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A SEP or SIMPLE? Small Biz Owners Have Choices

If you own a small business or are self-employed, you have plenty of retirement plan options. You could go with a traditional 401(k) plan, for instance, or even a defined-benefit pension plan designed to fund a particular level of retirement income for you and your employees. But those choices can be complicated and expensive to administer, and the pension plan could tie you into annual contributions that might be difficult to make in some years. Two of the most popular retirement plans for small businesses may be better alternatives, particularly if you are self-employed or have relatively few employees. They are the Simplified Employee Pension (SEP) and the Savings Incentive Match Plan for Employees (SIMPLE). As the names imply, they offer relatively simple solutions. Here's a side-by-side comparison:

SEPs at a Glance

To set up a SEP, a plan administrator (probably you) must fill out a one-page IRS form and give copies to participants. A SEP doesn't require you to provide the IRS with annual reports. Consider these other key aspects:

Eligibility: Contributions must be made for all employees age 21 and over who have worked for your company during three out of the previous five years. (You might have different obligations if your employees work under a union contract.) Employees who meet those criteria but work only part-time, or for just part of the year, must be covered under the plan if they earn a minimum amount ($550 for 2013).

Contributions: The maximum annual contribution you can make on behalf of an employee—and can deduct from the company's income—is the same as it is for other defined-contribution plans. The limit for 2013 is the lesser of 25% of compensation or $51,000. The maximum amount of compensation that may be taken into account for this purpose is $255,000. These contributions go into a SEP-IRA that each participant opens. They are responsible for managing the account and selecting investments, reducing your obligations and risks.

The amount you contribute is discretionary. For instance, you can boost contributions in profitable years or reduce or eliminate them in down years. However, you must contribute the same percentage of compensation to every plan participant.

Vesting: Contributions to a SEP are vested immediately. Even if employees quit right after you make a contribution, they get to keep that money.

Distributions: As with other qualified retirement plans, distributions must begin by April 1 of the year following the year in which an employee reaches age 70½ (or the year a non-owner employee retires, if that's later). Withdrawals made prior to age 59½ will normally be subject to a 10% penalty tax as well as regular income tax.

Deadline: A SEP can be set up and funded after the close of the tax year as

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Rebalancing Plays An Important Role In Producing Returns

The U.S. equity market has more than doubled in value over the past few years. Has your portfolio been rebalanced to take this change into account?

Diversification and asset allocation require periodic rebalancing. That's because 90% of returns are attributable to asset class choices rather than to specific securities.

Let's say your portfolio originally contained 50% U.S. stocks, with the rest split among bonds, real estate, and other alternatives. Between March 2009 and March 2013, the Dow Jones Industrial Average of U.S. stocks rose 129%, following the historic downturn of 2008. If you haven't made any adjustments, the value of the stocks in your portfolio likely has risen well past 50% of the overall value.

It's important to bring that share back down because that increased emphasis on equities has added risk to your portfolio. Stocks eventually will have a down year, and if they make up too great a share of your portfolio your losses could be proportionally higher than what you expect when the market drops.

When it comes to portfolio design, getting the recipe right is more important than the ingredients you choose. We will help you get the right mix of asset classes and ensure that your portfolio is rebalanced regularly to keep that mix intact, while taking into account your risk tolerance, changing situation, and the need to keep investment costs low.

Robert Pyle & Sarah Heller

Want To Shift Income? Give It Away

With three key tax provisions that took effect in 2013 raising the ante for high-income earners, you may be inclined to look for ways to shift income-producing assets to family members in lower tax brackets. That can be effective, as long as you're comfortable with the trade-offs.

By now, you know about the tax changes affecting those in upper-income brackets. There's a higher top rate for income—now 39.6%, up from 35%, which applies to single tax filers with income above $400,000 and joint filers above $450,000. There also has been a tax hike on capital gains and qualified dividends, with the usual maximum 15% rate for long-term capital gains and qualified dividends jumping to 20% for tax filers above those same income thresholds. And, finally, there's the Medicare surtax, a new 3.8% tax that applies to the lesser of net investment income or the amount by which your modified adjusted gross income exceeds $200,000 for single filers and $250,000 for joint filers.

What is the end result? If you earn enough, you might be forced to pay a combined 43.4% tax rate on some of your income, and that doesn't even count additional state or local income taxes.

To lighten this heavier tax load, there are several possibilities, including sophisticated trust arrangements. But by far the simplest—and potentially one of the most effective—ways to shift income is to give outright gifts to your children or to other low-taxed family members. Not only will the earnings from property you give away be taxed to your offspring—instead of to you in your higher tax bracket—but you also may be able to reduce or eliminate the 3.8% Medicare surtax.

Suppose you're in that combined 43.4% tax bracket and you shift $10,000 of annual taxable income to each of three children in the 25% tax bracket and two grandchildren in the 15% bracket. You'll save a total of $11,200 in taxes, this year, next year, and every year until the rules change again. (You will, however, have to watch out for the "kiddie tax," which calls for unearned income above a threshold—$2,000 in 2013—received by a dependent child under age 24 to be taxed at the parents' top tax rate.)

Though transfers to your kids are subject to gift tax, you can use the annual gift-tax exclusion ($14,000 per recipient in 2013) to limit that liability. And the annual exclusion is doubled for joint gifts by a married couple. If there's an excess, it may be covered by the lifetime gift-tax exclusion ($5.25 million in 2013). Similarly, direct gifts to grandchildren are sheltered from the generation-skipping tax by an exemption of the same amount.

Realize, though, that these are irrevocable gifts, so you're giving up complete control over the property. If you're not comfortable with that, you'll need to consider other options for reducing those higher taxes. ●

Saving For Retirement At All Ages

Financial planners often are asked, "When should I start saving for retirement?" Although everyone's circumstances differ, the answer usually is a variation on this theme: As soon as possible. But that doesn't mean it's ever too late to begin, or that you'll have the same financial priorities at every age. When you're embarking on a career, you may not have much extra income to set aside, but you can work on establishing sound financial habits. Later, though you'll likely earn more, you'll also likely have greater obligations—supporting your family, paying a mortgage note, and, yes, saving for retirement. Still other factors may come into play as you approach your golden years.

Consider these basic approaches during different financial stages of your life.

In your 20s. Retirement may seem several lifetimes away. What's more, the salary you earn during your early working years likely won't provide much cushion for savings. But you may be surprised by how much you can accumulate if you're dedicated, thanks largely to the power of tax-deferred compounding. For instance, if you save $1,000 a month and earn 8% on your savings compounded annually for 40 years until retirement, you will amass a staggering $3,271,022.95. (These figures are hypothetical and not indicative of any particular investment.)

The easiest way for most people to sustain tax-deferred growth is through a 401(k) or another tax-advantaged retirement plan. If your employer provides matching contributions, try to contribute at least as much as you need to qualify for the maximum match.

In your 30s and 40s. These are prime earning years, but you also might incur substantial expenses raising the kids, buying and maintaining a home, and paying for

New Law Poses Tax Risks For Wealthy Investors

It will take time for investors to absorb exactly what happened—and what did not happen—in the new tax law enacted to avert the "fiscal cliff." Under the new law, called the American Taxpayer Relief Act (ATRA), favorable tax rates on different types of investment income generally were preserved, but certain upper-income investors will face tax increases, beginning in 2013.

When you combine the ATRA changes with the new 3.8% Medicare surtax—also making its debut in 2013—you could be hit with a rate as high as 43.4% on a portion of your investment income.

Consider the following three main new tax law provisions:

1. Ordinary income. The existing federal income tax rate structure—with rates of 10%, 15%, 25%, 28%, 33%, and 35%—continues for most taxpayers. But ATRA adds a new top tax of 39.6% for single filers with income of more than $400,000 and joint filers with income above $450,000. That means that a short-term capital gain on the sale of a stock you've owned for a year or less—a profit taxed at ordinary income rates—could trigger the 39.6% federal rate.

2. Capital gains and qualified dividends. Under ATRA, the maximum tax rate for net long-term capital gains and qualified dividends remains 15% (0% for investors in the lowest tax bracket). If the law hadn't passed, the tax rate for capital gains would have soared to 20% (10% for investors in the lowest tax bracket), and dividends were scheduled to be taxed at ordinary income rates. Despite the reprieve for most investors, however, those who exceed those same high-income thresholds—$400,000 for single filers and $450,000 for joint filers—now will pay a maximum 20% tax rate on long-term capital gains and qualified dividends.

3. Medicare surtax. This "add-on" tax actually was included in the 2010 health care legislation—the Patient Protection and Affordable Care Act—rather than ATRA. But it also takes effect in 2013, and it can be just as lethal to upper-income investors as some ATRA changes. A 3.8% Medicare surtax now will apply to the lesser of "net investment income" (NII) or the amount by which your modified adjusted gross income (MAGI) exceeds a threshold amount—$200,000 for single filers and $250,000 for joint filers. These figures will not be indexed for inflation.

For this purpose, NII is defined to include interest, dividends, capital gains, rents, royalties, nonqualified annuities, income from passive activities, and income from the trading of financial instruments or commodities. Certain items are excluded from the NII definition, including wages, self-employment income, Social Security benefits, tax-exempt interest, operating income from a non-passive business, and distributions from qualified retirement plans and IRAs.

Now let's see how these tax changes might affect taxes on investment income:

Example 1. You're a joint filer with an annual MAGI of $170,000 consisting mainly of wages. This puts you in the regular 28% tax bracket. At the end of the year, you realize short-term capital gains of $10,000 and long-term capital gains of $40,000, for a total of $50,000 in NII. Because you don't exceed the threshold for ordinary income, your short-term gains still are taxed at the 28% rate. And you don't exceed the threshold for capital gains either, so your long-term gains are taxed at the 15% rate. Finally, the lesser of your NII or excess MAGI is zero, so you don't have to pay the 3.8% Medicare surtax.

Example 2. You're a single filer with an annual MAGI of $500,000, consisting mainly of wages. This puts you in the new top tax bracket of 39.6%. At the end of the year, you realize short-term capital gains of $25,000 and long-term capital gains of $75,000, for a total of $100,000 in NII. Your short-term gains are taxed as ordinary income at the 39.6% rate. In addition, you exceed the threshold for capital gains, so your long-term gains are taxed at the 20% rate. Finally, the lesser of your NII or excess MAGI is $100,000, triggering a Medicare surtax of $3,800 on top of your other taxes.

Accordingly, the new tax rules could affect the rates you pay on investment income. And while taxes alone never should determine your investment decisions, it makes sense to factor them in when you're considering what and when to buy or sell. Depending on your situation, you might accelerate income or capital gains into the current year to avoid higher taxes next year, or you could postpone income or gains to next year to avoid higher taxes this year. We can work with your tax advisor to help you decide what makes sense in your situation. ●

college. Nevertheless, you should do your best to stay disciplined and contribute as much as you can to your retirement plans. For 2013, you can defer up to $17,500 of salary to your 401(k). In addition, if you establish an IRA, the annual contribution limit is $5,500. Meanwhile, although contributions to a Roth IRA are never tax-deductible, future payouts may be tax-free. ï€†

In your 50s and 60s. This may be when you earn the highest salary of your career. If the kids are out of college and the mortgage is paid off, it's truly time to make hay while the sun shines. Although you might not have been as diligent at retirement saving in the past as you would have hoped to be, you can recover lost ground quickly by socking away more in your retirement plans at this point in your life. For 2013, you can contribute an extra $5,500 to a 401(k) and an additional $1,000 to an IRA, above the limits already discussed. And you can save still more in taxable accounts outside your retirement plans. ●

Find Extra Benefits In DI Insurance

The odds that you'll suffer a disabling injury or illness are far greater than the likelihood of you dying prematurely. A disability income (DI) insurance policy, used to supplement life insurance coverage, could help protect you from loss of income if you're unable to work. Indeed, a DI insurance policy might provide even more benefits than you expect.

Typically, a private DI insurance policy can pick up some of the slack if you're disabled for an extended time. Should you no longer be able to work, you will begin receiving a monthly disability benefit. Normally, the benefit is a predetermined amount, unlike employer-provided coverage, in which the benefit equals a percentage of compensation.

As with life insurance, DI terms can vary widely from policy to policy. Some key variables include the amount of the benefits you'll receive; the length of the coverage; the requirements for receiving full benefits; the definition of "disability"; the length of the waiting period before benefits begin; any cost-of-living adjustments; availability of partial benefits; and possible non-cancellation features. Naturally, the cost of the premiums also will vary, depending mainly on those variables.

But don't assume that you must be bedridden to collect any benefits. Frequently, a DI insurance policy will provide "residual benefits" in the event you can work some of the time or if you're slowly getting back on your feet. Some policies even offer benefits after you've returned to work if you are earning less than you did before your disability.

The residual benefits generally kick in when the loss of income is greater than 20% of previous earnings and the decline is due to the medical condition underlying the disability. This feature could be especially valuable to small business owners, including self-employed entrepreneurs, and professionals in fee-based practices, such as physicians, attorneys, and accountants.

For example, suppose a surgeon recovering from a severe illness returned to practice but was able to see fewer patients. If the surgeon's income was reduced from $50,000 a month to $30,000, the residual benefit could restore income to 80% of the pre-disability level—in this case, $40,000 a month. Similarly, if the side effects of chemotherapy make it too hard for a litigator to appear in court or for a CPA to handle a company's books, the residual benefits can soften the economic blow.

To see what your coverage may or may not include, take a close look at existing DI policies or any new policy you're considering and have your insurance agent explain the residual benefits section. The policy might be more valuable than you imagined or the residual benefits may be too restrictive. Those provisions could be a key component of your DI insurance coverage. ●

A SEP or SIMPLE?

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long as you complete the paperwork by the company's tax return due date (plus extensions, which could be as late as October 15 of the following year).

SIMPLEs at a Glance

Like SEPs, SIMPLEs are generally exempt from most reporting rules that burden other qualified retirement plans. There are actually two varieties: the SIMPLE-IRA and the SIMPLE-401(k). For ease of administration, most small employers favor the SIMPLE-IRA. Here are the key aspects:

Eligibility: A SIMPLE is available only to employers with 100 or fewer employees. Any worker who made at least $5,000 during any two previous years at the company (and who expects to receive at least that amount in the current year) is eligible to participate.

Contributions: For 2013, eligible employees may elect to contribute up to $12,000 to the plan ($14,500 if age 50 or over). As a general rule, the employer must provide matching elective contributions of up to 3% of compensation (but no less than 1% in more than two out of five years) or non-elective contributions of 2% of each eligible employee's compensation (based on maximum compensation of $255,000 in 2013). Matching contributions are deductible by the employer.

Vesting: As with SEPs, contributions to SIMPLEs are vested immediately. Therefore, employees are free to withdraw the funds at any time, subject to an early withdrawal penalty.

Distributions: The rules for mandatory distributions from qualified plans after an employee turns age 70½ also apply to SIMPLEs. In addition, withdrawals made prior to age 59½ normally are subject to a tax penalty. But note that the penalty is increased from the usual 10% to 25% for early withdrawals within the first two years of participation. After two years, the normal 10% penalty applies.

Deadline: A SIMPLE must be set up before October 1 of the current tax year. ●

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