Qualified accumulations are certain types of savings and investment vehicles that qualify for special federal tax treatment of:

- Contributions to the plan, and
- Earnings on those contributions.

Most nonqualified accumulations, on the other hand, are placed in savings or investment vehicles that receive no special tax treatment. (Life insurance and personally owned deferred annuities are exceptions: they enjoy tax-deferred accumulation even though “nonqualified.”) Both types of accumulations are intended to amass retirement income that will be withdrawn in the future.

Qualified accumulations can result from:

- Employer-sponsored retirement plans established for the benefit of employees, or
- Individual Retirement Accounts or Annuities (IRAs) established by individuals on their own behalf.

Qualified employer retirement plans that meet tax code requirements provide a tax deduction for contributions the employer makes on behalf of employees. The employer may deduct from its gross income contributions made to the qualified plan.

Employees benefit from a qualified employer-sponsored plan in several ways:

- Contributions are not included in the employee’s gross income.
- With arrangements such as a 401(k) or 403(b) plan, where employees contribute a portion of their earnings, employers frequently match the contributions up to a certain percentage of the employee’s income, further increasing the amount of the accumulations.
Ongoing contributions and the earnings on accumulations in the qualified plan grow on a tax-deferred basis—no taxes are generally due until funds in the plan are withdrawn.

Individual Retirement Accounts and Annuities (IRAs) may also qualify for tax advantages when certain requirements are met. Individual wage earners who are not covered under an employer retirement plan may make annual tax-deductible contributions for themselves and for an unemployed spouse, as long as they meet all of the federal requirements regarding income and age. The maximum amounts that may be contributed and deducted each year are stipulated by law and subject to change.

Certain wage earners who are covered by an employer retirement plan may also make deductible contributions if their incomes fall below certain thresholds that change annually. Above a certain level of income, however, individuals are no longer eligible to take a tax deduction for IRA contributions. These individuals may still contribute to the IRA with after-tax dollars. In all cases, the accumulations grow on a tax-deferred basis.

People age 50 and older may make additional or “catch-up” contributions that exceed the regular IRA contribution limits. In 2005, people age 50 and over may contribute up to $500 above the regular IRA limit of $4,000.

To summarize, IRA contributions are:

- Tax-deductible within limits and contribution maximums specified in the tax code.
- Permitted on an after-tax (nondeductible) basis when the individual does not qualify for a tax deduction.
- Allowed to accumulate on a tax-deferred basis until withdrawn.

Contributions to savings and investment plans that do not qualify for tax benefits are called nonqualified accumulations. Contributions are made with after-tax dollars; there is no tax deduction. However, when such funds are withdrawn, the principal amount that was invested is not taxed; only the earnings portion of the withdrawal is taxed.
Earnings in a nonqualified arrangement may be taxed currently, rather than tax-deferred, depending on the particular type of savings or investment vehicle. For example:

- Interest paid on a bank savings account or certificate of deposit is taxed as current income in the year it is received.

- Interest paid on most investments is taxed as ordinary income, but interest on certain investments, such as municipal bonds, may be tax-exempt.

- Dividends received on stock and mutual fund investments are generally taxed as ordinary income, subject to a special top tax rate of 15 percent on “qualified dividends.”

- Interest paid on the cash accumulation in a personally owned, nonqualified annuity contract generally is not taxed as long as it is left to accumulate. Tax is deferred until the owner begins receiving periodic income payments, or otherwise accesses the annuity values, and earnings are taxed at that time.

While life insurance and annuity contracts are not considered to be tax-qualified (except in the case of an annuity used to fund an IRA), the accumulations in these contracts receive favorable tax treatment.

The premiums paid for life insurance and annuity contracts are not tax-deductible, but the earnings for both accumulate on a tax-deferred basis until withdrawn. At that time, taxes are due only on the earnings portion of the withdrawal.

It is important to consider the tax consequences of savings and investment options before deciding how to accumulate retirement income. Some important questions include:

- Are contributions made with pre-tax or after-tax dollars?

- Are earnings taxed currently, or are taxes deferred?

- When accumulations are withdrawn, are they fully or partially taxed, or not taxed at all?
Qualified vs. Nonqualified Accumulation

What Are Qualified and Nonqualified Accumulations?
Qualified accumulations are savings and investment vehicles that qualify for special tax treatment of the money contributed and the earnings during the accumulation period. Most nonqualified accumulations receive no special tax treatment. (Life insurance personally owned deferred annuities are the exceptions). The purpose of both types of accumulations is to produce retirement income.

What Types of Accumulations May Be Qualified?
Qualified accumulations result from certain employer-sponsored retirement plans that are established for the benefit of employees. Individual Retirement Accounts (IRAs) established by individuals on their own behalf may also qualify for tax benefits. In both cases, these plans must be set up in accordance with the tax code requirements.

What Are the Benefits of These Plans?
Employers may make contributions on behalf of their employees and, subject to certain limits, deduct the contributions from their taxes. Employees enjoy even greater benefits:

- Contributions are generally made with pre-tax dollars that are not included in the employee's gross income.
- In plans such as 401(k)s, where employees make the contribution, employers often make matching contributions up to some limit.
- Accumulations grow on a tax-deferred basis so no taxes are due until the income is withdrawn.

IRAs are subject to limits on deductibility and contribution maximums. When such requirements are met, IRA contributions are tax-deductible and earnings grow tax-deferred until withdrawn as distributions.

For nonqualified accumulations, contributions are made with after-tax dollars. However, since taxes are already paid, there is no taxation of the principal amount when the funds are withdrawn. Earnings may or may not be tax-deferred, depending on the particular type of investment.

Do Life Insurance and Annuities Meet the Qualification Requirements?
Except for annuities used to fund an IRA, accumulations in these contracts are not considered to be qualified. Premiums are not tax-deductible; contributions are made with after-tax dollars. However, the accumulations in both life insurance and annuities do grow on a tax-deferred basis.

What Should I Consider in Choosing a Retirement Income Investment Vehicle?
- Are contributions made with pre-tax or after-tax dollars?
- Are earnings taxed currently, or are they tax-deferred?
- When accumulations are withdrawn, are they fully or partially taxed, or not taxed at all?
We want to thank you for your interest in our professional services, and for this opportunity to present a financial concept that may be pertinent in your personal circumstances.

Please contact us if we can answer any questions you have, or if we can provide any additional information on this or other financial topics.