January 2007 – Tax Advantaged Savings

We are often asked how to decide in what order you should contribute to the tax-deferred and tax-free accounts that are available under your particular circumstances. For example, should you first make a 401(k) contribution or a Roth IRA contribution? We realize that not all of you have earned income and that some of you are retired; however, we all have children, grandchildren or friends to which this may be applicable. We always urge young people to get started. Enhancing social security benefits with these tax-advantaged accounts will undoubtedly have a positive impact on the quality of life.

The following discussion as to types of plans and recommendations is not all inclusive, but should serve as a starting point to help you decide on the sequence of investment. (In all cases we assume that you have earned income). Contributions should generally be made in the following order:

- First, if your company offers a 401(k) or other similar qualified retirement plan that includes a company match, you should contribute an amount equal to the match maximum. Assuming you remain employed long enough to vest, you will earn an enhanced return. If your plan allows Roth contributions, consider maximizing them. Although they are not tax deductible, they will grow on a **tax-free** basis. Unlike their Roth IRA cousins, Roth 401(k) plans do not have income ceilings, which prohibit their use by higher income individuals.

- Second, if eligible based on your income, you should contribute to a Roth IRA, which allows for tax-free growth, but with non-deductible contributions.

- Third, a new vehicle in 2006 is the One-Person 401(k), which has very narrow qualification requirements. Generally, you have to be self-employed or own a business with no other employees except a spouse. Such plans may allow Roth contributions and may in certain circumstances provide for higher contribution levels than the SEP IRA discussed below. The One-Person 401(k), however, contains more rigorous compliance standards than the SEP.

- Fourth, a SEP IRA is a simple qualified plan available to small businesses and self-employed individuals. Only the employer can make contributions, but in the case of the self-employed, the restriction is mute. Depending on the circumstances, the maximum contribution may or may not equal that for the One-Person 401(k). Also, although SEP contributions are deductible and accumulate on a tax-deferred basis, they do not allow a Roth component as in the One-Person 401(k) case.

- Fifth, contributions above the match level to a company 401(k) or, if eligible, to a deductible traditional IRA should be considered next since the combination of tax-deductible contributions and tax-deferred growth is very attractive.

- Lastly, you can elect to make nondeductible contributions to a traditional IRA. As discussed in our last letter, the decision must be based on a number of factors and is not a simple one.

As the eligibility rules and contribution limits applicable to the above plans are complex, we urge you to consult a tax professional when you consider utilizing any of them. We have, however, attached some relevant information from the Schwab website, which along with the IRS website, is a good source for further discussion.

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