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POSSIBLE CHANGE TO INDIVIDUAL RETIREMENT ACCOUNTS

In May, the House of Representatives passed a bill, the Secure Act (Setting Every Community Up for Retirement Enhancements), with broad bi-partisan support. If passed by the Senate and signed into law, it will reduce the tax deferral benefits available to beneficiaries other than spouses who inherit an IRA. Currently, non-spousal beneficiaries of both traditional and Roth IRAs are generally required to withdraw (either directly or through a trust) the account balance over the unadjusted life expectancy of the beneficiaries at the date of the death of the account owner. The Secure Act would accelerate withdrawals and would generally result in inherited IRAs being emptied within 10 years after the death of the account owner.

Taxpayer favorable aspects of the Secure Act include requiring minimum annual distributions to begin at age 72 rather than the current 70½. The Act also allows contributions to IRAs by taxpayers with earned income regardless of age. Current law prohibits traditional IRA contributions after age 70½. Currently, contributions to Roth IRAs may be made after age 70½ but are subject to income limitations.

Two thoughts concerning inherited IRAs follow:

My retirement account will outlast me, what should I do?

Some of us will pass retirement savings to charity after our departure, which, hopefully, will put the funds (free of income tax) to good use. For most of us, however, our tax-deferred retirement savings will be transferred to loved ones who will pay income tax on withdrawal (except for a Roth account), and, again hopefully, spend and invest the remaining amount prudently.

Passing on a tax-deferred retirement account to a beneficiary can fulfill many different needs that your surviving beneficiary might have (current living expenses, education, future retirement). For example, under current law, passing even a modest IRA amount to a grandchild or other young beneficiary can, over a long period, produce a significant financial resource for your heir well beyond your lifetime.

To illustrate the current law, assume $50,000 of a traditional IRA is designated to a 5-year-old child, which is then transferred to the child's inherited IRA. Assume also that the IRA

(Continued on reverse)

earns 7 percent annually, and the child withdraws only the required minimum amount each year. At age 75, the beneficiary will have withdrawn a cumulative $1,240,139, and the IRA will still have an accumulated balance of $627,495. Although this sounds almost miraculous, such are the results of tax-deferred compounding of investment earnings over a very long period of time. This "stretch IRA" benefit will be all but eliminated if the Secure Act becomes law as it requires distribution within 10 years.

I've inherited a retirement account. What should I do?

What happens when one inherits a retirement account depends on a number of factors: type of account (Regular IRA, Roth IRA, 401(k) account, etc.), your relationship to the decedent (spouse or non-spouse), age of the decedent, your age, etc. An adequate discussion of the choices and rules is beyond the scope of this article. Briefly, however, the beneficiary generally has the option to withdraw any amount at any time and pay the income tax, but subject to a required minimum withdrawal each year over the beneficiary's lifetime beginning in the year following the original account owner's death. However, if the original account owner died prior to the beginning of his or her required minimum distributions (age 70-1/2), and the beneficiary's lifetime distributions are not started timely, then a penalty will generally apply unless the entire retirement account is withdrawn by the beneficiary within five years of the original account owner's death.

If you are an owner or beneficiary of a retirement account, you will want to understand the basic distribution rules and your options. The retirement plan administrator or IRA custodian should be able to explain your options in detail, and we encourage you to ask for their written explanation. Also, please let us know if we can be of any help as you consider your options.

Importance of Beneficiary Designations

While on the subject of retirement accounts, we want to emphasize the importance of updating beneficiary designation forms (including those for life insurance, annuities, etc.) when major changes occur in your life. Unlike most of your other assets, qualified retirement plan accounts, IRAs, life insurance, and annuities will not be distributed at your death according to your will (unless you designate your estate as the beneficiary). Those accounts will pass directly to the account's designated beneficiary without going through probate. Unfortunately, there continue to be incidents of benefits being paid to a no longer intended person (for example, a former spouse) to the dismay of a current spouse or decedent's descendants. Please remember that Designation of Beneficiary forms require updating (just as your will does) whenever major changes occur in your life.

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Tax & Business Alert

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CONSIDER THE FLEXIBILITY OF A SELF-DIRECTED IRA

Traditional and Roth IRAs can be relatively "safe" retirement-savings vehicles, depending on what they're invested in. But a drawback is that they limit your investment choices. A self-directed IRA gives you more flexibility in your investment choices but comes with greater risk as well.

GAINING MORE CONTROL

A self-directed IRA is simply an IRA that gives you greater control over investment decisions. Traditional IRAs typically offer a selection of stocks, bonds and mutual funds. Self-directed IRAs (available at certain financial institutions) offer greater diversification and potentially higher returns by permitting you to select virtually any type of investment, including real estate, closely held stock, limited liability company and partnership interests, loans, precious metals, and commodities (such as lumber and oil and gas).

A self-directed IRA can be a traditional or Roth IRA, a Simplified Employee Pension (SEP) plan, or a Savings Incentive Match Plan for Employees (SIMPLE). It's also possible to have a self-directed individual 401(k) plan, Health Savings Account or Coverdell Education Savings Account.

Self-directed Roth IRAs are particularly powerful estate planning tools, because they offer tax-*free* investment growth. (See "IRAs and your estate plan" on page 2.)

NAVIGATING THE TAX TRAPS

To avoid pitfalls that can lead to unwanted tax consequences, caution is required when using self-directed IRAs. The most dangerous traps are the prohibited transaction rules.

These rules are designed to limit dealings between an IRA and "disqualified persons," including account holders, certain members of account holders' families, businesses controlled by account holders or their families, and certain IRA advisors or service providers. Among other things, disqualified persons may not sell property or lend money to the IRA, buy property from the IRA, provide goods or services to the IRA, guarantee a loan to the IRA, pledge IRA assets as security for a loan, receive compensation from the IRA or personally use IRA assets.

The penalty for engaging in a prohibited transaction is severe: The IRA is disqualified and all its assets are deemed to have been distributed on the first day of the year in which the transaction took place, subject to income taxes and, potentially, penalties.

IRAs AND YOUR ESTATE PLAN

IRAs are designed primarily as retirement-saving tools, but if you don't need the funds for retirement, they can provide a tax-advantaged source of wealth for your family. For example, if you name your spouse as beneficiary, your spouse can roll the funds over into his or her own IRA after you die, enabling the funds to continue growing on a tax-deferred basis (tax-free in the case of a Roth IRA).

If you name a child (or someone other than your spouse) as beneficiary, that person will have to begin taking distributions immediately. But if the funds are held in an "inherited IRA," your beneficiary can stretch the distributions over his or her own life expectancy, maximizing the IRA's tax benefits.

This makes it very difficult to manage a business, real estate or other investments held in a self-directed IRA. So, unless you're prepared to accept a purely passive role with respect to the IRA's assets, this strategy isn't for you.

CONSIDERING THE OPTION

If you have assets such as precious metals, energy or other alternative investments, a self-directed IRA may be worth your while to consider. Contact our firm to discuss further. ■

TAX DOCUMENT RETENTION GUIDELINES FOR SMALL BUSINESSES

You may have breathed a sigh of relief after filing your 2018 income tax return (or requesting an extension). But is your office strewn with reams of paper consisting of years' worth of tax returns, receipts, canceled checks and other financial records? Or perhaps your computer desktop is filled with a multitude of digital tax-related files? You'll find it easier to file next year if you cut down on the clutter. To perform a summer cleanup, follow these retention guidelines.

GENERAL RULES

Retain records that support items shown on your tax return at least until the statute of limitations runs out — generally three years from the due date of the return or the date you filed, whichever is later. That means you can now potentially throw out records for the 2015 tax year if you filed the return for that year by the regular filing deadline. But some records should be kept longer.

For example, there's no statute of limitations if you fail to file a tax return or file a fraudulent one. So, you'll generally want to keep copies of your returns themselves permanently, so you can show that you did file a legitimate return.

Also bear in mind that, if you understate your adjusted gross income by more than 25%, the statute of limitations period is six years.

SOME BUSINESS SPECIFICS

Records substantiating costs and deductions associated with business property are necessary to determine the basis and any gain or loss when the property is sold. According to IRS guidelines, you should keep these for as long as you own the property, plus seven years.

The IRS recommends keeping employee records for three years after an employee has been terminated. In addition, you should maintain records that support employee earnings for at least four years. (This timeframe generally will cover varying state and federal requirements.) Also keep employment tax records for four years from the date the tax was due or the date it was paid, whichever is longer.

For travel and transportation expenses supported by mileage logs and other receipts, keep supporting documents for the three-year statute of limitations period. Regulations for sales tax returns vary by state. Check the rules for the states where you file sales tax returns. Retention periods typically range from three to six years.

WHEN IN DOUBT, DON'T THROW IT OUT

If you're unsure whether you should retain a document, a good rule of thumb is to hold on to it for at least six years or, for property-related records, at least seven years after you dispose of the property. But, again, you should keep tax returns themselves permanently, and other rules or guidelines might apply in certain situations. We can answer any questions you might have. ■

KNOW A TEACHER? TELL 'EM ABOUT THIS TAX BREAK!

When teachers are setting up their classrooms for the new school year, it's common for them to pay for a portion of their classroom supplies out of pocket. A special tax break allows these educators to deduct some of their expenses. This educator expense deduction is especially important now due to some changes under the Tax Cuts and Jobs Act (TCJA).

OLD SCHOOL

Before 2018, employee business expenses were potentially deductible if they were unreimbursed by the employer and ordinary and necessary to the "business" of being an employee. A teacher's out-of-pocket classroom expenses could qualify.

But these expenses had to be claimed as a miscellaneous itemized deduction and were subject to a 2% of adjusted gross income (AGI) floor. This meant employees, including teachers, could enjoy a tax benefit only if they itemized deductions (rather than taking the standard deduction) and only to the extent that all their deductions subject to the floor, combined, exceeded 2% of their AGI.

Now, for 2018 through 2025, the TCJA has suspended miscellaneous itemized deductions subject to the 2% of AGI floor. Fortunately, qualifying educators can still deduct some of their unreimbursed out-of-pocket classroom costs under the educator expense deduction.

NEW SCHOOL

Back in 2002, Congress created the above-the-line educator expense deduction because, for many teachers, the 2% of AGI threshold for the miscellaneous itemized deduction was difficult to meet. An above-the-line deduction is one that's subtracted from your gross income to determine your AGI.

You don't have to itemize to claim an above-the-line deduction. This is especially significant with the

TCJA's near doubling of the standard deduction, which means fewer taxpayers will benefit from itemizing.

Qualifying elementary and secondary school teachers and other eligible educators (such as counselors and principals) can deduct above the line up to $250 of qualified expenses. If you're married filing jointly and both you and your spouse are educators, you can deduct up to $500 of unreimbursed expenses — but not more than $250 each.

Qualified expenses include amounts paid or incurred during the tax year for books, supplies, computer equipment (including related software and services), other equipment and supplementary materials that you use in the classroom. For courses in health and physical education, the costs of supplies are qualified expenses only if related to athletics.

MORE DETAILS

Some additional rules apply to the educator expense deduction. If you're an educator or know one who might be interested in this tax break, please contact us for more details. ■

PLANNING FOR THE NET INVESTMENT INCOME TAX

Despite its name, the Tax Cuts and Jobs Act (TCJA) didn't cut all types of taxes. It left several taxes unchanged, including the 3.8% tax on net investment income (NII) of high-income taxpayers.

You're potentially liable for the NII tax if your modified adjusted gross income (MAGI) exceeds $200,000 ($250,000 for joint filers and qualifying widows or widowers; $125,000 for married taxpayers filing separately). Generally, MAGI is the same as adjusted gross income. However, it may be higher if you have foreign earned income and certain foreign investments.

To calculate the tax, multiply 3.8% by the lesser of 1) your NII, or 2) the amount by which your MAGI exceeds the threshold. For example, if you're single with $250,000 in MAGI and $75,000 in NII, your tax would be 3.8% × $50,000 ($250,000 – $200,000), or $1,900.

NII generally includes net income from, among others, taxable interest, dividends, capital gains, rents, royalties and passive business activities. Several types of income are excluded from NII, such as wages, most nonpassive business income, retirement plan distributions and Social Security benefits. Also excluded is the nontaxable gain on the sale of a personal residence.

Given the way the NII tax is calculated, you can reduce the tax either by reducing your MAGI or reducing your NII. To accomplish the former, you could maximize contributions to IRAs and qualified retirement plans. To do the latter, you might invest in tax-exempt municipal bonds or in growth stocks that pay little or no dividends.

There are many strategies for reducing the NII tax. Consult with one of our tax advisors before implementing any of them. And remember that, while tax reduction is important, it's not the only factor in prudent investment decision-making. ■