Johnston Investment Counsel
Trusted Fiduciaries & Fee-Only Advisors

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

Retirement Plans for Your Small Business

Withdrawals from Traditional IRAs

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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%

Retirement Plans for Your Small Business

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Simplified employee pension (SEP) plans

A SEP plan allows small business owners to set up traditional IRAs, called SEP-IRAs, for themselves and each employee. You must generally contribute a uniform percentage of pay, up to 25%, for each eligible employee (up to $50,000 in 2012), but you don't have to make contributions every year. The plan must generally cover any employee aged 21 or older who has worked for you for three of the last five years and who earns $550 or more during the year.

Your employees don't directly contribute to the SEP plan, although they can make their regular annual IRA contributions to their SEP-IRAs if they choose (SEPs are traditional IRAs and can't accept Roth IRA contributions). All contributions to the plan are fully vested (that is, immediately owned by your employees), and your contributions are fully deductible.

Most employers, regardless of size, can establish a SEP plan. SEP plans have low startup and operating costs, and can be established using a two-page IRS form.

SIMPLE IRA and SIMPLE 401(k) plans

You can adopt a SIMPLE IRA plan if you have 100 or fewer employees who earn $5,000 or more. A SIMPLE IRA plan lets your eligible employees contribute a percentage of their salary on a pretax basis, up to $11,500 in 2012 ($14,000 for employees age 50 and older). Each employee who earned $5,000 or more in any two prior years, and who is expected to earn at least $5,000 in the current year, must be allowed to participate in the plan.

You're required to either match each employee's contributions dollar for dollar--up to 3% of the employee's compensation--or make a fixed contribution of 2% of compensation for all eligible employees. (The 3% match can be reduced to 1% in any two of five years.) Like SEPs, all contributions to the plan are fully vested, and your contributions are fully deductible.

SIMPLE IRA plans are easy to set up (you fill out a short IRS form to establish the plan), easy to administer, and inexpensive to maintain. You can let each employee set up a SIMPLE IRA account at a financial institution of his or her choosing, or you can select the financial institution that will serve as trustee and initially hold all plan contributions.

Note that unlike any other retirement plan, early withdrawals (before age 59½) from SIMPLE IRAs during the first two years of participation are subject to a 25% penalty tax, unless an exception applies. After the first two years of participation, the penalty tax drops to 10% (consistent with other retirement plans).

SIMPLE 401(k) plans are similar to SIMPLE IRAs, but can also allow loans and Roth contributions. And in most cases, you don't have to perform complicated discrimination testing. But because they're still qualified plans (and therefore more complicated and costly to establish and administer than SIMPLE IRAs), and allow less deferrals than traditional 401(k)s, SIMPLE 401(k)s haven't become popular retirement plans.

But don't rule out a 401(k) plan entirely

No employees? Then there is one qualified plan you should consider--the individual 401(k) plan (also known as a solo 401(k) plan).

An individual 401(k) plan is a regular 401(k) plan combined with a profit-sharing plan. You can elect to defer up to $17,000 of your compensation to the plan for 2012 ($22,500 if you're age 50 or older), just as you could with any 401(k) plan. Contributions can be pretax or Roth. In addition, as with a traditional profit-sharing plan, your business can make a tax-deductible contribution to the plan of up to 25% of your compensation.

Total contributions to your account in 2012 can't exceed $50,000, plus any catch-up contributions (or, if less, 100% of your compensation). If you're self-employed, compensation is your earned income from your business.

Since an individual 401(k) plan can cover only the business owner and his or her spouse, it isn't subject to the often burdensome and complicated administrative rules and discrimination testing requirements that generally apply to regular 401(k) and profit-sharing plans.

If you're a small business owner and haven't established a retirement savings plan, what are you waiting for? It's time to select the plan that best fits your needs, and the needs of your employees.

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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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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.

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