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EPIC CAPITAL

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Consider an IRA Charitable Rollover

If you want as tax break and want to help a non-profit, this may be a good move.

HAve you ever wanted to make a charitable gift? Would you like a significant federal tax break in acknowledgment of that gift? If so, an IRA charitable rollover may be a good financial step to take.

If you are age 70½ or older and have one or more traditional IRAs, you may want to explore the potential of this tax provision, first introduced in 2006 and recently made permanent by Congress. In the language of federal tax law, it is called a Qualified Charitable Distribution (QCD) – a direct transfer of up to $100,000 from the IRA to a qualified charity.[1,2]

An IRA charitable rollover may help you lower your adjusted gross income. That may be a goal in your tax strategy, especially if your AGI is large enough to position you for increased Medicare premiums, greater taxation of your Social Security benefits, or exposure to the 3.8% investment income tax and the 0.9% Medicare surtax. If your AGI passes a certain threshold, you also lose the ability to itemize deductions.[2]

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Up to $100,000 may be excluded from your gross income in the year in which you make the gift. The gifted amount also counts toward your Required Minimum Distribution (RMD).[1,2]

By the way, this $100,000 annual QCD limit is per individual. If you are married, you and your spouse may gift up to $200,000 in a year through IRA charitable rollovers. Imagine lowering your household's AGI by as much as $200,000 in a tax year.[2]

A QCD will not afford you an opportunity for a charitable deduction. That would amount to a double benefit for the taxpayer making the gift, which is not something federal tax law allows.[3]

You need not be rich to do this. When many people first learn about the IRA charitable rollover, they think it is only for multi-millionaires. That is a misconception. Even if you do not think of yourself as wealthy, a QCD could prove a significant element in your tax strategy.

How does it work? Logistically speaking, an IRA charitable rollover is a trustee-to-trustee transfer: *the IRA owner does not take possession of the money as the gift is arranged.* Rather, the custodian or trustee overseeing the IRA writes a check for the amount of the gift payable to the charity. It is a direct transfer of funds, not a withdrawal.[2]

An IRA owner must be age 70½ or older to do this, and he or she must be the original owner of the IRA (an inherited IRA may not be used). The gifted assets must come from an IRA (or multiple IRAs) subject to RMD rules. SEPs and SIMPLE IRAs are ineligible if an employer contribution has been made for the particular year.[4,5]

Can you gift appreciated securities as well as cash? You can. Securities held within an IRA may be directly transferred from an IRA to a qualified charity in a QCD. You can claim an income tax deduction for the full fair market value of those securities.[4,5]

The charity or non-profit involved must pass muster with the IRS. It must be an entity that qualifies for a charitable income tax deduction of an individual taxpayer, and it cannot be a donor-advised fund, a private foundation that makes grants, or a supporting organization under Internal Revenue Code Section 509(a)(3). The charity must provide you with a letter of acknowledgement denoting that you received no goods, services, or benefits of any kind in exchange for your gift, and that you shall not receive any in the future as a consequence of your gift. If that letter is not quickly sent to you, be firm in requesting it.[4,5]

"Up to $100,000 may be excluded from your gross income in the year in which you make the gift."

In case you are wondering, you can actually contribute more than your IRA RMD amount for a particular year through an IRA charitable rollover, as long as the gifted amount does not exceed $100,000. If you pledge a donation to a qualified charity or non-profit, an IRA charitable rollover can be used to satisfy your pledge.[5]

This tax break has been a boon to charities and IRA owners alike. Correctly performed, a charitable IRA rollover may help to lessen tax issues while benefiting qualified non-profit organizations.

TOD or Living Trust?

A look at two basic methods for shielding assets from probate.

How do you keep assets out of probate? If that estate planning question is on your mind, you should know that there are two basic ways to accomplish that objective.

One, you could create a revocable living trust. You can serve as its trustee, and you can fund it by retitling certain accounts and assets into the name of the trust. A properly written and properly implemented revocable living trust allows you to have complete control over those retitled assets during your lifetime. At your death, the trust becomes irrevocable and the assets within it can pass to your heirs without being probated (but they will be counted in your taxable estate). In most states, assets within a revocable living trust transfer privately, i.e., the trust documents do not have to be publicly filed.[1]

If that sounds like too much bother, an even simpler way exists. Transfer-on-death (TOD) arrangements may be used to pass certain assets to designated beneficiaries. A beneficiary form states who will directly inherit the asset at your death. Under a TOD arrangement, you keep full control of the asset during your lifetime and pay taxes on any income the asset generates as you own it outright. TOD arrangements require minimal paperwork to establish.[2]

This is not an either/or decision; you can use both of these estate planning moves in pursuit of the same goal. The question becomes: which assets should transfer via a TOD arrangement versus a trust?

Many investment accounts can be made TOD accounts. Originally, that was not the case – for decades, only bank accounts and certain types of savings bonds could pass to beneficiaries through TOD arrangements. When the Uniform Transfer on Death Security Registration Act became law in the 1980s, the variety of assets that could be transferred through TOD language grew to include certificates of deposit and securities and brokerage accounts.[2]

"The beauty of the TOD arrangement is that the beneficiary form establishes the simplest imaginable path for the asset as it transfers from one owner to another."

Many investment & retirement savings accounts are TOD to begin with. Take IRAs and workplace retirement plans, for example. In the case of those assets, the beneficiary form legally precedes any bequest made in a will.[3]

The beauty of the TOD arrangement is that the beneficiary form establishes the simplest imaginable path for the asset as it transfers from one owner to another. The risk is that the instruction in the beneficiary form will contradict something you have stated in your will.

One common situation: a parent states in a will that her kids will receive equal percentages of her assets, but due to TOD language, the assets go to the kids not by equal percentage but by account, with the result that the heirs have slightly or even greatly unequal percentages of family wealth. Will they elect to redistribute the assets they have inherited this way, in fairness to one another? Perhaps, and perhaps not.

Placing valuable property items into a living trust makes sense. Real estate, ownership shares, precious metals, pricy collectibles such as fine art, classic cars, antiques, and rare stamps and coins – these are all worthy candidates for inclusion in a living trust. If your net worth happens to run well into the millions, these assets may constitute

the bulk of it, and a trust offers a degree of protection for such assets that TOD language cannot. A trust also allows you to name a successor trustee, which TOD language cannot do for you.[2]

A "pour-over" will usually complements a revocable living trust. As your net worth will presumably keep growing after the trust is implemented, a "pour-over" will may be used to allow your executor to "pour over" assets not already in the trust at your death into the trust. That will mean added privacy for those assets in most states – but the downside is that these "poured-over" assets will be subject to probate.[1]

Of course, you can add and subtract from the original contents of a revocable living trust as you wish during your lifetime – you can remove assets retitled into it when it was originally created and retitle them again in your name, you can "pour in" new assets, and you can sell or give away specific assets in the trust.[4]

Is it ever wise to name a trust as the beneficiary of a retirement account? Under three circumstances, it might be worth doing. If you worry about your heirs rapidly spending down your IRA assets, for example, naming a trust as the IRA beneficiary more or less forces them to abide by a stretch IRA strategy. Are there "predators and creditors" who want some of your net worth? That is another reason to consider this move. If you want to leave your retirement account assets to someone who is currently a minor, this idea may be worthwhile as well.[4]

How complex should your estate planning be? A conversation with a trusted legal or financial professional may help you answer that question, and illuminate whether simple TOD language or a trust is right to keep certain assets away from probate.

Explaining the Basis of Inherited Real Estate

What is cost basis? Stepped-up basis? How does the home sale tax exclusion work?

At some point in our lives, we may inherit a home or another form of real property. In such instances, we need to understand some of the jargon involving inherited real estate. What does "cost basis" mean? What is a "step-up?" What is the home sale tax exclusion, and what kind of tax break does it offer?

Very few parents discuss these matters with their children before they pass away. Some prior knowledge of these terms may make things less confusing at a highly stressful time.

Cost basis is fairly easy to explain. It is the original purchase price of real estate plus certain expenses and fees incurred by the buyer, many of them detailed at closing. The purchase price is always the starting point for determining the cost basis; that is true whether the purchase is financed or all-cash. Title insurance costs, settlement fees, and property taxes owed by the seller that the buyer ends up paying can all become part of the cost basis.[1]

At the buyer's death, the cost basis of the property is "stepped up" to its current fair market value. This step-up can cut into the profits of inheritors should they elect to sell. On the other hand, it can also reduce any income tax liability stemming from the transaction.[2]

Here is an illustration of stepped-up basis. Twenty years ago, Jane Smyth bought a home for $255,000. At purchase, the cost basis of the property was $260,000. Jane dies and her daughter Blair inherits the home. Its

present fair market value is $459,000. That is Blair's stepped-up basis. So if Blair sells the home and gets $470,000 for it, her complete taxable profit on the sale will be $11,000, not $210,000. If she sells the home for less than $459,000, she will take a loss; the loss will not be tax-deductible, as you cannot deduct a loss resulting from the sale of a personal residence.[1]

The step-up can reflect more than just simple property appreciation through the years. In fact, many factors can adjust it over time, including negative ones. Basis can be adjusted upward by the costs of home improvements and home additions (and even related tax credits received by the homeowner), rebuilding costs following a disaster, legal fees linked to property ownership, and expenses of linking utility lines to a home. Basis can be adjusted downward by property and casualty insurance payouts, allowable depreciation that comes from renting out part of a home or using part of a residence as a place of business, and any other developments that amount to a return of cost for the property owner.[1]

"Basis can be adjusted upward by the costs of home improvements and home additions…"

The Internal Revenue Code states that a step-up applies for real property "acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." In plain English, that means the new owner of the property is eligible for the step-up whether the deceased property owner had a will or not.[2]

In a community property state, receipt of the step-up becomes a bit more complicated. If a married couple buys real estate in Arizona, California, Idaho, Louisiana, New Mexico, Nevada, Texas, Washington, or Wisconsin, each spouse is automatically considered to have a 50% ownership interest in said real property. (Alaska offers spouses the option of a community property agreement.) If a child or other party inherits that 50% ownership interest, that inheritor is usually entitled to a step-up. If at least half of the real estate in question is included in the decedent's gross estate, the surviving spouse is also eligible for a step-up on his or her 50% ownership interest. Alternately, the person inheriting the ownership interest may choose to value the property six months after the date of the previous owner's death (or the date of disposition of the property, if disposition occurred first).[2,3]

In recent years, there has been talk in Washington of curtailing the step-up. So far, such notions have not advanced toward legislation.[4]

What if a parent gifts real property to a child? The parent's tax basis becomes the child's tax basis. If the parent has owned that property for decades and the child cannot take advantage of the federal home sale tax exclusion, the capital gains tax could be enormous if the child sells the property.[2]

Who qualifies for the home sale tax exclusion? If individuals or married couples want to sell an inherited home, they can qualify for this big federal tax break once they have used that home as their primary residence for two years out of the five years preceding the sale. Upon qualifying, a single taxpayer may exclude as much as $250,000 of gain from the sale, with $500,000 being the limit for married homeowners filing jointly. If the home's cost basis receives a step-up, the gain from the sale may be small, but this is still a nice tax perk to have.[5]

Financial Planning with Health Insurance in Mind

How much might health care cost you someday?

"Financially speaking, what would be the worst thing that could happen to you?" If you ask a hundred people in their forties that question, you may get a dozen different answers. Some may say "my business going under" or "losing my house." Some might say "a divorce," "a lawsuit," or "being laid off." But how many would say "a severe illness?"

A catastrophic illness seems like a remote possibility to many; distant, decades away. As a result, that possibility may be overlooked in our financial planning.

The healthiest of us may need to save the most for health care. This may seem paradoxical, but think about what many people in their eighties or nineties experience: years of declining health and mobility, and accompanying high health care expenses.

Two projections of average retirement health care costs are very illuminating in this regard. Empower Institute (an offshoot of retirement plan administration firm Great-West Financial) has calculated the amount of money that 65-year-old males with particular medical conditions will need in order to absorb 90% or more of future health care expenses. A 65-year-old man with Type 2 diabetes, forexample, will need $88,300 (in today's dollars) to cope with those costs, according to Empower's projection. It also estimates that a 65-year-old tobacco user will require $114,900 and a healthy, non-smoking 65-year-old male, $143,800.[1]

Why the difference? According to the Empower forecast, the 65-year-old diabetic has a life expectancy of 78, versus 81 for the tobacco user, and 87 for his healthier counterpart.[1]

How about a healthy 65-year-old woman? Empower projects she will need a retirement health care fund of $156,000, as women currently outlive men on average.[1]

Another take on all this comes from the respected Employee Benefit Research Institute. EBRI estimates that the average healthy 65-year-old today will need $124,000 to handle future medical expenses. EBRI's director of health research, Paul Fronstin, told the *Wall Street Journal* that a pre-retiree should adjust that number for inflation as follows: increase it by 5% for each year remaining until your planned retirement date. So if you are 50 right now, you will need about $250,000 to cover medical costs if you retire in 2031.[1]

> *"The healthiest of us may need to save the most for health care."*

The more you earn, the more you may pay for essential health benefits. Take the case of Medicare premiums. Most Medicare beneficiaries who are single filers with modified adjusted gross incomes of $85,000 or less are paying monthly Part B premiums of $104.90-$121.80 this year. In contrast, single filers with MAGIs between $85,001-107,000 are paying Part B premiums of $170.50 a month. That premium jumps to $243.60 for a single filer with MAGI greater than $107,000, and

extremely high-earning individuals pay more than that. Pre-retirees should be mindful of this, and the fact that Medicare does not pay for long term care or dental care.[2,3]

Your income level may also affect how much you pay for health coverage before you retire. As an example, a Texas household of four that expects its 2016 income to be between $24,300 and $60,625 can go to the Health Insurance Marketplace and qualify for health plans with relatively low premiums, plus savings on deductibles and copayments. A similarly sized Texas household with income higher than $97,000 cannot qualify for any such savings and must pay full price for their health coverage at the Marketplace.[4]

So looking ahead, is a Health Savings Account a good idea? For the future, it may be. HSAs must be used in conjunction with high-deductible health plans, but even with that requirement, these accounts can give pre-retirees a nice, dedicated savings vehicle to plan for future health care expenses. An HSA may become an important part of a long-run financial strategy.[5]

The annual contribution limit on an HSA is currently $3,350 for individuals, $6,750 for families. Contributions are 100% tax-deductible. (You can even make $1,000 catch-up contributions beginning in the year you turn 55, as long as you are not a Medicare recipient.) You can also optionally invest the money within the account. An HSA is tax-advantaged: assets get tax-free growth, and withdrawals are tax-free if you use the money to pay for qualified health expenses. HSAs also have another nice feature: once you turn 65, you may use withdrawals from them for non-medical purposes, though such withdrawals will be taxable. If you enroll in Medicare, you can no longer contribute to an HSA – so it is vital to fund these accounts for some years before retiring.[5,6]

It is only prudent to factor potential health care costs into your financial plan. Some healthy pre-retirees may assume that they will need only a five-figure rather than six-figure sum to address them. That assumption may be flawed.

If you would like to further discuss any of the topics written about in this newsletter, or inquire about any of our other services, please feel free to contact us

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