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Hello again,
I hope everyone enjoyed the Labor Day Weekend.

I don't know about you, but for me, the last four months of the year seem to fly by. All of a sudden it will be January. Many interesting events will unfold in the next four months.

Don't let short term political, economic or news events derail your financial plan. Remember, "think long term, have a plan". To that end, there is an interesting article included in this newsletter about Investment Policy Statements (IPS). Since I am a fee-only, hourly planner and do not directly manage people's money, you may want to think about crafting your own IPS. If you want some assistance in this task, please let me know.

As always, your thoughts, comments and questions are most welcomed. Have a great month!

September 2012

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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 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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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.

