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Retirement Savings Tax Planning Tips

Given a constantly changing tax environment, what's the most effective way to save for retirement?

In the next few years, Congress will decide the fate of several tax laws that are set to expire, such as the lower tax rate on investment capital gains and dividends held one year or more (ranges from 28% to 5%, depending on your income tax bracket). No one can definitively know what tax laws will be in effect in years to come. But you should not let tax law uncertainty disrupt your long-term planning — try to focus on those tax benefits that support your long-term retirement goals.

The following product tips will help you save for the long haul.

Don't Overlook Any Employer Match

No low-tax product can surpass free money from your employer. If you're eligible to contribute to an employer-sponsored retirement plan, such as a 401(k), 403(b) or Public 457(b) plan, always contribute at least the amount that's required for you to receive a matching contribution from your employer. Check with your benefits office or employer to learn about your contribution options.

Consider Making Supplemental Retirement Plan Contributions

Making automatic pretax contributions to a 403(b), 457(b) or 401(k) supplemental retirement plan involves a trade-off. (All your supplemental plan contributions, and any earnings, will grow tax-deferred until you withdraw them. Withdrawals are generally restricted until retirement or after age 59½, when you'll pay ordinary income taxes on the money. Distributions before age 59½ may be subject to an additional 10% tax penalty.)

Unquestionably, these plans offer an excellent, disciplined, tax-deferred savings approach — a major advantage if it's difficult for you to put money aside for retirement. The only drawback is that retirement distributions from these plans (and from pre-tax traditional IRAs) are taxed as ordinary income, which could be higher than taxes on nonretirement products. (Roth supplemental plans and Roth IRAs are the exceptions, since they're completely income tax free if you meet their holding period requirements. For further comparative discussion on traditional, pretax 403(b)s/401(k)s and after-tax Roth 403(b)s/401(k)s, see our article "Saving More With Roth 403(b)s / 401(k)s," written by our actuaries, Michael Heller and Benjamin Goodman, also in our library of articles.)

You therefore may fare better by investing outside your retirement plan. For example, income from an individual stock or mutual fund outside a retirement plan can currently be taxed at a 5%, 15% or 28% rate — depending on your tax bracket — if the investment is held for one

year or more. This could be lower than your ordinary income taxes during retirement. The difference between the income taxes you'll pay on withdrawals from pretax retirement plans and your capital gains and dividends taxes from mutual fund or individual stocks or bonds, could be significant.

But "could" is a tough word to negotiate. Aside from saving enough to get an employer matching contribution, which you should always do, should you dismiss these pretax retirement plans, if you believe you'll be in a lower income tax bracket at retirement? Not necessarily. It's impossible to truly know what tax rates will be in the years ahead. Before very long, in fact, we may all be paying higher income taxes because of the growing national deficit.

What is certain, however, is that you can choose to make pretax contributions to your available supplemental 403(b), 401(k), or 457(b) retirement plan today, and, if you're eligible, to a tax-deductible IRA. It's also undeniable that you can make larger contributions to these plans (and therefore save more money today) because you don't pay income taxes on what you're saving now.

Consider the Roth Alternative

But if you feel strongly that saving money on an after-tax basis is the better way to go, consider the new Roth supplemental 403(b) and 401(k) plans, if available to you. With these plans, your savings can potentially grow for years. Then, as long as you don't withdraw your savings before meeting the specified time requirements, your money will be available to you completely tax-free at retirement.

You can also make after-tax contributions to a Roth IRA, generally, if you're adjusted gross income is less than \$95,000 (for single filers) and \$150,000 (for married filers). In addition, you may convert some or all of your taxable IRA assets to a Roth IRA if you meet two requirements:

- Your modified adjusted gross income does not exceed \$100,000, and
- If you're married, you're not filing a separate tax return.

Make sure, however, that you have enough money outside your IRA to pay the income taxes that will be due upon conversion. A Roth IRA conversion can also be part of an overall retirement asset consolidation plan.

Consider Saving Outside Your Retirement Plan

It may sound like a contradiction, but you don't have to use only retirement plan products to save for retirement. After you've maximized contributions to retirement plans and IRAs, consider mutual funds and after-tax annuities. To figure out which product is better for you, or if you need both, ask yourself what financial goal you want to fulfill. For example, when you retire, do you plan to use these additional retirement savings for estate planning purposes, to purchase a second home, to buy a boat, to keep a reserve for a personal emergency or to create a stream of additional income?

The Case for Mutual Funds

If your goal is to pass on money to a beneficiary, mutual funds are without a doubt the best choice, with or without tax law changes. That's because a mutual fund outside of a retirement plan can take advantage of the "stepped-up basis" rule, which says that if you die while owning a fund that's gone up in value, that increase (unrealized capital gain) is not subject to income taxes. Your beneficiary will pay the capital gains tax only on the increase from the time he or she inherits the fund. However, don't confuse the estate tax and income tax requirements: The inherited money may still be subject to estate taxes, regardless of the "stepped-up basis" rule.

If your goal is to save money for an emergency or for another retirement need, there are three reasons why you might still want to invest in mutual funds:

First, with mutual funds, there is no 10% penalty tax for withdrawing your money before age 59½, while there generally is a penalty if you receive retirement income before 59½ other than in the form of an annuity, or in substantially equal payments over your life expectancy. (An annuity provides an income stream over your life, however long it is.) But if you do annuitize your savings, or if you take pre-59½ distributions at least annually in "substantially equal payments" over your life expectancy, or over the joint life expectancy of you and your designated beneficiary, the 10% penalty will not apply. Just make sure you clearly understand how this penalty tax may or may not apply to you if you're thinking about retiring early, or semi-retiring before age 59½.

Second, your breakeven point — the time needed for a tax-deferred annuity to surpass a mutual fund as an investment — is roughly 15 to 20 years. You will also have to pay ordinary income taxes on any annuity earnings you withdraw in retirement, whereas mutual fund dividends and capital gains will be taxed at a lower rate — at least according to current tax laws.

It therefore seems that if you'll need the money in less than 15 or 20 years, you might be better off with mutual funds. However, to be fair, you should understand that this is a general time estimate, since many factors, including costs and expenses, as well as investment returns, are seldom the same for both products during their accumulation periods. There's also an implicit assumption for both products that today's tax laws will be similar during retirement, which is nearly impossible to ensure.

When Annuities Make Sense

Generally, if your goal is to create additional retirement income for life, annuities may make the most sense, even if the capital gains tax rate doesn't change. Unlike a mutual fund, an annuity has its investments wrapped in an insurance contract. As a result, you can convert your accumulations into an annuity income payment contract for as long as you live.

The idea behind an annuity is actually simple: It allows many participating annuity owners to pool their income-generating assets with an insurance company. Annuitants receive lifelong payments from this pool, while the insurance company makes sure the payments can be supported.

The annuity assets of those annuitants who die before their life expectancies are used to support the income payments of those annuitants who live longer. *(Please note that all annuities are not the same. Some have charges such as surrender fees, and almost all have early withdrawal penalties and mortality risk expenses. And, depending on the financial company you choose, product features and availability may vary by state. So always read the prospectus carefully before investing.)*

An annuity can also provide lifetime income for a couple, not just one person. If desired, annuitants can select guaranteed payments for a minimum period (such as 10, 15 or 20 years), subject to the person's life expectancy. This feature protects the annuitant's financial interests in the event of an early death.

For example, if you die before starting to receive your annuity income, your beneficiary may receive a guaranteed minimum death benefit equal to the contract value or to the original investment, less any adjusted withdrawals. A conservative, risk-averse person may prefer annuities because of these guarantees.

There are, of course, variable and fixed annuities. A variable annuity is a security (just like a mutual fund) whose investment performance is driven by the performance of its underlying securities. A "fixed" or traditional annuity offers an account that guarantees your contributions and a minimum interest rate. These guarantees are backed by the claims-paying ability of the insurance company offering the annuity.

If you contribute to a variable annuity, you can transfer your money among its allocation options without paying taxes on the transaction. This is unlike mutual funds, where any transfers are potentially taxable.

Thus, if you expect your needs and risk tolerance to change over time, the ability to rebalance your portfolio without paying any transfer-related taxes may make a variable after-tax annuity a worthy savings product to consider.

Who's Behind the Annuity Payments?

The income payments for a guaranteed account within an annuity are backed by the claims-paying ability of the insurance company that issues the annuity. Income payments from stock and bond accounts within an annuity are based on the variable performance of the underlying portfolios.

Put Everything into Perspective

In the end, don't focus just on whether one product has a better tax advantage than another for now. Rather, try to understand your retirement and investment goals and then decide which products' benefits — tax advantages being one of them — will help you get to where you want to go.

To learn more about which products make the most sense for your retirement, contact us at **800 842-2776**, or visit **www.tiaa-cref.org**.

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