a policy after August 13, 1982, the first withdrawals made before the annuity starting date are treated as investment earnings and are fully taxable. After all the investment earnings have been withdrawn, additional withdrawals are a return of principal and are tax free. This treatment also applies to withdrawals that are attributable to investment made after August 13, 1982 in contracts that were purchased before August 14, 1982. Loans from policies subject to this tax rule are treated as cash withdrawals and therefore may be taxable.

If you invested before August 14, 1982, the tax treatment is the exact opposite (and more favorable, which may be why Congress changed it). The first withdrawals are treated as returns of the investor's capital and are tax free; after the entire principal has been withdrawn, additional withdrawals are treated as taxable investment earnings. Loans from such policies are tax-free.

Taxable withdrawals are taxed as ordinary income at Federal rates as high as 39.6 percent. This applies even to variable annuities, even though the income withdrawn from these may represent capital gains that, if they came from a regular mutual fund, would be taxed at a top rate of only 20 percent. In effect, an annuity converts capital gains into ordinary income. Investors must balance the advantage of tax-deferred compounding within an annuity, against the more favorable treatment accorded to capital gains realized outside of an annuity. A variable annuity still may be suitable if you plan to seek investment buildup primarily through reinvested dividends and interest rather than unrealized capital gains.

To discourage investors from using policies for short-term tax sheltering, the IRS levies a tax penalty equal to 10 percent of the taxable portion of any withdrawal or surrender made before the policyholder reaches age 59 1/2. The few exceptions to this penalty include payments received by a totally disabled person, payments received by a beneficiary or estate after the policyholder's death, and, notably, withdrawals that are part of a series of equal payments received over the life expectancy of the taxpayer or the joint life expectancies of the taxpayer and a beneficiary.

If a deferred annuity is held as an IRA, the policyholder may, without tax consequences, withdraw the entire investment and deposit it within 60 days, or "roll it over" directly, into another IRA or qualified retirement plan. Non-IRA annuities may be transferred tax-free to other annuity accounts (with the same insurance company or a different one), but this transfer should be done carefully, without the policyholder directly receiv-

Table 1
DESCRIPTION OF MAJOR RATINGS SYSTEMS

	A. M. Best	Fitch	Moody's	Standard & Poor's	Weiss Research
Superior	A++	AAA	Aaa	AAA	A+
Excellent	A+	AA+	Aa1	AA+	A
	A	AA	Aa2	AA	A-
	A-	AA-	Aa3	AA-	B+
Good	B++	A+	A1	A+	B
	B+	A	A2	A	B-
		A-	A3	A-	C+
Adequate	B	BBB+	Baa1	BBB+	C
	B-	BBB	Baa2	BBB	C-
		BBB-	Baa3	BBB-	D+
Below Average	C++	BB+	Ba1	BB+	D
	C+	BB	Ba2	BB	D-
		BB-	Ba3	BB-	E+
Weak	C	B+	B1	B+	E
	C-	B	B2	B	E-
	D	B-	B3	B-	
Nonviable	E	CCC+	Caa1	CCC	F
	F	CCC+	Caa2	CC	
		CCC-	Caa3	R	
		CC/C	Ca		
		DDD	C		
		DD/D			

ing any funds, so as to avoid taxation. (Ask the company to do a "1035 exchange.") These tax-free options are useful if you find yourself stuck in an annuity earning poor returns, or if the financial position of your insurance company deteriorates, but beware: surrender fees can make such transfers costly during the early years of the policy.

A final tax consideration is the treatment of death benefits in the event the annuitant dies before the annuity starting date, *i.e.*, before beginning to receive annuity income. Death benefits in excess of premium payments — in other words, investment gains — are taxable to heirs as ordinary income. In contrast, the cost basis in regular investments usually is "stepped up" to the market value at the time of death, therefore heirs pay no tax on investment gains that occurred before death. This different tax treatment makes deferred annuities unsuitable for accumulating assets to leave to heirs.

Choosing a Company

Annuities are marketed as investment products by insurance companies, stock brokerages, financial services companies, and banks, but legally they are insurance products and must be underwritten by an insurer. Before

purchasing a policy, it is advisable to check the financial condition of this insurer. This is a particular concern if you buy a traditional fixed-rate annuity, because premiums paid into such annuities may be held by the insurance company in a pooled account of "general funds." If the company becomes insolvent or declares bankruptcy, these pooled funds could be used to satisfy creditors. In contrast, if you buy a variable deferred annuity your funds are registered in a separate account of the insurance company and thus are protected from creditors' claims against the company. (A growing number of companies place the premiums for fixed-rate annuities in separate accounts as well.)

Unlike bank deposits, funds invested in annuities are *not* insured by the Federal Government. This applies even to annuities purchased from banks. These policies are underwritten by insurance companies, not the banks. Thus, it is as important to check the financial condition of the insurance company underwriting an annuity marketed by a bank as it is to examine insurers selling policies through agents and brokers. Particularly with fixed-rate annuities, a bank-marketed annuity is only as sound as the insurance company that underwrites it.

There are five major ratings services, each with its own method of evaluating an insurance company. The roughly comparable ratings are shown in Table 1. Few companies are top-rated by everyone. Weiss Research, in particular, uses an especially conservative approach and rates only a few companies as superior. Look for a company that is highly rated by most of the agencies, and be wary if it receives more than one low rating.

You should be able to obtain these ratings, at no charge and in writing, from the policy salesperson. However, insurance companies may be reluctant to share ratings that are less than stellar or to explain what the ratings mean, and it is hard to ascertain if their information is accurate and up-to-date.

A better source for these ratings is *The Insurance Forum*. This monthly newsletter is edited by Joseph Belth, a frequent critic of the insurance industry. Each year the highly recommended September issue of the *Forum* contains a ratings list of every life insurance company rated by A.M. Best, Fitch, Moody's, Standard and Poor's, and Weiss. It includes an explanation of each firm's rating system (an "A+" may look like a top rating, but as shown in Table 1, for two firms it is only the fifth highest ranking). It also includes a watch list of insurance companies that appear financially vulnerable. This information is invaluable for anyone contemplating a substantial investment in an annuity. The September ratings issue costs \$20. Inquiries should be directed to The Insurance Forum, P.O. Box 245, Ellettsville, IN 47429, www.theinsuranceforum.com, telephone 812-876-6502.

IX.

IMMEDIATE ANNUITIES

ONE of the biggest financial fears of older people is that they will outlive their savings. Immediate annuities (also called income annuities) provide protection against this risk, by allowing retirees to convert their savings into a steady stream of income that lasts for as long as they live. In addition to providing financial security, annuities are attractive to retirees who want to maximize their monthly income, perhaps to supplement their Social Security benefits or pay for ongoing uninsured medical expenses.

Annuities are best suited to the circumstances of older people for two reasons: 1) older people are most likely to have accumulated sufficient funds to buy them, and 2) they are at an age at which the return on an annuity is most attractive. The income that can be obtained for a given premium increases with the age at which the annuity payments begin, because older individuals on average will live (and receive annuity income) for a shorter period than younger individuals.

For example, if a 65-year old man paid \$100,000 for an annuity, he would receive an income of about \$725 per month, based on the annuity income rates currently available. But if a 75-year old bought the same policy, his monthly income would be about \$975. An 85-year old could buy an income of \$1,225.

Another advantage of annuities is that a large portion of the income usually is tax-free. This is because the income payments are partly a return *of* principal and partly a return *on* principal. If the annuitant was taxed on the principal (the premium) when he earned his income, a tax on the entire annuity payment would involve taxing that income again. Only the earnings on the premium payment constitute new income to the annuitant, and only the portion of annuity income that represents these investment earnings is taxable. The exception is an annuity purchased directly with funds from an IRA or other tax-favored retirement account. Assuming no tax was ever paid on either the original investment or the investment earnings in the IRA, *all* of the annuity income is taxable.

How They Work

Annuities provide a stream of income to the annuitant for as long as he lives. Insurance companies are able to do this because the income payment they guarantee for a given premium amount is based on the predictable mortality experience of a large group of individuals. Even though the number of years a particular individual will live is unpredictable, mortality

tables reveal the average number of years a person in any group will live.

Annuity contracts guarantee to those who live payments that are funded in part by the premiums of those who die. The greater total sum paid to those who live to unusually advanced ages will be balanced by the smaller total payments made to those who die within a few years after the income payments began. To illustrate, for males aged 71, life expectancy is about 10 years. Thus if 1,000 males aged 72 each pay a premium of \$10,000 (a total of \$10,000,000), each can be guaranteed a payment of \$1,000 per year for life. Those who live beyond the average of 10 years have their "excess" payments funded by those who die before 10 years have elapsed. (This is an oversimplification, especially because it ignores the interest-earning power of a present sum of money.)

The word "annuity" implies a payment made each year. Actually, annuity income payments may be made annually, semiannually, quarterly, or monthly. The essential feature of these payments is that they are continued for as long as the recipient, or "annuitant," lives, once the individual pays the initial premium. The simplest annuity pays income only until the annuitant dies, but other types of contracts are available that obligate the insurance company to continue payments after death, to a beneficiary.

As noted, annuities are more advisable for older persons. In addition, because the annual payouts per premium amount are determined by average mortality experience (with some modification that is favorable for the company), annuity contracts are more attractive to persons whose present health, living habits, and family mortality experience suggest they are good candidates for living longer than "average." Of course, as a general rule annuities are not advisable for persons in poor health, but even this rule has its exceptions.

The term "annuity rate," also referred to as the "yield" of an annuity, applies to the annual income that can be obtained for each \$1,000 of purchase price. (Another common term, "rate of return," is a misnomer because the income payment includes a return of principal as well as a return on principal.) Fixed-dollar annuity rates are determined by the earnings on the investments of the insurance company, while variable-dollar annuity rates are determined by the investment earnings on assets in mutual-fund type subaccounts selected by the policyholder. In addition, each company's marketing and administrative expenses, as well as the mortality experience among the company's annuitants, affects its annuity rates.

With the exception of variable-rate annuities, annuity income payments from most policies are fixed. They are based on the highest yield that the insurance company can safely pay in the form of fixed-dollar income, with

no allowance for an increase if either price inflation accelerates or interest earnings increase as nominal interest rates rise. The usefulness of fixed-dollar annuities is greatly reduced during inflationary times because they do not in fact provide assured income in purchasing power terms.

No medical examination is required for any annuity unless the contract includes insurance features. The reason is that as far as the company is concerned, the poorer one's health, the better for the company.

The annuity income that can be purchased with a given premium at a given age is usually smaller for women than for men, because the life expectancy of a woman is on average longer than that of a man. At retirement age, a woman's life expectancy is approximately the same as that of a man 4 or 5 years younger. Some companies use the same tables for both sexes, with the provision that the purchase price, rates, and so on, for a woman shall be the same as for a man 5 years younger; others publish separate rates for male and female annuitants.

Some U.S. insurance companies now use unisex mortality tables for men and women, with no provision for taking into account the fact that women's actuarial life expectancies are longer. Women will find it to their financial advantage to buy from a company offering equal rates for men and women. Men will find the opposite.

All companies ordinarily require evidence of the annuitant's age. A pro rata allowance usually is made for the time elapsed between the past and coming birthdays.

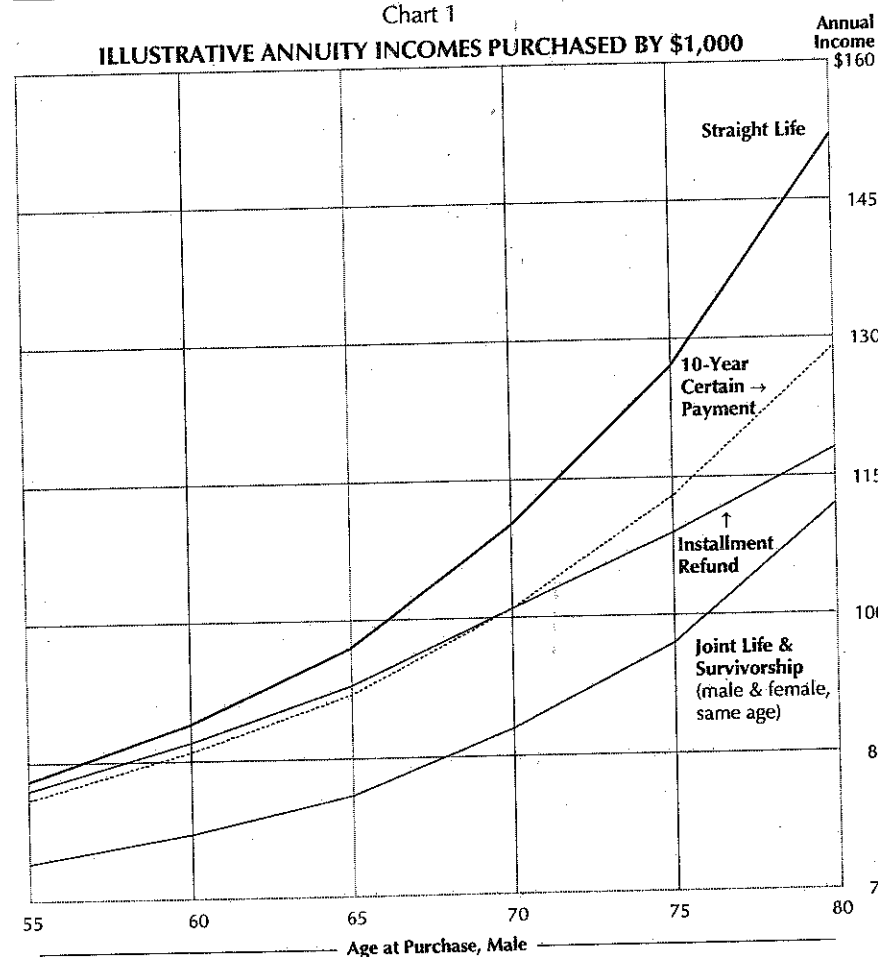
The more frequent are income payments to the annuitant, the greater is the purchase price; an annuity of \$10 a month will cost slightly more than an annuity of \$120 a year. There are two reasons for this. One, by paying \$10 a month, instead of \$120 at the end of each year, the company loses some interest, and the price of the annuity must be increased accordingly. Two, the last year that the contract is in force the company will lose a sum that will depend on when the annuitant dies. If he dies at the end of the fifth month, the company will have paid \$50 during this last year; whereas if the annuity were payable in a single sum at the end of the year, the company's liability would be nothing because the annuitant would be dead before the payment was due. Of course, sending out 12 checks annually rather than one also is somewhat costly to the company. The same principles hold true to a lesser extent for semiannual and quarterly payments.

In selling annuities, most companies have minimum limitations on the purchase price and the annuity payments. A common provision is to require that the purchase price be at least \$1,000 and that each annuity payment be at least \$10.

Income Options

Straight Life or "Lifetime Only" Annuity. The straight life annuity was the first type of annuity to be issued. These annuities were used very early in recorded history; mortality tables for computing their values were compiled by the Romans and have been found in Egypt and Babylon. Several medieval wars were financed by selling state annuities in much the same manner that bond issues are sold by modern governments.

The income provided by a straight life annuity terminates with the death of the annuitant, and no further payment is made by the company. For these reasons, the yield of this type of annuity is higher than that from other types of annuities (see Chart 1). This fact makes the straight life annuity



advisable in far more circumstances than any other type.

Many people are reluctant to purchase a straight life annuity because they fear that they will die sooner than "average" and they will not receive in annual income payments all that they pay as the premium. That indeed is a possibility. But if there are no others who need the income, its cutoff upon the death of an annuitant is no loss to anyone. On the other hand, should annuitants live longer than average, they would receive in income much more than the original purchase amount and they would have had the peace of mind that the income would not run out no matter how long they were to live. This is the very scenario that makes annuities an attractive option to begin with.

Installment Refund. The installment refund annuity provides that if the annuitant dies before the total amount of annuity payments received by him equals or exceeds the purchase price, the unpaid balance will be paid to a named beneficiary in annual installments equal in amount to the annuity payments. If no beneficiary survives the annuitant, there will be paid in one sum to the executors or administrators of the annuitant's estate the value (after adjustment for the interest-value of money) of the stipulated payments then remaining unpaid. If the annuitant dies after the total annuity payments have equaled or exceeded the purchase price, the company's liability ceases with the last regular annuity payment preceding death.

As depicted in Chart 1, the annual income is less than that from a straight life annuity. This is because the company does not get to use the unpaid balances of those who die earlier than average to make payments to those who die later than average.

Cash Refund. The cash refund annuity guarantees a life income to the annuitant and further provides that if he dies before receiving income payments equal to the purchase price, the balance of the purchase price will be paid in one sum to the executors of his estate or to a named beneficiary. This contract is similar to the installment refund annuity, but the two should not be confused. The installment refund annuity provides for a continuation of the annuity payments to the beneficiary until such payments, together with those received by the annuitant during his lifetime, equal the purchase cost of the annuity. The cash refund annuity provides that the balance of the purchase price will be paid in a lump sum. The yield of a cash refund annuity is slightly lower than the yield of an installment refund annuity.

Stipulated Payments. A life annuity with stipulated payments guarantees a specified income to the annuitant for as long as he lives and further provides that, if he dies before the expiration of 5, 10, 15, or 20 years, as he

may select, the payments will be continued to a designated beneficiary until the end of the stipulated period. If no beneficiary survives the annuitant, the interest-adjusted value of the stipulated payments then remaining unpaid will be paid in one sum to the executors or administrators of the annuitant's estate. The yield of such an annuity depends to a large degree on the length of the guaranteed (or "certain") income-payment period that the annuitant selects, but it always is less than the yield of a straight life annuity.

Refund annuities (installment, cash, or stipulated payments) are sometimes purchased not because the refund serves a financial purpose but because the annuitant dislikes the idea of forfeiting part of his capital if he were to buy a straight life annuity and die before receiving annual payments totaling his premium. Like other financial decisions, the type of annuity to purchase (if any) should be made for the financial benefits obtained in relation to the costs. Unless a refund were needed for some purpose — that is, unless someone would suffer in the absence of it — the annuitant would gain a higher annual income for as long as he lives from purchasing a straight life annuity.

Stepped-Up Payments. A stepped-up annuity provides the annuitant with smaller payments until he reaches a specified age (for example, retirement), and larger payments afterwards. This type of annuity is actually a combination of a straight life annuity and a smaller temporary annuity that pays benefits only during the specified early period rather than for the annuitant's entire life. A "stepped-down" annuity is similar, but is designed for individuals who expect their financial needs to decrease rather than increase in their later years. It pays a larger benefit in the early years of the annuity period, and a smaller benefit after the annuitant reaches a certain age.

Joint-Life-and-Survivorship. With a joint-life-and-survivorship annuity, income is payable during the joint lifetime and during the lifetime of the survivor of two or more annuitants. One of the principal advantages of a joint-life-and-survivorship annuity is that much of the need for life insurance is eliminated. For example, if a husband and wife have such an annuity that provides sufficient income for their needs, little or no insurance is necessary, because the survivor will be supported by the annuity income even after the spouse's death. This arrangement makes possible substantial life insurance premium savings at the advanced ages, when to carry any life insurance policy involves a high cost.

This form of annuity is more advantageous for a married couple than the installment or cash refund type. The refund annuity involves a decreasing benefit. If a surviving spouse needs the funds provided by the refund

provision of an annuity, there is no assurance that the refund provisions will not cease long before the death of that survivor. On the other hand, if an annuity of the joint-life-and-survivorship type is purchased, the income will be continued for the lifetime of the survivor.

Traditional joint-life-and-survivorship annuities pay the same annuity income during the lifetime of the survivor as during the joint lifetimes of the annuitants. In the case of an annuity issued to a man and woman, the rates usually are based on the woman's age to a greater extent than on the man's age because of two factors. In the first place, women have a life expectancy equal to that of a man 4 or 5 years younger. Second, most women are younger than their husbands. For these reasons, most wives have life expectancies greater than their husbands. Therefore, the yield on a joint-life-and-survivorship annuity must be based primarily on the wife's age. The yield on this type of annuity is less than that on a straight life annuity purchased by either one of the annuitants. If the contract is entered at an early retirement age of the husband, say 60, the income may be relatively small, in which case it might be better to wait a few years before buying the policy.

An alternative to separate annuities or a traditional joint-life-and-survivorship annuity is a "variable payment" joint-and-survivor annuity. (This is not to be confused with "variable rate" annuities, discussed below) This pays a larger benefit while both annuitants are living and a smaller benefit to the survivor after one annuitant dies. The yield of a variable-payment annuity depends on whether the benefit is to be reduced upon the death of only one specified annuitant or upon the death of either annuitant regardless of who dies first.

In most instances, separate annuities or a variable-payment annuity for a husband and wife are preferable to a traditional joint-life-and-survivorship annuity. The survivor will not need as much income as the couple, especially because medical expenses for the one probably will be about half those for two. If separate annuities are purchased, the younger spouse could wait a few years before buying one, and until then the capital would be available for investment in interest-earning assets. What would be best would depend on the couple's available capital and their needs as they see them.

Variable-Rate Annuities

Traditional annuities that provide a fixed-dollar income have one big drawback: in inflationary times, the purchasing power of the income is eaten away by rising prices. If price inflation remains relatively low, as it has been in recent years, this is a lesser concern. But there is no assurance

that the rate of price increase will not accelerate. And even a relatively low rate of price inflation takes its toll over long periods. An annual inflation rate of just 3 percent would cut the buying power of the dollar to just 75 cents in 10 years. This makes fixed-dollar annuities a questionable investment for younger retirees, since they would be locked in to the fixed income for the longest time. So long as the price level continues to rise, the purchasing power of fixed-dollar annuity income is virtually guaranteed to fall.

Some insurance companies reportedly now offer annuities that provide a regular upward adjustment of income to compensate for price inflation. Presumably the benefit is "indexed" to the Consumer Price Index or some other price series. We have not actually seen such policies, but if the income yields they initially provide are competitive with other policies, they would appear to merit consideration.

A more widely available alternative is a variable-rate annuity, which provides an income that varies with the return on the assets in which the premium is invested. Variable-rate immediate annuities are similar to variable-rate deferred annuities (discussed in the preceding chapter), in that the premium is invested in one or more subaccounts chosen by the policyholder, and the policyholder rather than the insurance company bears all of the investment risk.

The monthly annuity income is a fixed percentage of the value of the fund, but the dollar income will vary from one payment to the next. It might increase if the investment value of the subaccount increases, but it might decrease if the subaccount loses value. The income will fluctuate with the investment performance. Some policies provide a guaranteed minimum income, however this amount is likely to be smaller than the income from a comparable fixed-dollar annuity. In short, there is no risk-free or costless way to protect annuity income from the loss of purchasing power.

Some policies allow the annuitant to split his premium between a fixed-rate annuity and a variable annuity. The income from this combination is the sum of a fixed-dollar income payment and an income payment that varies according to the value of the investments in the subaccounts selected by the policyholder.

The insurance company typically offers the investor a range of funds from which to choose. Unlike deferred annuities, most variable-rate immediate annuities offer very restricted opportunities to switch around among funds. Some policies prohibit any transfers. Thus, the investor who chooses the "wrong" fund may be stuck with a policy that provides shrinking income. In any event, investors should consider variable-rate annuities

Table 2
TAX TREATMENT OF A \$10,000
IMMEDIATE STRAIGHT LIFE ANNUITY

Age	IRS Expected Return Multiples	Exclusion*	Age	IRS Expected Return Multiples	Exclusion*
61	23.3	\$ 429.19	76	11.9	\$ 840.34
62	22.5	444.44	77	11.2	892.86
63	21.6	462.96	78	10.6	943.40
64	20.8	480.77	79	10.0	1,000.00
65	20.0	500.00	80	9.5	1,052.63
66	19.2	520.83	81	8.9	1,123.60
67	18.4	543.48	82	8.4	1,190.48
68	17.6	568.18	83	7.9	1,265.82
69	16.8	595.24	84	7.4	1,351.35
70	16.0	625.00	85	6.9	1,449.28
71	15.3	653.60	86	6.5	1,538.46
72	14.6	684.93	87	6.1	1,639.34
73	13.9	719.42	88	5.7	1,754.39
74	13.2	757.58	89	5.3	1,886.79
75	12.5	800.00	90	5.0	2,000.00

* For U.S. Federal income tax purposes per \$10,000 contract.

only if they are prepared to accept fluctuations in their income. They also should clarify how income rates would be calculated under the various income options discussed in the preceding section.

Tax Treatment

The portion of the annual income from an annuity that represents earnings on the original investment is taxable as income. The portion that represents a return of the premium(s) is tax free. The IRS specifies a method for determining the amount of annuity income that is taxable, based on the investment in the contract and age of the annuitant at the time the annuity payments begin.

Very simply, the investment amount (generally the premium) is divided by the IRS's "expected return multiple" for an annuity purchased at a given age to determine the annual amount that is excluded from Federal income taxation. The expected return multiples for immediate straight life annuities, and the corresponding tax-free portions of annuity income, are shown in Table 2. To illustrate, in the case of an annuitant aged 65 who purchases an immediate straight life annuity for \$10,000, that amount is divided by the expected return multiple 20.0 shown in the table. The result, \$500, is the amount of annuity income annually excludable from Federal income taxation.

For annuities for which the entire investment was made after 1986, the sum of annual exclusions taken over the annuitant's lifetime cannot exceed

his original investment in the contract. In the above example, by age 85, after receiving annuity payments for 20 years, the annuitant would have excluded a total of \$10,000 from taxation. Since this equals his original investment, he would not be entitled to any exclusion in subsequent years. In effect, the law prevents annuitants who outlive their projected life expectancy from excluding more than their original investment. (Annuitants who began receiving income before 1987 can still do this.) The number of years a straight life annuitant can exclude annuity income is shown by the IRS expected return multiples in Table 2 (e.g., 20 years for a 65-year old).

IRS Publication 939 includes various tables of expected return multiples for other types of annuities and an explanation of how to use them. Various tax guides, such as *J. K. Lasser's Your Income Tax*, also are helpful in making this calculation. However, any U.S. life insurance company will provide the amount of annuity payments that are excludable from Federal income tax to you. When doing your retirement-income planning, you should ask for these figures on any annuity before buying it. After your purchase, the taxable portion of your annuity will be indicated in Box 2A of Form 1099-R sent to you annually by the company.

The tax treatment of variable-rate annuities is slightly different. Since the income from a variable-rate annuity fluctuates with its investment performance, it is possible that in some years the income received will be less than the amount that (based on the original investment) should be tax free. The tax law allows the investor to make up the difference by claiming a larger amount of tax-free income in later years, using a procedure specified by the IRS for recalculating the tax-free portion of income.

Choosing a Policy

It is essential to check the financial standing of any insurance company before buying an annuity. An annuity requires a large up-front investment in return for a promise of future income, and with a fixed-rate annuity that promise is only as good as the company that makes it. Moreover, once annuity income payments begin, it is difficult if not impossible to break an annuity contract and get a refund. A number of rating services evaluate the financial condition of insurance companies. Their rating systems are described on page 60. Investors should buy only from top-rated insurers

Comparing Income Payouts

It pays to shop among companies for a fixed-rate annuity; the income rates vary greatly. Because the immediate annuities offered by most life insurance companies are nonparticipating, no dividends are paid by the company to supplement the stipulated income payments. Therefore, such policies may be compared on the basis of the monthly income per \$1,000

premium payment. Table 3 shows this comparison for annuity contracts available to a man or woman aged 65 or 75, based on a \$100,000 premium. The table is based on a survey conducted in June 1998 by the A.M. Best Company, one of the ratings services. A.M. Best rates insurance companies' financial condition on a scale of A++ to F, and the table includes only companies rated A or higher. The income payments shown are for the "life-time only" option, which provides the highest monthly payment until the annuitant's death and no payments thereafter.

The companies are ranked according to the income provided to 65-year old males. The income rates for 75-year old men and for women age 65 and 75 are not ranked, but the highest and lowest income rate available in each category is underlined in the table.

The differences in monthly income rates can add to a substantial sum over time. For example, a \$100,000 annuity purchased from top-ranked CUNA Mutual Life by a 65-year old man would pay \$100,800 during a 10-year period compared with \$79,440 that would be paid by bottom-ranked SAFECO Life — a difference of \$21,360.

The relative rankings for women are similar but not identical to those for men. Policies that pay high incomes to men generally are generous to women as well — for example, top-ranked CUNA Mutual Life. However, companies that use unisex rates (that is, they offer the same income rates to women and men) offer relatively better deals to women. For example, SAFECO Life's annuity pays \$662 per month to a 65-year old annuitant, male or female. This is the lowest of the payouts available to men, but it is the median payout among women's policies. This illustrates our earlier observation that women will find it advantageous to buy from companies that use unisex annuity rates, while men will do better with companies that use separate tables for men and women.

The relative positions of the various companies in the table for policies issued at different ages do not vary markedly. A company that offers relatively generous income rates to a 65-year old is likely to offer good rates to a 75-year old. However, income rates are higher across the board for older annuitants, and the increase in income to an individual who postpones annuitizing until a late age can be substantial. For example, Berkshire Life pays \$779 in monthly income per \$100,000 premium for a 65-year old male. For the same \$100,000, the company pays \$1,029 to a 75-year old. The catch, of course, is that these larger income payments, guaranteed for one's remaining lifetime, are likely to be paid for fewer years.

Actual monthly income may be slightly less than the figures indicate because of premium taxes imposed by some states. Discounts for larger

annuities offered by some companies could result in larger income, and premiums less than \$100,000 might buy smaller incomes. Factors such as these, and others, make it imperative that you investigate as many companies as practicable and not limit your search to companies having a high rank in our lists.

In addition, the income available from fixed-rate annuities at the time you consider annuitizing may be more or less generous than the rates shown in our table. This is due to the fact that, by law and by custom, bonds account for the bulk of the assets that insurers use to back their annuity obligations. Not surprisingly, the income rates available today are lower than they were 10 or 15 years ago, reflecting the substantial decline in long-term interest rates. In the late 1980s, a new \$100,000 policy purchased by a 65-year old man paid, on average, an income of \$900 per month. In the late 1990s, when interest rates reached a 20-year low, a comparable new policy paid only \$740, nearly 20 percent less. Since 1998, however, the general level of interest rates has increased. If it continues to do so, the income payouts on new policies are likely to become more attractive. In other words, the best time to lock in a high income rate on an annuity is when the market level of interest rates is relatively high.

Because variable-rate annuities provide an income that fluctuates with the market value of a stock fund or a similar variable measure, they cannot be ranked on the basis of future income. As with mutual funds, investors must rely largely on historical performance for an indication of what future returns *might* be. Sources of such information are described in our discussion of variable-rate deferred annuities on pages 55-57.

Table 3
"Lifetime Only" Annuity Income Rates — Income Payments
Cease Upon Annuitant's Death

Company	Rating*	Monthly Income per \$100,000 Premium			
		Age 65		Age 75	
		Male	Female	Male	Female
CUNA Mutual Life	A	\$840	\$771	\$1,083	\$959
American Family Life	A+	826	748	1,107	971
Mod. Woodmen of America	A+	819	741	1,100	964
ReliaStar Life of New York	A+ g	807	732	1,050	902
Great American Life	A g	797	714	1,098	982
Aid Assoc. for Lutherans	A++	791	711	1,074	918
Federated Life	A+	785	711	1,052	922
Equitable Life of Iowa	A+ g	779	687	1,057	906
American Heritage Life	A	779	701	1,060	925
Berkshire Life	A	779	703	1,029	897
Kansas City Life	A g	778	702	1,042	909
Sunset Life of America	A g	778	702	1,042	909
COVA Fin. Services Life	A	770	692	1,050	916
Keyport Life	A+	770	699	1,016	901
Aetna Life & Annuity	A+ g u	770	705	1,033	917
Farm Family Life	A	768	693	1,037	908
Acacia National Life	A	768	686	1,065	930
Penn Insurance & Annuity	A g	767	683	1,030	874
Penn Mutual Life	A g	767	683	1,030	874
SunAmerica Life	A+ g	765	691	1,032	903
Lafayette Life	A	763	685	1,042	909
Amer. Gen. Life & Accident	A+	762	687	1,031	901
Baltimore Life	A g	756	675	1,046	904
Security Mutual Life of N.Y.	A	751	674	1,034	925
Southern Farm Bureau Life	A g	750	676	1,011	887
Fed. Kemper Life Assur.	A	745	669	1,022	890
Kemper Investors Life	A	745	669	1,022	890
TMG Life	A++ g	745	667	1,025	892
USAA Life	A++	744	673	1,060	916
Northern Life	A+ g	743	664	1,025	893
Jackson National Life	A+	742	668	1,002	875
AmerUs Life	A g	741	663	1,025	887
Delta Life & Annuity	A	741	663	1,025	887
Woodmen of the World	A+	739	664	1,008	881
Variable Annuity Life	A+	738	668	983	863
Manufacturers Life (USA)	A++ g	737	638	1,016	839
Farm Bureau Life	A+	737	657	1,026	885
Union Central Life	A	736	661	999	874
Gleaner Life	A	735	661	999	872
Canada Life	A++ g	731	657	987	865
IDS Life	A+ g	730	678	956	873
Ameritas Life	A+ g	729	657	988	864
Lincoln Benefit Life	A+ r	727	662	971	859
Lutheran Brotherhood	A++ g	724	650	990	863
Shenandoah Life	A	724	651	987	861
Midland National Life	A+	723	654	952	835
Minnesota Mutual Life	A++	721	647	983	858
American Life of N.Y.	A+ g	720	633	977	803
Great-West Life & Annuity	A++ g	720	646	974	844

Table 3 (continued)
 "Lifetime Only" Annuity Income Rates — Income Payments
 Cease Upon Annuitant's Death

Company	Rating*	Monthly Income per \$100,000 Premium			
		Age 65		Age 75	
		Male	Female	Male	Female
Security Benefit Life	A+	\$720	\$647	\$968	\$841
American Gen. Annuity	A+	720	647	981	856
Standard Insurance	A	719	673	942	861
Franklin Life	A+ g	719	653	941	825
American General Life	A+ g	718	672	950	872
State Farm Life	A++	716	644	971	844
American Mayflower Life	A+	716	668	976	879
Equitable Life	A g	712	626	968	849
Old Line Life of America	A+	710	640	965	840
Metropolitan Life	A+ g	708	639	941	817
Security First Life	A g	706	646	909	818
Indianapolis Life	A g	702	619	971	833
Sun Life of Canada (U.S.)	A++ g	702	623	987	855
American United Life	A+	701	626	962	832
Provident Mutual Life	A g	701	632	887	783
Providentmutual Life & Ann.	A g	701	632	887	783
AUSA Life	A	696	630	917	803
Life Investors of America	A+	696	630	917	803
Monumental Life	A+	696	630	917	803
PFL Life	A+	696	630	917	803
New York Life	A++ g	694	616	959	822
Northwestern Mutual Life	A++ g	692	624	923	808
American Life & Casualty	A g	689	615	890	785
American National	A++	689	625	959	837
Manufacturers Life of N.Y.	A++ g	686	614	929	802
Manu. Life of N. America	A++ g	686	614	929	802
Massachusetts Mutual	A++	684	605	938	804
Golden Rule Insurance	A	682	629	920	829
Mutual of America	A+ g	677	677	886	886
Lincoln National Life	A+ g u	675	601	944	815
Ohio National	A+ g	674	617	857	780
First SAFECO National Life	A+	662	662	853	853
SAFECO Life	A+	662	662	853	853
Highest Income		\$840	\$771	\$1,107	\$982
Lowest Income		662	601	853	780
Median Income		728	662	987	864

Note: Companies are ranked by income rates for a 65-year-old male. The highest and lowest income rates for men and women of either age are underlined. Rates as of June 1998. * Ratings by A.M. Best in June 1998: A++ and A+ = Superior, A = Excellent, g and r = rating based on a company's affiliation with a group of insurers (g) or with a reinsurance company (r), u = under review for a rating change. Source: A.M. Best Co.

X. CONCLUSION

NOW that you are familiar with the specific advantages and disadvantages of each investment discussed, it is up to you to take action. Your decisions will depend on your particular financial position and your needs as you see them.

We have limited our focus to wealth-building, tax-reducing strategies that are available to most taxpayers, are relatively simple, and make good investment sense. Our discussion has not been comprehensive. There are probably as many ways to save on taxes as there are tax laws as evidenced by the growing number of people who make their living as tax planners, tax accountants, and the like. We believe that investors should be taking advantage of basic tax-favored opportunities before even thinking about more complicated strategies.

In most instances, your first tax-favored investment should be your home. Not only is the income from your investment received "in kind" (a place to live) but any mortgage interest may be deducted from your cash income.

Not all of the investments discussed in this booklet are suitable for every investor. The phrase "tax-deferred" means just that — the tax is payable in the future. This means, among other things, that tax-deferred investments are suited to long-term savings programs. There is little sense in accumulating tax-deferred funds, which are often less liquid than taxable alternatives, that you expect to spend within the next 5 years or so, unless you expect to be in a lower tax bracket when you "cash in" the tax-deferred holdings.

On the other hand, it is easy to overestimate the impact of the 10 percent penalty on early withdrawal from pension programs (and some annuity contracts). The ability to exclude annual contributions to, and the investment income received in, such accounts will, in a relatively short period of time, make more available for a "rainy day" *even after the 10 percent penalty*, than can be accumulated with fully taxable savings. Moreover, if you really need to get at the funds, there is a good chance you will be in a lower tax bracket if and when the "rainy day" arrives.

This means you should contribute as much to your company's retirement plan and/or your IRA or Keogh plan as your budget and the tax laws allow. The tax benefits are immediate, the investment earnings compound tax free, and if your employer makes matching contributions the return is virtually unbeatable.

Contributions to Roth IRAs are not deductible, but taxes on investment earnings are deferred and qualified withdrawals are completely tax-free — an advantage offered by few other investment alternatives. Roth IRAs are more flexible than traditional IRAs. The penalties for early withdrawals are less harsh, you may contribute to Roths after reaching age 70 1/2, and the minimum distributions required from traditional IRAs after age 70 1/2 do not apply to Roth IRAs.

Education IRAs offer a tax break for students and their families. If Congress enacts the various proposals to expand Ed IRAs, such as raising the contribution limit and allowing tax-free withdrawals by taxpayers who claim education tax credits, these accounts could become a significant means of saving for education.

U.S. savings bonds, deferred annuities, or tax-exempt municipal bonds can be accumulated with savings in excess of the maximums allowed for tax-favored retirement and education accounts. Savings bonds are relatively safe and can be purchased in small denominations. Deferred annuities and municipal bonds carry more risk but offer potentially higher returns. Deferred annuities are most suitable for investors whose employer-sponsored retirement plans are inadequate, while municipal bonds or bond funds are most appropriate for investors in high tax brackets. They are most suitable for investors with relatively large portfolios.

While they do have some tax advantages, immediate annuities are most suitable for retired investors who need to maximize their current spendable incomes.

A final word of caution: Congress tinkers continually with the tax code, and some of the laws described here may soon change. Before investing any money, you are well-advised to ask your broker, insurance agent, or tax advisor about the latest developments.

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