401(k) TODAY

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New Roth Plan is a real opportunity

Finally, a "Loophole for the Little Guy"

by Stephen J. Butler

"Only the little people pay taxes," said Leona Helmsley on her way to jail for tax evasion years ago.

Reading about Bernie Ebbers and the $400 million that he had borrowed tax-free from his company reminded me of how the so-called "power elite" conspire among themselves to abuse the financial security of American stockholders and taxpayers. In Ebbers' case, he never paid taxes on the money and it was spent with no hope of ever paying the money back. In theory, he owes the rest of us citizens $200 million in taxes on this money, but heaven help our efforts to collect.

Dennis Kozlowski, the convicted former CEO of Tyco, conveniently "forgot" to include $25 million in forgiven company loans on his tax return. He was just too busy. And a departing senior executive at Morgan Stanley was awarded more than $20 million after just three months on the job. What sane director representing us stockholders would have ever agreed to that? At what point does egregious executive compensation become a form of theft?

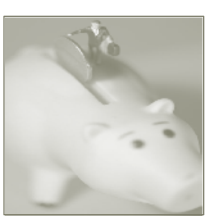
From where I sit, it looks like the United States is splitting into two camps. There's the interlocking handful of senior management executives and directors of, say, the largest 3,000 U.S. public companies -- and then everyone else. However, those in the "everyone else" group (and you know who you are) have been thrown a bone in the form of the new Roth 401(k). You too can generate tax-free income without the risk of a felony indictment.

Beginning in 2006, a 401(k) plan will be able to offer a Roth feature with the same basic attributes as the current Roth IRA. But in the new 401(k) version, anyone, regardless of annual income, will be able to contribute, and the maximum contribution amounts per year will be much greater: $15,000 plus another $5,000 "catch-up" for anyone over 49 years of age.

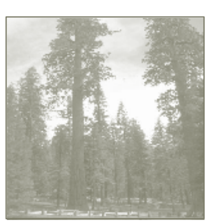
Within these maximums, a typical 401(k) plan will give participants the option of having their contribution be pre-tax as usual or after-tax (the Roth treatment). This year's Roth IRA maximums, by comparison, are only $4,000 plus another $500 for those over age 49. High-income taxpayers can't contribute to today's Roth IRA at all, but the Roth 401(k) will have no such limitation.

The advantage of a Roth contribution is that all the money taken out at retirement is totally tax-free. The annual contributions are made with after-tax dollars, and this may be a hurdle for

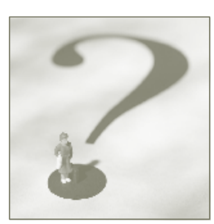
(continued on page 5)



Death is certain; taxes maybe not. My college roommate held the Ivy League high-jump record of 7 feet, 1 inch for a few months in 1966. His training regimen had included leaping over... **PAGE 2**



Playing the bounce. I have saved a Garrison Keillor piece from the June 21, 1982, New Yorker magazine that explored the problems he faces as a very tall person. **PAGE 3**



Is an HSA right for you? Think of an HSA as a 401(k) for your medical expenses. It can be a tremendous benefit as long as you can afford to fund it and let the magic of compound interest make it grow. **PAGE 4**

Death is certain taxes, maybe not

by Stephen J. Butler

My college roommate held the Ivy League high-jump record of 7 feet, 1 inch for a few months in 1966. His training regimen had included leaping over the hoods of cars until the day he hit someone's radio antenna. While recovering, he wrote a screenplay that included a scene where a character had made a home movie of their own reading of their will. The idea was that, as a surprise, the lawyer would screen the film for heirs after the character's death.

The so-called "hand out of the grave" is a concept that intrigues me, because it is increasingly germane in today's world of retirement accounts. Many complicating factors control how money gets taxed when the single owner of a retirement plan dies. The single owner, of course, could be a remaining spouse or someone who is not married. Even some married people, especially those in blended families, have specific reasons for why they would want their retirement funds to go directly to children rather than as a tax-free rollover to their surviving spouse.

"Confiscatory" is a term that best describes the tax treatment of retirement plan assets on death. It hardly seems fair until we appreciate the fact that Congress, in its wisdom, never intended these plans to be a means of passing wealth on to heirs. The tremendous tax benefits offered by these plans were only designed to help people provide for their own retirement.

In the face of congressional intent, there are some ways to work around the system and accomplish more for heirs than just delivering up a lump sum of money that would be taxed at 50 percent. For married couples, it's simple. Any money from the IRA (or other retirement plans) owned by the first to die can go directly to the spouse with no taxes due. The surviving spouse then controls the money in what becomes their IRA.

For someone lucky enough to inherit an IRA or retirement account from someone other than their spouse, they have the luxury of being able to spread the tax bite out over the rest of their lives. Required installment payments will often be less than the annual returns in the account.

To accomplish this, however, the money needs to be deposited directly into a specific account solely established for the inherited funds. It cannot be dumped into an existing IRA.

The money must also be delivered as a so-called "trustee to trustee" transfer to avoid immediate taxation on the lump sum. This means that the current IRA or retirement account must send the check directly to the new institutional trustee of the new inherited IRA account. A check cannot be written to the named beneficiary and then deposited in the account.

In some cases, a Roth IRA might be advisable, but this decision must be made by the decedent before they die. It cannot be made after the fact by the beneficiaries. In the case of someone inheriting a Roth IRA, the gains over the years would be tax-free years later when they qualify to be withdrawn. A child inheriting a relatively small amount of money in a Roth IRA could be set up for life by the time retirement rolled around, exactly what Congress was trying to avoid.

Naming an estate or a trust as a beneficiary can create problems because only the named beneficiaries in the documents of the retirement plan determine where the money goes. The beneficiaries of a trust or an estate do not have the ability to treat the money as an inherited IRA, and they get hit with taxes on the lump sum.

Having made this statement about estates and trusts in general, a trust with special attention to detail (and some expense to set up) may offer what is called a "see-through" provision that would allow the beneficiaries to be treated as named people for the purpose of establishing an inherited IRA account.

Beyond just the income tax issues, there are possible estate-tax issues. The current vanishing estate tax has a sunset provision that brings it all back after 2010. This is why the law is referred to as the "throw Momma from the train" act. One can just imagine what the owners (or beneficiaries) of substantial estates will be agonizing over as they approach Dec. 31st of 2010.

People also need to know that they can begin receiving distributions from an IRA without penalty before the normal age of 591/2. Electing this option re quires a commitment to take "substantially equal" payments for at least five years or until age 591/2 (whichever is

(continued on page 6)

Playing the bounce

by Stephen J. Butler

I have saved a Garrison Keillor piece from the June 21, 1982, New Yorker magazine that explored the problems he faces as a very tall person. It is especially problematic when a tall person falls, because they have a long way to go before they hit the ground.

He points out "when tall fellows stumble, they go down like cut timber. We're not like Walter Payton of the Chicago Bears, who bounces right up from the turf when he's tackled. We're more like the tall trees in the National Basketball Association. When they fall, there's ligament damage or torn cartilage ... and (then) a stretcher crew runs out onto the floor to stack the debris."

I thought about this when I compared the performance of small-company, value-oriented stocks to large-company, value-oriented equivalents. These small-company mutual funds are the Walter Paytons of the industry. Their performance lacks the slow-moving dignity of the larger companies, but their ability to bounce back quickly after a downdraft in the economy makes them candidates for a greater percentage of an aggressive investment portfolio.

I had always assumed that the superior performance of small companies was transitory. They generally outpaced other investment styles during an economic rebound because their flexibility had allowed them to do the course correcting that "saved their bacon" during the downturn. Later in an economic recovery, small cap performance would be eclipsed by the solid numbers that larger companies put up. Over the past five years, the first of the recovery, the average small cap value fund has generated annual returns of about 20 percent per year.

What I failed to realize was the extent to which small cap value funds, over long periods of time, dramatically outpaced the market averages. Going back about 15 years, the small cap funds that have been in business that long have generated average annual returns in the range of 14 percent to 15 percent. By comparison, large cap value funds have generated averages in the 12 percent range.

Looking at the 25-year period from 1979 until 2004, the S&P 500 averaged a total annual return of 14.9 percent. The same investment in small cap value funds during that extended period would have generated a 21 percent average annual return. On a compounded basis, this additional 6 percentage points of return amounts to a huge reward (or so-called "risk premium") for taking additional risk.

Small-company value-oriented mutual funds are looking for companies that are still below the radar of the major analysts who only have time to follow larger companies. At some point, exceptional performance or a greatly increased amount of gross sales will attract the attention of the investing public, and these formerly "unloved" stocks can watch their stock prices take off. Central Garden and Pet, headquartered in Lafayette, was a beneficiary of this phenomenon a few years ago when it rose from obscurity to become the best-performing public company in the Bay Area for that year.

Before we get all excited about this investment style, we need to discuss the dark side of small cap funds. The volatility of these funds can be substantially greater than the performance characteristics of large companies. While the standard deviation of the stock market as a whole can be within a range of 17 percent upward or downward about 70 percent of the time, a comparable range of performance for small-company funds can be up or down by substantially more. To personally experience the dramatic gains these funds can promise, an investor needs to have patience and fortitude.

One possible application of these volatile but rewarding investments is to add them to a portfolio that is already hedged with some bond funds. The "sweet spot" of bonds added to a portfolio to reduce volatility seems to be 30 percent. This 30/70 percent mix of bonds to stocks reduces average returns by 1 percent in return for reducing volatility by about one-third. If a portion of the stocks included some small cap value funds that were going to be held to perpetuity, this long-term hold making up about 20 percent of the stock portion could offset the 1 percent lower annual return caused by the bonds. And let's face it, those small cap investments are more fun to own than some stodgy large cap index fund.

Any young person with 30 years until retirement would do well to load up on

(continued on page 6)

FlexNews

Is an HSA right for you? by Michelle L. King

Think of an HSA as a 401(k) for your medical expenses. It can be a tremendous benefit as long as you can afford to fund it and let the magic of compound interest make it grow.

If you have very low health related expenses right now, you can reduce what you pay in monthly premiums by enrolling in a Qualified High Deductible Health Plan (if your employer does not have this option you can find an individual plan). Then you can put the money you save in premiums into an HSA account.

If your employer offers a Cafeteria Plan you may even make contributions via pre-tax payroll deductions (note the contributions are free of federal tax but currently the state of California still wants their piece of your pie).

If you are unfortunate and find yourself with an unexpected health related expense, you can use the money in your HSA to pay for it. But, as long as you remain healthy and have very low health related costs, you can build your HSA balance and invest it in a mutual fund to compound its growth. This money will be available to you later in life when you find yourself with some significant medical expenses. It can even be used to pay for retiree medical coverage and/or Medicare premiums.

The "magic" of these plans is really the growth and investment opportunity, more so than the reduced premiums on the Qualified High Deductible Health Plan.

If you are regularly going to the doctor or buying prescriptions for chronic conditions (i.e. asthma, allergies, hypertension, etc) then these plans aren't going to do much for you. You will end up drawing out as much you put in leaving little to invest and/or grow.

Another aspect to consider: if you plan on contributing to an HSA you can not be covered by a standard medical flexible spending account. Most flexible spending accounts are set up to cover the employee and their family members. That means your spouse's medical flexible spending account could disqualify you from being able to contribute to an HSA. Keep in mind that enrolling in a Qualified High Deductible Health Plan is not an eligible reason to change an existing medical flexible spending account election. So you'll have to think this through prior to open enrollment for both benefits, for both spouses.

The good news is that once you have an HSA, it isn't going anywhere. Once you establish an account with a balance, that account is YOURS. It stays with you regardless of where you work or what kind of health coverage you have. You can have a Qualified High Deductible Health Plan one year (and contribute), switch to an HMO the next year (and not contribute), then switch back to the Qualified High Deductible Health Plan the year after that. The money in the HSA account is always available to you and it is tax free if you use it for medical services. If you choose to you can even use it for non-medical services, but then it is taxable to you.

Bottom line, it is your account and you have total control over how and when the money is used.

If you are interested in more information on these accounts there is a lot of information on the internet (try www.hsabank.com) or you can contact Michelle L. King at (925) 956-0505 ext. 112 or Mking@pensiondynamics.com.■

Helpful web sites by Michelle L. King

www.Crbestbuydrugs.org Consumer Reports' free drug-rating service. Compares product prices and effectiveness so you can talk to your doctor about the best medication for your condition and your wallet.

www.Familydoctor.org Research your symptoms, find natural remedies, look up illnesses/conditions and their treatments, find ideas on weight loss and how to keep kids healthy, and much, much more.

www.Drugstore.com has an "FSA Store" that lists various over-the-counter items that are considered reimbursable through your Medical Reimbursement Account. When you use a debit/credit card (tied to your flex plan) to purchase these items through your Medical Reimbursement Account, the reimbursement may be approved automatically via electronic interface, reducing the need for you to submit additional paperwork.

FSA Elections Start planning for 2006!

More then **80%** of employees do not take the time to estimate their health care costs each year.

79% think they can't do anything to control those costs. (try ideas found at www.familydoctor.org)

57% have never researched provider cost or quality (second opinion anyone?)

24% never ask about prescription drug options (see www.crbestbuydrugs.org)

Pay your medical expenses while reducing your tax liability.

by Michelle L. King

If you had access to a Flexible Benefit Plan this year, and as little as **$1000.00** in health related and/or daycare expenses, but chose NOT to participate, you are **paying an extra $300-$400 in taxes** that you could have avoided!

When you take advantage of a Flexible Benefit Plan (also called a Cafeteria or Section 125 Plan), you're saving the **Combined Effective Rate** on each dollar you run through the plan (see table below). This means that a married couple, with a combined income over $60,000 could save $.33 on every dollar they spend on Medical and/or daycare expenses. A combined income over 175,000 would create a savings opportunity of $.41 on every dollar.

Add up your medical expenses. I'm not just talking about your portion of insurance premiums. What about the $10 & $20 copayments you make each time you see the doctor or fill a prescription? How much did you pay your dentist this year for cleanings, x-rays, and maybe a filling or crown? Does anyone in your household wear prescription glasses or contacts? With a little planning, you can set aside pre-tax dollars (through a Flex Plan) to pay for all of these expenses, plus daycare for your children while you are at work, and **pay fewer taxes !!**

Maybe you think that it is just as easy to itemize your medical expenses on your tax return at the end of the year and get your tax break that way…**Think Again**! Although the I.R.S. allows you to itemize your out of pocket health related expenses, you will only receive a tax credit for any amount *in excess* of 7.5% of your adjusted gross income. A married couple with an AGI (adjusted gross income) of $90,000 would only receive a credit for medical expenses *that exceed* $6750.00. A Section 125, or Flexible Benefit Plan, allows you to save taxes on **all** of your qualifying health related expenses up to the plan maximum for the year.

Using our example of a married couple with an AGI of $90,000, and estimated medical expenses of $5000 for the year, they would receive **no** medical tax credit on their tax return at all (their expenses do not exceed 7.5% of their AGI). However, that same married couple would have over **$1600** in **tax savings** if they used a **Flexible Spending Account** for those same expenses.

Take the time to review your medical expenses for the past year. I think you'll find it worth the effort to enroll in your company's Flexible Benefit Plan for 2006! ■

2005 Income Tax Brackets
Marginal Rates of Federal Income and Fica Taxes

Single or Married Filing Separate		Married Filing Joint		Head of Household	
Adj. Gross Income	CA + FED	Comb. Adj. Gross Income	CA + FED	Adj. Gross Income	CA + FED
$21,827 - $28,400	21%	$21,827 - $28,400	21%	$21,827 - $28,400	21%
$28,401 - $30,298	31%	$28,401 - $30,298	31%	$28,401 - $30,298	31%
$30,299 - $68,800	33%	$30,299 - $68,800	33%	$30,299 - $68,800	33%
$68,801 - $143,500	36%	$68,801 - $143,500	36%	$68,801 - $143,500	36%
$143,501 - $311,950	41%	$143,501 - $311,950	41%	$143,501 - $311,950	41%
$311,951 and above	43%	$311,951 and above	43%	$311,951 and above	43%

Concerned about the increasing cost of health care?

HMO plan average rate hike for 2006 = 12.4%

This can mean annual premiums for Single coverage over $3,500 and for Family coverage over $10,000.

Nationwide Employers spend an average of $3,137 annually for single coverage for their employees, and $7,280 toward family coverage.

That means employees are paying an average of 10% of their single coverage, and an average of only 25% of their family coverage.

New Roth Plan… *(from page 1)*

some, but the prospect of tax-free distributions for you or your heirs at what might be a generation away is too good to be true. I have to pinch myself to believe it, and here is why.

Someone contributing $3,000 a year to a Roth and earning an average of 12 percent per year in small cap stocks will have $909,000 in 30 years. At an 8 percent return, they would accumulate $372,000. In either case, their total after-tax contribution would only have been $90,000, and all the excess would have been spendable tax-free cash.

Most people get excited about the deductibility of what they contribute to retirement plans, but these numbers illustrate how valuable the tax-free buildup and eventual tax-free distributions can be. In another example, $10,000 per year for 20 years at only 8 percent accumulates to more than $500,000. The contributions total $200,000 and the tax-free spendable earnings add up to $300,000.

Roth 401(k) accounts open several new windows of opportunity to save taxes

(continued on page 6)

Death is certain... *(from page 2)*

the longer period). From an estate-planning standpoint, this might be an option to trigger distributions earlier rather than later if the idea is to use the money as part of a gifting program or to pay for a grandchild's education.

With money growing in retirement plans at more than 13 percent per year, getting the money out will be more important to some than building it up in the first place. The industry's bible on the subject is Twila Slesnick's "IRA's, 401(k)'s and Other Retirement Plans -- Taking Your Money Out." A copy should be on everyone's nightstand. ■

New Roth Plan... *(from page 1)*

and pass more money on to heirs. Many people today may not have the income to support what the law allows as maximum annual contributions to 401(k) plans, but someone with after-tax savings or some inherited money could consider spending that money on living expenses while they contribute equal amounts into the Roth. This effectively turns taxable compounding of investment earnings on after-tax money into earnings that will never be taxed. Moreover, money in a retirement plan can be invested more effectively when investment changes and reallocations can be conducted without triggering any taxes on profitable trades.

If 401(k) money is converted to Roth money before someone dies, that money then inherited by children (or grandchildren) will enjoy the Roth characteristics that would allow it to grow tax-free in what would become Roth IRA accounts.

The introduction of the Roth 401(k) will change the landscape for investors thanks to the enormous opportunity they present. Looking back, we recall that IRA accounts were available for several years with relatively little interest on the part of investors. Then, 401(k) plans succeeded where IRAs failed, because key management of companies had an incentive to promote 401(k) plans effectively in order to participate themselves. Matching contributions, automatic payroll deductions and loan possibilities were all part of the legislative brew that gave 401(k)s their "kick."

I see the same thing happening today with the Roth 401(k). Here is a legal opportunity to generate money and never pay taxes on it. In the Monopoly game of life, we "little people" get to pass "GO", collect $200 and NOT go to jail. ■

Playing... *(from page 3)*

small cap mutual funds and then just be patient. In the football movie “Jerry Maguire,” there’s the scene where Cuba Gooding Jr.’s character has taken a huge hit and appears to be knocked out. After enjoying the moment, however, he springs to life and starts climbing into the stands while the crowd goes wild.

When they’re down, think of your small cap value funds in a similar light. Keep the money rolling in. Wait for them to bounce off the turf and into the next play for a touchdown. ■

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