SEMI-RETIRED SHOULDN'T OVERLOOK
LOW-INCOME RETIREMENT TAX CREDIT

A tax credit provision in the 2001 Tax Relief Act designed to encourage younger, lower-income taxpayers to save for retirement may also benefit taxpayers who are nearly retired. The catch is, for both young and old, the credit only lasts four years.

Here's how the credit works. Couples filing jointly with adjusted gross incomes of no more than $30,000, and taxpayers filing singly with AGIs of no more than $15,000, receive a 50 percent credit on their contributions to a qualified retirement plan, such as a 401(k), or an individual retirement account (IRA). The maximum credit they can receive in a year is $1,000 (filing single) or $2,000 (couples filing jointly).

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

Some taxpayers earning more than the limits cited above may qualify for smaller maximum credits. For example, couples with AGIs of $30,001-$32,500 can receive a 20 percent credit ($400 maximum), and couples with AGIs of $32,501-$50,000 receive a 10 percent credit ($200 maximum). There is no credit available for AGIs over $50,000 ($25,000 filing singly).

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

The credit is not available to full-time students, dependents or someone who is not age 18 by the end of the tax year. The credit is also reduced or even eliminated for the current and possibly future tax years if you take money out of a tax-deferred retirement account for such use as the first-time purchase of a home or to pay for medical or education expenses.

Moreover, the credit is good only for tax years 2002 through 2006. And remember, even if you don't contribute, or don't contribute the maximum in calendar year 2002, you may be able to retroactively contribute as late as the filing date of your 2002 return. This applies to some retirement accounts such as an IRA or simplified employee pension plan (SEP), but not all.

One of the major criticisms of this credit, besides the five-year tax window, is the fact that many lower-income households find it difficult to scrape up the funds to contribute to retirement accounts, even with the credit. But one group of taxpayers who may be able to take advantage of this tax break is the semi-retired taxpayer.

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

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

Of course, you'll want to explore this credit with your financial planner before making any final decisions. Your planner may find alternative retirement and tax-saving strategies that are more appropriate for your situation.

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