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

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Do I have the right type of life insurance?

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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

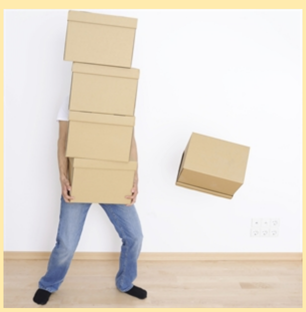
Simply dividing total income tax paid by total amount of AGI results in the following average federal income tax rates:

- 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%

Ways Parents Can Help Their Boomerang Kids

A financial strain

Parents naturally want to help their children during hard times, but in some cases, the financial strain of another adult (or two or three) in the house can be too much of a financial shock. If your adult child needs to move back home, discuss how long your child plans to stay and how he or she can contribute financially to the household.



It's been called the new retirement wild card. But it's not inflation, health-care costs, or taxes, though those things certainly matter. What is it that's causing so much uncertainty? It's boomerang kids, and the money their parents spend on them.

The trend

According to the U.S. Census Bureau, there were 6 million young adults ages 25 to 34 living at home in 2011--19% of all men (up from 14% in 2005) and 10% of all women (up from 8% in 2005). Not surprisingly, the percentages are higher for young adults in the 18 to 24 age bracket, with 59% of young men and 50% of young women living with their parents in 2011.

Sociologists have cited a number of reasons for this trend--the recession, college debt, the high cost of housing, delayed marriage, and a tendency toward prolonged adolescence. But whatever the reason, there's no doubt that boomerang children can be a mixed blessing for their parents, both emotionally and financially. Just when parents may be looking forward to being on their own and preparing for their retirement, their children are back in the nest and relying on their income. While the extra company might be welcome, you don't want to sacrifice your emotional and financial health to help your kids.

Set ground rules

If your adult children can't afford to live on their own, establish ground rules for moving back home, including general house rules, how long they plan to (or can) stay, and how they can contribute to the household in terms of rent and chores. As an adult, your child should be expected to contribute financially to the household overhead if he or she is working. Determine a reasonable amount your child can contribute toward rent, food, utilities, and car expenses. You can then choose to apply this money directly to household expenses or set it aside and give it to your child when he or she moves out, when it can be used for a security deposit on an apartment, a down payment on a car, or some other necessary expense.

You should also discuss your child's long-term plan for independence. Does your child have a job or is he or she making sincere efforts to look for work? Does your child need or want to go back to school? Is your child working and saving money for rent, a down payment on a home, or graduate school? Make sure your child's plans are realistic and that he or she is taking steps to meet those goals.

It's a balancing act, and there isn't a road map or any right answers. It's common for parents to wonder if they're making a mistake by cushioning their child's transition to adulthood too long or feel anxious if their child isn't making sufficient progress toward independence.

Turn off the free-flowing money spigot

It can be tempting for parents to pay all of their adult children's expenses--big and small--in an effort to help them get on their feet, but doing so is unlikely to teach them self-sufficiency. Instead, it will probably make them further dependent on you.

If you can afford it, consider giving your child a lump sum for him or her to budget rather than just paying your child's ongoing expenses or paying off his or her debt, and make it clear that is all the financial assistance you plan to provide. Or, instead of giving your child money outright, consider loaning your child money at a low interest rate. If you can't afford to hand over a sum of cash or prefer not to, consider helping with a few critical expenses.

Evaluate what your money is being spent on. A car payment? Credit card debt? Health insurance? A fancy cell phone? Student loans? General spending money? Your child is going to have to cut the frills and live with the basics. If your child is under age 26, consider adding him or her to your family health plan; otherwise, consider helping him or her pay for health insurance. Think twice about co-signing a new car loan or agreeing to expensive lease payments. Have your child buy a cheaper used car and raise the deductible on his or her car insurance policy to lower premiums. Help your child research the best repayment plan for student loans, but don't pay the bills unless absolutely necessary. Same goes for credit card balances. Have your child choose a less expensive cell phone plan, or consolidate phones under a family plan and have your child pay his or her share. Bottom line--it's important for your child to live within his or her financial means, not yours.

Solidify your own retirement plan

Even if your child contributes financially to the household, you may still find yourself paying for items he or she can't afford, like student loans or medical bills, or agreeing to pay for bigger ticket items like graduate school or a house down payment. But beware of jeopardizing your retirement to do this--make sure your retirement savings are on track. A financial professional can help you see whether your current rate of savings will provide you with enough income during retirement, and can also help you determine how much you can afford to spend on your adult child now.

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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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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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