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Winter 2006/2007

LYNCH FINANCIAL ADVISORS

Michael S. Lynch
Lynch Financial Advisors
916.772.3103 • 916.772.3104 fax
info@lynchfinancialadvisors.com
www.lynchfinancialadvisors.com
Fee-Only Financial Advice

THE NEW ROTH 401(k) - IS IT A 401(k) OR A ROTH IRA?

by J. Marc Vorchheimer, CFP®

Many folks have heard of what are referred to as qualified retirement plans. These include 401(k), 403(b), or 457 plans. In fact, many of us even participate in one of these plans through our employer. They are wonderful ways to save for retirement because the money goes right into the retirement account directly from your paycheck so you don't have to worry about putting the money away at the end of the month. In addition, these plans offer the benefit of tax deferral. This benefit is really two-fold. First, it means the amount you contribute directly from your paycheck is not taxed as income like the balance of your paycheck that you actually do receive. Second, the money you put into these qualified retirement plans grows tax deferred as well, which means you are not paying tax on the annual increase in your account value.

Since January 1st of this year, changes in the tax law have allowed new types of qualified retirement plans called the Roth 401(k) and Roth 403(b). The two new plans have many similarities so for simplicity this article will focus only on the Roth 401(k). Like a traditional 401(k), the new Roth 401(k) allows employees to contribute up to the same amounts annually. The major differences between the 401(k) and the new Roth 401(k) is how your contribution is taxed while you are employed and how any distributions you receive in retirement are taxed. The 401(k) allows you to avoid paying income tax on your contribution to the plan; the new Roth 401(k) does not allow you this tax deduction. Once you reach retirement and begin distributions from your 401(k) you need to count every dollar you withdraw as taxable income; the new Roth 401(k) is different since distributions taken in retirement are not taxed as income. A recent provision has made this tax-free distribution a permanent feature of the new Roth 401(k).

In fact the new Roth 401(k) behaves a lot like a Roth IRA which has been around for over a decade and which individuals can start on their own if their employer does not offer a 401(k) or Roth 401(k). You may be asking yourself, if the new Roth 401(k) is so similar to a Roth IRA, why is it such big news for 2006? The answer lies in understanding some of the limitations of the Roth IRA. One is not eligible to contribute to a Roth IRA if he or she has an adjusted gross income (AGI) of $110,000 or more for singles (or $160,000 or more for married couples filing jointly). This restriction excludes many individuals from participating in a Roth IRA. The new Roth 401(k) does not have this income restriction and therefore will be available to many more people than the Roth IRA is. Another limitation of the Roth IRA is the lower contribution limits – only $4,000 for those under age 50 or $5,000 for people 50 or older. The new Roth 401(k) has much higher contribution limits - for 2006, the maximum contribution is $15,000 for those under

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INSIDE THIS ISSUE

HOLIDAY READING SUGGESTIONS FROM CAMBRIDGE ADVISORS

by Robert Roy Reed, Ph.D., CFP®

The holiday season is hard upon us. This is always a good reason (as if you really needed one) for wandering through a bookstore to see what looks good. Below is a list of books Cambridge Advisors are recommending. (All books are available through Amazon.com or as otherwise noted.)

"Our" Financial Books

Of course we have strong opinions about these. Let's start with four books written by Cambridge Advisors.

- Bert Whitehead, founder of the Alliance of Cambridge Advisors, has published *Facing Financial Dysfunction: Why Smart People Do Stupid Things with Money!* In this book you probably will find many of the ideas and approaches your own advisor uses. It is also a nice gift to introduce friends to how the Cambridge System™ works.
- If you want something concise, the perfect size for a stocking stuffer, check out Ken Robinson's *Financial Tips for a Better Life: Simple and Effective Steps to a Better Financial Future*. This is an especially useful book for kids going out on their own for the first time. It is available by calling 1-877-536-8020 or at www.KennethRobinson.com.
- Jill Gianola in Columbus, Ohio has written a valuable book for people beginning a life together, *The Young Couple's Guide to Growing Rich Together*. Jill offers realistic and workable advice for people confronting the realities of living together. Especially useful for young people are her discussions on student loan debt, buying your first home, and the finances involved with having children.
- And speaking of children, there is *The Ultimate Parenting Map to Money Smart Kids* by Linda Leitz. This book is especially useful because it gives tips on how to get kids **thinking** about money and the family dynamics involved with raising financially literate children. (Personal disclaimer: I learned a lot about myself from this book.)

Non-Fiction Books

This selection has a wide range of recommendations, from books that will improve your life to books that will fill in odd corners of your knowledge.

Ken Robinson from Cleveland, Ohio recommends

- *Getting Things Done: The Art of Stress-Free Productivity* by David Allen. Many Cambridge Advisors recommend this book and use it themselves. I know it has helped me tremendously.
- *Traveling Mercies: Some Thoughts on Faith* by Anne Lamont. Ken notes that this book has "mature themes," but then any honest book about living your faith will speak in a forthright manner about topics that many people avoid.
- *It Takes a Village Idiot: Complicating the Simple Life* by Jim Mullen and *I'm a Stranger Here Myself: Notes on Returning to America After 20 Years Away* by Bill Bryson. Both of these are fish-out-of-water memoirs. Mullen leaves Greenwich Village (grudgingly) for the country life, while Bryson returns to his country after living abroad for twenty years.
- *Eats, Shoots & Leaves* by Lynne Truss. You will just have to trust Ken (and myself) on this. This book on punctuation is really, really funny. Really. Trust us. It really is. Funny. We are not kidding.

Bert Whitehead recommends *The Laws of Lifetime Growth: Always Make Your Future Bigger Than Your Past* by Dan Sullivan and Catherine Nomura. Bert says, "I learned a number of these 10 laws from my dad: 'Always make your contribution greater than your reward,' and 'Always make your purpose greater than your money.' Dan's pithy explanations of each of the laws are very motivating. While each of the laws is on its face counter-intuitive to what is considered the norm in our capitalistic society, I believe they reveal the true spiritual basis of our heritage. The truly successful people whom I know and respect seem to know these laws and incorporate them into their everyday behavior, attitudes, and dealings with others."

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THE NEW ROTH 401(K) (continued from page 1)

age 50 or $20,000 if you are 50 or older. The new Roth 401(k) should increase the amount of wealth people can stash away in their retirement accounts if they were only contributing lower amounts to their Roth IRA.

One caveat about the new Roth 401(k) - not all employers are offering them yet. However, that is not entirely bad news either as there is much debate about the pros and cons of the new Roth 401(k) versus the traditional 401(k). Whether or not a Roth 401(k) is your best option depends on various factors in your financial life, such as your tax situation, income level, your projected tax rate in retirement, and the assumption of whether income tax rates will rise or fall over time. Once again, it sounds like a good time to run this issue by your trusted financial and tax advisor.

HOLIDAY READING SUGGESTIONS
(continued from page 2)

Rebecca Preston in Providence, Rhode Island suggests

- *The Tender Bar: A Memoir* by J.R. Moehringer. He "grew up fatherless in Manhasset, Long Island (famous for its alcohol consumption and the only town after which a cocktail is named) and found male companionship and guidance at the local bar. It is funny and poignant and startlingly honest."
- *Paris 1919: Six Months That Changed the World* by Margaret Macmillan and Richard Holbrooke. "If you like political history, this book tells about how and why the Western powers following World War I carved up the planet into the nations that we still struggle with today."
- *What Went Wrong?: The Clash Between Islam and Modernity in the Middle East* and *The Crisis of Islam: Holy War and Unholy Terror*, both by Bernard Lewis. These are good books "to get some background on the current conflict between Islamic terrorists and the West."

And finally I am recommending *Your Little Legal Companion: Helpful Advice for Life's Big Events* by the Editors of Nolo Press (America's leading do-it-yourself legal publisher). This practical, down-to-earth book contains this-is-the-way-things-**really**-work information. It covers not only your legal rights and obligations, but also gives good advice for renting an apartment, coaching your daughter's soccer team, getting arrested, holding a garage sale, and dozens of other situations. You may never want to change your name, but it is interesting to learn what is involved.

Fiction Books

The time does come when you want to just snuggle up with a blanket, cup of tea, and a good story (the minimal components to my definition of heaven).

Ken Robinson recommends

- *A Mango-Shaped Space* by Wendy Mass. Ken writes, "Though written for children in grades 5 – 8, this is an interesting story about a 13-year-old girl with synesthesia." (Synesthesia is the **stimulation of one sense alongside another:** the evocation of one kind of sense impression when another sense is stimulated - for example, the sensation of color when a sound is heard.)
- *The Complete Sherlock Holmes* by Arthur Conan Doyle. Ken likes it, and I have read the complete "canon" three times straight through plus Baring-Gould's annotated version. If you have never read the original, you are in for a treat.

Rebecca Preston suggests *The Kite Runner* by Khaled Hosseini, a story about two boys growing up in Afghanistan. This book has won many awards and deservedly so. It is not a happy story, but it is a very human one.

And finally there is me, your humble compiler.
I recommend

- *The Shadow of the Wind* by Carlos Ruiz Zafon (Lucia Graves, translation). This book made a huge splash in Europe (the author is Spanish) but is relatively unknown here. How can you not love a book that begins, "I still remember the day my father took me to the Cemetery of Forgotten Books for the first time."
- *Ophelia* by Lisa Klein. Ophelia in Shakespeare's *Hamlet* is a bit of a twit. Nothing in Klein's book contradicts what goes on in the play. Instead we get to see what happens before and during the play from Ophelia's point of view. The plot devices are familiar to any reader of Shakespeare, but the girl/woman Ophelia is much deeper and psychologically nuanced than she appears in Shakespeare's play. (Full disclosure: Lisa Klein is my wife—but it is still a good read.)

HEALTH SAVINGS ACCOUNTS

by Robert Roy Reed, Ph.D., CFP®

This is the time of year when many of us must revisit our health insurance options to re-enroll. Many of us will confront a new option, the Health Savings Account (HSA). HSAs were authorized by the Medicare Act of 2003 but are only now coming on the market. Employers are beginning to offer them, and they are also becoming available for the self-employed and self-insured.

HSAs have many familiar elements but also contain distinctive features you must understand if you are going to make an informed choice. Even if an HSA does not fit your needs now, it might in the future so you should know the basics.

A Heath Savings Account has two parts: high-deductible health insurance and a savings account that is used only for health costs. The health insurance requirement sounds scary at first, but the savings account more than makes up for it.

High-deductible health insurance is exactly what it sounds like, health care where you pay more of your initial health care costs. With an HSA, for 2007 the **maximum** you can pay for health care (that is, your deductible) is $5,500 for individual coverage or $11,000 for a family.

Sounds scary, doesn't it? But those high deductibles are also the maximum that can be contributed (by you, your employer, or both) to your Health Savings Account. The **minimum** contribution to your HSA (again, by you, your employer, or both) is $1,100 for an individual or $2,200 for a family. The higher health care costs that you pay before you hit your deductible can be paid from your HSA savings account.

So why choose to pay a higher deductible for health care? Your health insurance premiums are much lower when the insurance company does not have to worry about every minor illness, ache, or pain. Insurance works best—financially speaking—when it is used only for catastrophic events: your house burning down, not a broken window; a heart bypass, not an ear infection. Broken windows and ear infections are important and should be treated immediately, but they are not catastrophic. With high-deductible health insurance you pay the minor costs, and your insurance company pays the big bills.

The savings account part of an HSA makes paying for minor costs easier and cheaper. A Health Savings Account is used **only** for health care expenses (but can include annual check-ups, over-the-counter medicines, and other costs typically not covered by health insurance). An HSA's advantage is that money (contributed by you, your employer, or both) goes in pre-tax, and it is paid out the same way. In effect your health care costs are paid tax-free.

Now many people will say, "That sounds just like my Flexible Spending Account at work!" These accounts go by different names (Flex-Benefits, cafeteria plans, Medical Savings Account, for example), but they are all the same in that you choose how much pre-tax money you put in your health care account and then you pay health care expenses out of that account.

The difference is that in a Flexible Spending Account any money left at the end of the year disappears. With a Health Savings Account, money left at the end of the year rolls over into the next year.

Let's say you had a $3,000-deductible HSA plan. In 2006 you and your employer contributed $3,000 but you spent only $1,000 on health care. Your 2007 HSA starts with $2,000 already in it (the unspent money from 2006). If you and your employer contribute $3,000 again, the plan now has $5,000, but your health insurance pays anything over $3,000 (remember, you still have a $3,000-deductible health plan). A few years of not spending all that $3,000 on health care and you can amass a sizable amount of money.

Well, if you don't need to spend the extra money on health care, what happens to it? You can keep it in the HSA for future medical costs, you can use it to purchase long-term care insurance, some Medigap coverage, or even COBRA benefits if you want to keep your old company's plan while you look for a new job. Or you can invest it just as you would any retirement account because when you leave the company or retire the money can be rolled over directly into an IRA. The important point is that you never lose your unspent health care money.

Health Savings Accounts offer many advantages, especially for younger workers, healthy individuals, and people who need to save more for retirement but have maxed out their current plans. These plans deserve to be considered. But because they are new there is a lot of variation in the policies. You should consult your Cambridge Advisor to see if an HSA plan is a good fit for you.