THE COMPASS CHRONICLE

Highlighting important wealth management issues *Fall 2007*

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A client-focused wealth management firm dedicated to providing objective advice to individuals, families, and retirement plans.

Our wealth management services include:

- Investment Management and Consulting
- Retirement Planning
- Education Funding
- Gift Planning

In This Issue . . .

The Roth 401(k):[1] Is It Right For You?

Since the beginning of last year, employers that offer 401(k) plans have had the option to also offer a Roth 401(k). What are the differences between the traditional 401(k) and the Roth 401(k) and is the new option, if it is available to you, appropriate given your circumstances?

TRADITIONAL 401(k) VERSUS ROTH 401(k)

The difference between the traditional 401(k) and the Roth 401(k) is that contributions to the Roth version are made with after-tax dollars, whereas contributions to the traditional 401(k) are pre-tax and thus lower your taxable income today. However, in retirement, withdrawals from a Roth 401(k) are exempt from income taxes,[2] while withdrawals from a traditional 401(k) are taxable at your then marginal income tax rate.

TAXES: NOW OR LATER?

The key decision variable regarding whether to contribute to a traditional 401(k) versus the new Roth 401(k) is your income tax rate, both now and during retirement. While you can determine your current income tax rate, your future income tax rate is unknown. Most people assume that their income tax rate will either stay the same or decline in retirement. While this is normally true, state and federal governments' tax policy is subject to change and tax rates could be increased in the future.

Most tax experts advise the following:

1. If you believe ***your income tax rate will be lower in retirement, continue contributing pre-tax to your traditional 401(k) account.*** You avoid paying taxes at today's higher rate and postpone paying taxes until retirement, when you are assumed to be in a lower tax bracket.

2. If you believe ***your income tax rate will be the same or higher in retirement, switch your contributions to a Roth 401(k) account.*** Your contributions will be made with after-tax money, but at today's assumed lower tax rates.

Some tax advisors even suggest that you pursue a strategy known as "tax diversification", similar to the idea behind investment diversification. Since you do not know with certainty your future income tax rate, you may want to contribute to a traditional 401(k) account, as well as a Roth 401(k) account, though you need to ensure that you do not exceed the maximum allowed contribution level in a given calendar year (in 2007, $15,500 for those under 50 years of age and $20,500 for the over 50 set).

[1] Depending on the type of employer, the plan may be called a Roth 403(b) instead of a Roth 401(k).
[2] To benefit from tax-free withdrawals, you must have had the account for at least five years and be at least 59½ years of age.

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The Roth 401(k): Is It Right For You?

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THE MINUTIAE

If you think contributing to a Roth 401(k) may make sense for you, consider the following items:

1. If you divert your contributions to a Roth 401(k) from a traditional 401(k), you will experience a decline in your take-home pay as Roth 401(k) contributions are made with after-tax money. The amount of the decline will be greater if you are in a higher tax bracket.

2. Switching to a Roth 401(k) will cause your taxable income to increase; consequently, your eligibility for certain tax credits and deductions may be reduced, such as for daycare expenses and educational costs.

3. Unlike a Roth IRA, for which you must be under certain income limits in order to qualify, the Roth 401(k) has no such limitation. Remember that diverting your contributions from a traditional 401(k) to a Roth 401(k) increases your taxable income and, depending on your income level, may disqualify you from making Roth IRA contributions.

4. If your employer matches your Roth 401(k) contributions, the match will still be on a pre-tax basis. Thus, you will owe income taxes on the matching funds when withdrawn in retirement.

5. After age 70½, you will be subject to required minimum distributions (RMDs) from your Roth 401(k). However, you can avoid RMDs by rolling your Roth 401(k) balance into a Roth IRA.

Although the Roth 401(k) is a retirement investment account, the decision as to whether to contribute to such an account relative to a traditional 401(k) is really a tax question. We encourage our affected clients to check with their tax preparer as to whether the traditional 401(k) or the Roth 401(k) is best-suited for their particular situation.

Lou Conrad Named To Fidelity Advisor Council

Louis E. Conrad II, CFA, COMPASS Wealth Management's founder and president, was recently asked to join Fidelity Institutional Wealth Services' Advisor Council. The Council, comprised of 13 individuals representing registered investment advisory firms throughout the country, provides feedback to Fidelity on its current and contemplated products and services, as well as provides Council members with access to the industry's thought leaders. Council membership is expected to last one year.

When To Begin Collecting Social Security Benefits

At present, the long-term prospects for the Social Security system are rather bleak. Each year, if you have paid into the system, you receive a statement from the Social Security Administration (SSA). On page one of the statement, the SSA now states the following:

> …the Social Security system is facing serious financial problems, and action is needed soon to make sure the system will be sound when today's younger workers are ready for retirement. In 2017 we will begin paying more in benefits than we collect in taxes. Without changes, by 2041 the Social Security Trust Fund will be exhausted and there will be enough money to pay only about 75 cents for each dollar of scheduled benefits.

With the solvency of Social Security in the spotlight and retirement fast approaching for many of our clients, we are frequently asked at what age you should begin collecting your Social Security benefits. Well, as is often the case, it depends upon your specific situation.

FULL RETIREMENT AGE

To determine whether it makes sense to retire early, we first need to determine what Social Security considers "full retirement age" or "normal retirement age". It varies based on the year of your birth.

Year of Birth	Full Retirement Age
1937 or earlier	65
1938—1942	65—66*
1943—1954	66
1955 —1959	66—67*
1960 and later	67

* SSA uses a graduated retirement age depending on the actual year of birth.

REDUCED BENEFIT AT 62

If you retire at your full retirement age, then you will receive your full Social Security benefits. However, if you retire prior to reaching your full retirement age, then your benefits will be reduced permanently. Under normal circumstances, the earliest you can begin collecting reduced benefits is upon reaching 62 years of age. The later your birth year, the more your benefits are reduced by retiring at age 62.

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