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Beware of the most common biases noted in Michael M. Pompian's Aug. 16th article in Morningstar Advisor News.

1. The pain of losses is greater than the pleasure of gains
2. Getting "Anchored" to a price when making an investment decision.
3. Believing that investment outcomes should have been able to be predicted
4. Taking investment action based on the most recent data or trend rather than putting current situation into historic perspective
5. Making current investment decisions using the results of past similar investments as a frame of reference
6. Not taking action to change one's investment portfolio (i.e.doing nothing when promoting to do so)
7. Past (poor) performance decisions affect future investment decisions

Your referrals are appreciated! Joe

2012 August

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

Should You Make Large Gifts in 2012?

Withdrawals from Traditional IRAs

Do I have the right type of life insurance?

Current Financial Topics

Food for Thought

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%

Should You Make Large Gifts in 2012?

Other gift considerations

- *While it might seem obvious, gifts should only be made if you can afford to part with the property.*
- *In general, it is usually preferable to make as many gifts as possible using the annual exclusion and the qualified transfers exclusion for medical and educational expenses before making taxable gifts that use up the gift and estate tax exemption. Annual exclusion and qualified transfer exclusion gifts do not use up the gift and estate tax exemption.*
- *When you make a gift of property, your income tax basis in the property (generally, what you paid for the property, with some up and down adjustments) is generally carried over to the person who receives the gift. When you transfer property at your death, the basis of the property is usually "stepped up" (or "stepped down") to fair market value at the time of your death.*

Currently, the exemptions for federal gift tax, estate tax, and generation-skipping transfer (GST) tax are at historic highs, and the gift, estate, and GST tax rates are at historic lows. But, in 2013, the exemptions are scheduled to substantially decrease, and the tax rates are scheduled to substantially increase. This raises the question of whether 2012 might be a good time to make large gifts that take advantage of the current exemptions while they are still available.

Looking into the future

When you transfer your property during your lifetime or at your death, your transfers may be subject to federal gift, estate, and GST tax. (Your transfers may also be subject to state taxes.) Currently, there is a basic exclusion amount (sometimes referred to as an exemption) that protects up to $5,120,000 from gift tax and estate tax, a $5,120,000 GST tax exemption, and a top tax rate of 35%. Unless new legislation is enacted, in 2013 the gift tax and estate tax exemption will decrease to $1,000,000, the GST tax exemption will decrease to $1,000,000 (as indexed), and the top tax rate will increase to 55%.

No one knows what the future holds for these taxes, but there is a lot of speculation about what Congress might do. Among the possible scenarios, tax rates could increase and exemptions decrease, tax rates could decrease and exemptions increase, or current tax rates and exemptions could be extended. The question then arises: "Should large gifts be made in 2012 to take advantage of the large $5,120,000 exemption while it is still available?"

To answer that question, you should generally consider the following: the size of your estate and the rate at which it can be expected to grow (or decrease), whether you can afford to make large gifts, what the future of the transfer taxes might be, and whether "claw back" would apply in future years.

Claw back

Claw back refers to a situation where the benefit of certain tax provisions is essentially recaptured at a later time due to changes in tax law. There is some split in opinion as to whether claw back applies to the estate tax. A couple of examples will illustrate the difference.

Example(s): *Assume the gift and estate tax change as currently scheduled in 2013 and claw back applies. Assume you make a taxable gift of $5 million in 2012 that is fully protected by your gift tax exemption and you have a taxable estate of $5 million when you die in 2013. Estate tax, after reduction by the unified credit but not the state death tax credit, is $4,795,000. The result is essentially the same as if you had not made the taxable gift in 2012 and your taxable estate is $10 million in 2013.*

Example(s): *Assume the same facts as above, but with no claw back. Estate tax, after reduction by the unified credit but not the state death tax credit, would be $2,750,000. So, the federal estate tax is $2,045,000 lower if there is no claw back.*

Guidelines for large gifts in 2012

If you expect that you can keep your estate down to around $1 million ($2 million total for both spouses if you are married) using annual exclusion gifts (generally, up to $13,000 per recipient per year; effectively, $26,000 for gifts by married couples) and qualified transfers exclusion gifts for medical and educational expenses, there may be no advantage to making taxable gifts in 2012. If you have a larger estate, you may wish to consider making taxable gifts sheltered by exemptions in 2012, depending on your evaluation of how the guidelines here apply to your particular circumstances.

If you make taxable gifts sheltered by the gift and estate tax exemption in 2012, and the gift and estate tax rates later increase, the exemptions decrease, and there is no claw back, you may save gift and estate taxes by making the gifts in 2012. Even if there is claw back, your gift and estate taxes will probably be no worse than if you hadn't made the gifts. And, if the gift and estate tax rates later decrease or stay the same and the exemptions increase or stay the same, your gift and estate taxes will probably be no worse than if you hadn't made the gifts.

If you make generation-skipping transfers sheltered by the GST tax exemption in 2012, and the GST tax rate later increases and the exemption decreases, you may save GST tax by making the GST in 2012. Even if the GST tax rate later decreases or stays the same and the exemption increases or stays the same, your GST tax will probably be no worse than if you hadn't made the GST in 2012.

In each of these scenarios, it has been assumed that values do not appreciate. If the property transferred by gift increases in value after the gift, there may also be transfer tax savings from removing the appreciation from the transfer tax system.

You'll want to consider how these guidelines for large gifts in 2012 might apply to your specific circumstances. An estate planning professional can help you evaluate them.

Withdrawals from Traditional IRAs

In these challenging economic times, you may be considering taking a withdrawal from your traditional IRA. While you're allowed to withdraw funds from your IRAs at any time, for any reason, the question is, should you?

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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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Do I have the right type of life insurance?

Your need for life insurance changes as your life changes. You may need less life insurance when you're younger, but as you take on more responsibilities and as your family grows, the amount and type of life insurance that fits your circumstances changes.

There are many different types of life insurance. But generally, life insurance policies fall into one of two categories, temporary or term insurance, and permanent or cash value insurance.

Term insurance

Term insurance provides coverage for a specified period ranging from 1 to 30 years. Premiums are typically lower compared to permanent life insurance. If you die during the coverage period, your beneficiary receives a specified death benefit. If you live to the end of the specified period, coverage ends and the policy has no cash value.

Permanent insurance

Unlike term insurance, permanent insurance continues throughout your life as long as you pay the premiums. As with term insurance, permanent insurance pays a death benefit to your beneficiary at your death, but it also contains a cash value account funded by your premium dollars. The cash value portion of the policy grows, tax deferred, as long as the coverage remains in force. With permanent insurance, you can tap the dollars in the policy even while you're alive. You can borrow against the policy, and in some cases, withdraw part of the cash value. Keep in mind, though, that unpaid loans and withdrawals will decrease the death benefit available to your beneficiaries, and reduce the cash value, which may cause the policy to lapse.

What's right for you?

Think about what protection you need and what you can afford before you purchase any type of life insurance. If you really need insurance but don't have the discretionary income, term insurance may be your best choice. On the other hand, if you want lifetime coverage and you're interested in accumulating cash value, then permanent insurance may make more sense.

Should I buy my life insurance through my employer or on my own?

Many companies offer their workers employer-sponsored life insurance coverage as part of their employee benefits package. If you're offered this opportunity, it may be in your best interest to accept. Buying life insurance through your employer can be a relatively inexpensive and hassle-free way to get some of the life insurance coverage you need.

With a group life insurance plan, your employer purchases a single policy that covers all employees. This policy is subject to a single group premium payment. Some employers may pay the entire cost of the group policy (which is tax deductible to the employer). But if the plan requires you to pay a portion of the group premium, that amount will probably be lower than what you would pay for the same type and amount of individual insurance coverage. And you generally don't need to pass a medical exam when applying for group life insurance.

A disadvantage of employer-sponsored life insurance is that it may not be portable. If you leave your job, your group life insurance coverage may end--potentially leaving you underprotected, especially if you can't purchase an individual policy at a reasonable cost because of your age or changes in your health. However, you may be allowed to convert your group insurance to an individual policy, which would allow you to keep your insurance coverage, regardless of your age or health, but you'd have to pay the entire premium out-of-pocket.

Another disadvantage of group life insurance is that the policy may not be tailored to your individual needs. For example, the amount of coverage may be less than what you require to be fully protected. If so, the group policy may give you the option of purchasing more coverage for an additional cost and for which you may be asked to answer medical questions. But even if you end up buying supplemental insurance through a separate company, your employer-sponsored plan gives you a head start in meeting your life insurance needs.

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