



# Generating Tax-Free Income

## What is generating tax-free income?

To engage in personal income tax planning, you should be aware of a number of concepts, including that of generating tax-free income. Although income is usually taxable, there are a number of vehicles that can produce tax-free or nontaxable income. Some of the more popular forms of nontaxable income include the following:

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

## How can IRAs be used to generate tax-free income?

There are two IRAs that are best suited to generate tax-free income: the Roth IRA and the Coverdell ESA. (The benefits of these IRAs may not be available to higher income taxpayers.)

## Roth IRA

Unlike contributions to a traditional individual retirement account (IRA), contributions to a Roth IRA are never tax deductible. Since you are taxed on your IRA contributions currently, that money will be returned to you tax free when withdrawn in the future. In addition, the earnings (interest) on Roth IRAs grow federal income tax deferred and are tax free when withdrawn (assuming your distribution is a "qualified" one). Because of these features, the Roth IRA is a useful tool for generating tax-free income.

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

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

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

### Tax-exempt bonds

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

**See disclosures on final page.**

state or local tax. Municipal bonds, therefore, can help generate tax-free income for you.

**Caution:** For investors who are subject to the alternative minimum tax (AMT), however, interest income from certain municipal securities must be included in income when calculating the tax.

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

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

### Death benefit

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

### Cash value insurance transactions

The cash value in a universal life insurance policy can also be a useful tool for generating tax-free income. In general, amounts received under a life insurance contract (other than an annuity) are treated first as a recovery of basis; only after the entire basis has been recovered is

there taxable income. Therefore, any withdrawal you make from your cash value life insurance policy (up to the amount of your basis or investment in the contract) can be taken tax free.

It is also possible for you to obtain a loan from your insurance company in an amount up to the cash value of the policy. For the most part, loans are not treated as taxable distributions (although interest will be charged by the insurer). At present, it is possible (in some cases) for an insured to stop paying premiums and use his or her policy's cash value as a retirement fund of sorts, without paying tax on the cash value. Basically, you borrow the cash value (even if it exceeds the investment in the policy) and do not have to pay it back until you die or unless the policy lapses. The loan plus interest will be deducted from the death benefit paid.

Example(s): Assume John buys a \$160,000 life insurance policy for which he has paid \$40,000 in premiums to date (basis). The cash surrender value of the policy is \$55,000. John borrows \$50,000 of the cash value of the policy to fund his retirement, pays no more premiums, and retains the insurance coverage as long as the remaining cash value covers future premium payments. As it turns out, the interest rate that the insurance company charges him for the loan is precisely the same interest rate he is earning on the cash value, so there is a wash (i.e., the borrowing creates no out-of-pocket cost to him).

Congress could close the above loophole at some point. Accordingly, a less risky move may be appropriate.

**See disclosures on final page.**

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

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

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

- Ten times the taxpayer's (aggregate) adjusted basis in the stock that is sold, or
- \$10 million of gain from stock in that corporation

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

- You sell or trade stock in a corporation that qualifies as an empowerment zone business during substantially all of the

time you held the stock

- You acquired the stock after December 21, 2000

**Caution:** The part of the gain that is included in income will be taxed at a rate of 28 percent.

**Caution:** Gain from the sale of qualified small-business stock that is excluded from taxable income may still be subject to the alternative minimum tax.

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

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

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

Even if you fail to meet these two tests, though, you may be eligible to claim a partial exemption.

### Disclosures – Important – Please Review

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

Securities offered through Securities Equity Group, member FINRA, SIPC, MSRB  
Copyright 2006 Forefield, Inc. All rights reserved.