THE PERSONAL PLANNER

Personal Financial Planning Tips for Today and the Rest of Your Life

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It's been a month with some relief from the drought and some small relief from the continual decline in the markets although there doesn't appear to be any certainty that both are not merely temporary. In August, we've seen short cycles of 3 to 4 days each in which fixed income, equity, and real asset categories have risen and fallen. There's no real trend at work here. It makes our Active Portfolio Risk Management strategy a bit more difficult to manage but all the more important because of the underlying uncertainties.

Hopefully, we'll enjoy a more temperate climate in September, both meterologically and financially. Have a great month!

Bruce Heling, CFP CPA

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HELING ASSOCIATES
Bringing the Personal to Financial Planning

Breaking Down the Taxpaying Population: Where Do You Fit In?

Every quarter, the Statistics of Income Division of the Internal Revenue Service (IRS) publishes financial statistics obtained from tax and information returns that have been filed with the federal government. Recent reports reflect data gleaned from 2009 individual federal income tax returns. These reports offer a snapshot of how Americans break down as taxpayers.

Sources for data: *IRS Statistics of Income Bulletin, Spring 2012 and Winter 2012, Washington, D.C.; IRS, Data on the 400 Individual Income Tax Returns Reporting the Largest Adjusted Gross Incomes, 2009 Update to Statistics of Income Bulletin, Spring 2003, Washington, D.C.*

The big picture

Individuals filed roughly 140 million federal income tax returns for 2009. Of those returns, just under 82 million (approximately 58%) reported federal income tax greater than zero--representing the lowest percentage of taxable federal income tax returns in 24 years.

Half of all the individual income tax returns filed showed adjusted gross income of under $32,396. (Adjusted gross income, or AGI, is basically total income less certain adjustments--e.g., deductible contributions to a traditional IRA.) As a whole, this bottom-50% group accounted for just 13.5% of the total AGI reported on all federal income tax returns. Put another way, 86.5% of AGI was concentrated in the top 50% of returns filed.

A look at the top

What did it take in AGI to make the top 5% of all individual filers? Probably not as much as you think. If your return showed AGI of $154,643 or more, you would have been one of the almost 6.9 million filers comprising the top 5%. This group reported about $2.5 trillion in AGI--31.7% of the total AGI reported--and was responsible for 58.7% of the total income tax for the year.

The roughly 1.3 million returns showing AGI of at least $343,927 made up the top 1% of all filers. This group reported 16.9% of total AGI; in other words, over $1.3 trillion of the $7.8 trillion in AGI reported was reported by the top 1% of filers. This group was responsible for 36.73% of the total income tax for the year.

There were just under 138,000 tax returns with AGI exceeding $1.4 million. These returns, making up the top 0.1% of all filers (that's the top one-tenth of one percent), accounted for approximately $610 billion in AGI (about 7.8% of all AGI), and paid just over 17% of the total income tax.

Not all high-income returns showed tax

There were just over 3.9 million returns filed with AGI of $200,000 or more. Of these returns, 20,752 (0.529%) showed no U.S. income tax liability. Why did these returns show no income tax? The IRS report that provided the data noted that high-income returns generally show no income tax as a result of a combination of factors, including deductions for charitable contributions, deductions for medical and dental expenses, and partnership and S corporation net losses.

Average tax rates

Simply dividing total income tax paid by total amount of AGI results in the following average federal income tax rates:

- Top 0.1%--Average federal income tax rate of 24.28%
- Top 1%--Average federal income tax rate of 24.01%
- Top 5%--Average federal income tax rate of 20.46%
- Top 10%--Average federal income tax rate of 18.05%
- Top 50%--Average federal income tax rate of 12.5%

The Investment Policy Statement: A Portfolio's Road Map

Even though an investment policy statement may target a desired return on the portfolio, that does not mean the portfolio will necessarily achieve that return. All investing involves risk, including the potential loss of principal, and there can be no guarantee that any investing strategy will be successful.

In some cases, investors choose to authorize a money manager to make the actual investing decisions for their portfolio rather than simply make recommendations. In such cases, it can be valuable to have a mechanism for making sure in advance that investor and manager are on the same page.

An investment policy statement (IPS) is designed to ensure that both sides understand the scope of the manager's decision-making authority and the guidelines on which investment decisions will be based. The portfolio's owner can take comfort in knowing that the investment manager has a clear sense of what's expected, while the manager can employ his or her best judgment and experience in following the IPS guidelines.

An investment policy statement also can be used by an investment committee--for example, officials responsible for managing the assets of a nonprofit organization, pension fund, or university endowment--to spell out the policies underlying the committee's investment decisions. Such a statement can increase transparency and improve consistency in case of turnover in committee membership.

Though an investment policy statement can be as simple or as complex as the parties involved want it to be, here are a few elements that are likely to appear.

Roles and responsibilities

An IPS generally spells out which accounts are covered by the policy statement and establishes procedures to be followed--for example, how subsequent modifications to the IPS itself will be handled. It also may set forth a process for ongoing monitoring of the portfolio, such as how often the investment manager will report on performance. In the case of an institutional investor, the IPS may specify who will be responsible for reviewing those reports and communicating with the investment manager, and which party is responsible for documenting compliance with any regulatory requirements.

Investment objectives and/or philosophy

An IPS generally will spell out the portfolio owner's goals and objectives. For example, it might state that the portfolio's primary goal is providing a certain level of income annually, or pursuing maximum growth; it also might specify how much volatility the owner is comfortable with. Such guidelines will affect the portfolio's asset allocation and the manager's selection of individual investments, though there obviously is no guarantee that a portfolio might not occasionally exceed the agreed-upon volatility guidelines or fail to achieve the desired goal.

Asset allocation and criteria for investment selection

Based on the above factors, an IPS may specify asset classes that are or are not appropriate for the portfolio. For example, it might allow investments in both individual bonds and bond funds, but exclude investments in the sovereign bonds of emerging markets. As a general rule, an IPS does not name specific securities for either inclusion or exclusion, permitting the manager to select individual securities within the approved asset classes. However, there may be exceptions--for example, when an investor already has a concentrated stock position. An investor who holds a large number of shares accumulated by exercising stock options granted as part of an employee compensation program might want to ensure that those holdings are not increased.

An IPS may or may not spell out a general asset allocation for a portfolio or set targeted ranges for each permitted asset class; for example, it might permit a portfolio's allocation to equities to range from 50% to 70%. It also may specify how often or under what circumstances the portfolio will be rebalanced to maintain a targeted asset allocation; set liquidity and marketability requirements; outline any specific cash reserves needed; and encourage or prohibit tax management strategies.

Criteria for gauging performance

A portfolio that doesn't produce the return necessary to meet its owner's financial and legal obligations--for example, pension payments owed by a pension fund--has even bigger problems than a portfolio that falls short of providing the return hoped for by an individual owner. That's why an IPS will often include expected performance criteria, such as a targeted percentage return or a requirement that the portfolio's assets match or exceed the performance of one or more appropriate benchmark indices.

As you can see, an IPS can be as detailed or as general as the parties involved feel is appropriate. Your financial professional can help you explore whether an IPS is appropriate for your individual situation.

Withdrawals from Traditional IRAs

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Why you should think twice

Financial professionals generally recommend using your retirement funds for one purpose only--retirement. Why? Because frequent dips into your retirement funds will reduce your ultimate nest egg. Plus, there will be less money available to take advantage of the twin benefits of tax deferral and any compound earnings. Depleting your retirement funds too soon can create a dire situation in your later years.

And then there are taxes. If you've made only deductible contributions to your traditional IRA, then all the funds in your account are subject to federal income tax when you withdraw them. They may also be subject to state income tax. If you've made any nondeductible (after-tax) contributions to your IRA, then each withdrawal you make will consist of a pro-rata mix of taxable (your deductible contributions and any earnings in your account) and nontaxable (your nondeductible contributions) dollars.

All your traditional IRAs (including SEPs and SIMPLE IRAs) are treated as a single IRA when you calculate the taxable portion of a withdrawal. So you can't just transfer all your nondeductible contributions into a separate IRA, and then withdraw those funds tax free. And, if you're not yet age 59½, the taxable portion of your withdrawal may be subject to a 10% federal early distribution tax (your state may also apply a penalty tax).

10% early distribution penalty

To discourage early withdrawals from IRAs, federal law imposes a 10% tax on taxable distributions from IRAs prior to age 59½. Not all distributions before age 59½ are subject to this penalty, however. Here are the most important exceptions:

- Distributions due to a qualifying disability
- Distributions to your beneficiary after your death
- Distributions up to the amount of your tax-deductible medical expenses
- Qualified reservist distributions
- Distributions to pay first-time homebuyer expenses (up to $10,000 lifetime)
- Distributions to pay qualified higher education expenses
- Certain distributions while you're unemployed, up to the amount you paid for health insurance premiums
- Amounts levied by the IRS
- Distributions that qualify as a series of substantially equal periodic payments (SEPPs)

The SEPP exception to the early distribution penalty

The SEPP exception allows you to withdraw funds from your IRA for any reason, while avoiding the 10% penalty tax. But the rules are complex, and this option is not for everyone. SEPPs are amounts you withdraw from your IRA over your lifetime (or life expectancy) or the joint lives (or joint life expectancy) of you and your beneficiary. You can take advantage of the SEPP exception at any age.

To avoid the 10% penalty, you must calculate your lifetime payments using one of three IRS-approved distribution methods and take at least one distribution annually. If you have more than one IRA, you can take SEPPs from just one of your IRAs or you can aggregate two or more of your IRAs and calculate the SEPPs from the total balance. You can also use tax-free rollovers to ensure that the IRA(s) that will be the source of your periodic payments contain the exact amount necessary to generate the payment amount you want based on the IRS formulas.

Even though SEPPs are initially determined based on lifetime payments, you can change--or even stop--the payments after five years, or after you reach age 59½, whichever is later. For example, you could start taking SEPPs from your IRA at age 50, without penalty, and then, if you no longer need the funds, reduce the payments (or stop them altogether) once you reach age 59½.

Short-term loan

If you only need funds for a short period of time you may be able to give yourself a short-term loan by withdrawing funds from your IRA, and then rolling those dollars back into the same or a different IRA within 60 days. However, watch the deadline carefully, because if you miss it, your short-term loan will instead be treated as a taxable distribution. And keep in mind that you can only make one rollover from a particular IRA to any other IRA in any 12-month period. A violation of this rule can also have serious adverse tax consequences.

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Heling Associates, Inc. is a fee-only financial and investment advisory firm that has been providing financial planning, financial counseling, and portfolio management services since 1991. The firm is registered as an investment advisor with the Department of Financial Institutions of the State of Wisconsin. If you’ve been thinking about seeking help from an objective and professional financial advisor, we welcome your inquiry.

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My wife just started a new job. Should we switch from my health insurance plan to hers?

It depends. When it comes to comparing health insurance plans, you'll need to consider a variety of factors, such as cost, levels of coverage, and the types of service offered by each plan.

Your first step should be to compare the premiums you would have to pay for each health plan. Does your employer pay all or part of the premiums for your current health insurance? Or will your wife's employer pay more? Obviously, the lower the premium you have to pay, the more attractive the plan.

When it comes to cost, however, premiums aren't the only factor to consider. You'll also want to compare the deductibles and co-payments required for each health plan. These payments can end up greatly increasing your out-of-pocket costs. As a result, even if one health plan offers a lower premium, it may end up costing you more in the long run if it has higher deductibles and co-payments.

Next, you should compare the level of coverage that each plan provides--especially if you have a pre-existing condition. Be sure to look at the choice of in-network doctors and specialists that each plan offers. Would switching plans require you to find another primary care physician or specialist? If so, are there any out-of-network options that are available? You'll also want to find out about the types of coverage offered for specific services, such as rehabilitation and physical therapy. In addition, there may be extras to consider such as vision, dental, mental health, and prescription drug benefits that are offered by one plan but not the other.

And be sure to look at each health insurance plan's track record when it comes to customer service. Is there typically a long wait time to get through to a representative? Do they usually pay claims in a timely manner?

Finally, keep in mind that if you do decide to switch to your spouse's plan, you'll have to stick with your decision until the next open enrollment period (usually in the fall) to make any changes.

Can I use a dependent care flexible spending account to help pay for my child's preschool?

Yes. Preschool, along with nursery school and other pre-K programs, is considered to be child care by the IRS and thus will qualify as an expenditure eligible for reimbursement from a dependent care flexible spending account (FSA). This is good news for working parents who are faced with the prospect of having to keep up with the rising costs of child care. According to the National Association of Child Care Resource and Referral Agencies, the average cost for center-based care for an infant was higher than a year's tuition and related fees at a four-year public college.

A dependent care FSA allows you to contribute pretax dollars (up to $5,000 annually--although your employer's limit may be lower) from your paycheck to a fund that is earmarked for dependent care expenses. This means that you don't pay federal income/FICA tax on the money you contribute to an FSA. You then typically pay your child's preschool tuition out-of-pocket and would later be reimbursed from your tax-free FSA. In order for your child's preschool tuition to qualify for reimbursement under an FSA, it must be necessary for your employment/schooling and, if you are married, for the employment/schooling of your spouse as well. In addition, you will need to list on your federal income tax return the name, address, and taxpayer identification number of the person or party (in this case, the preschool) that provides dependent care to your child.

In addition to your employer's dependent care FSA, you may want to look into whether or not you are eligible to claim the dependent care tax credit. The dependent care tax credit is an income tax credit for up to 35% of qualifying dependent care expenses, depending on your adjusted gross income. Qualifying expenses are limited to $3,000 for one qualifying dependent and $6,000 for more than one qualifying dependent. Keep in mind, however, that expenses that are reimbursed from an FSA cannot be claimed as part of the dependent care tax credit. As a result, you may want to consult a tax professional to determine which tax-saving option would be more beneficial to you.