October 2016 Newsletter

Newsletter

Korbitz Financial Planning LLC

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Clients and Friends: This newsletter finds us in the middle of fall, my favorite season due to the cooler temperatures and changing colors of our world.

I continue to receive calls from "the IRS" demanding my immediate payment or I will be called before a "magistrate judge." I know many of you receive these calls too. This is another reminder that the IRS will **never** initiate a telephone call to you. If you receive a call like this, hang up immediately.

The first article addresses an area of increased IRS scrutiny: charitable contribution documentation. The IRS has targeted these deductions and is routinely disallowing them without the appropriate documentation.

The second article discusses the different types of 401(k) contributions and how you choose which to make.

The third article talks about inherited IRAs, which are becoming more common.

Finally, the fourth page is aimed at readers age 65 and older who are on Medicare.

Please let me know if you have any questions.

Eric

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Substantiating Your Charitable Gifts

When you claim a federal income tax deduction for charitable contributions, you must substantiate the contributions by maintaining certain records. The records must establish the charity to whom the gift was made, the amount of cash or the type and value of other property donated to charity, whether anything was received in consideration for the contribution, and certain other requirements. The records needed generally depend on the type and value of the property donated; there may be some overlap in requirements. In general, do not attach the records to your income tax return. Keep the records so that you can provide them to the IRS if requested to do so.

Cash contributions

In order to claim a charitable deduction for any contribution of cash, a check, or other monetary gift, you must maintain a record of such contributions through a bank record (such as a cancelled check, a bank or credit union statement, or a credit card statement) or a written communication (such as a receipt or letter) from the charity showing the name of the charity, the date of the contribution, and the amount of the contribution. If you make charitable contributions through payroll deductions, you generally may substantiate the charitable deduction using the charity's pledge card along with either a pay stub, a Form W-2, or some other employer-furnished document showing the amount withheld and paid to charity. If you make a single contribution of $250 or more by payroll deduction, the pledge card or a document from the charity must state that no goods or services were provided in return for the payroll deduction.

All contributions of $250 or more

If you claim a charitable deduction for any contribution of $250 or more, you must substantiate the contribution with a contemporaneous written acknowledgment of the contribution from the charity. The acknowledgment must contain the name of the charity, the amount of any cash contribution, and a reasonably detailed description of any non-cash contribution. The acknowledgment must also include either (1) a statement that no goods and services were provided by the charity in return for the contribution, (2) a good-faith estimate of the value of such goods and services (these reduce the amount of the charitable deduction), or (3) a statement that the goods and services were token benefits or consisted entirely of insubstantial membership benefits or intangible religious benefits. The acknowledgment is considered contemporaneous if you receive it by the earlier of the date on which you file your tax return for the year of the contribution or the due date (including extensions) for the return.

Noncash contributions

If you make any noncash contributions, you must generally get a receipt from the charitable organization with the name of the charitable organization, the date and location of the contribution, and a reasonably detailed description of the property. You must also keep a reliable written record showing the name and address of the charitable organization, the date and location of the contribution, a reasonable detailed description of the property, the fair market value of the property (and how it was determined), the adjusted basis of the property, the amount claimed as a deduction, and the terms of any conditions attached to contribution of the property.

If the value of the contribution is $250 or more, you must also substantiate the contribution with a contemporaneous written acknowledgment of the contribution from the charity as described previously.

If the value of the contribution is over $500, your records must also include how you got the property (e.g., purchase, gift, inheritance, or exchange), when you got the property, and the cost or other basis of the property (including any adjustments).

If you claim a deduction of over $5,000 for a noncash charitable contribution of one item or a group of similar items, you must also obtain a qualified written appraisal of the donated property from a qualified appraiser.

Pretax, Roth, or After-Tax Contributions: Which Should You Choose?

When choosing between pretax and Roth contributions, the general rule is to consider whether you think you will benefit more from the tax break today than you would from a tax break in retirement. Specifically, if you think you'll be in a higher tax bracket in retirement, Roth contributions may be more beneficial in the long run.

Generally, non-Roth after-tax contributions should be considered after reaching the maximum contribution amount for pretax and Roth options.

Keep in mind that distributions of earnings on non-Roth after-tax contributions will be subject to regular income taxes and possibly penalty taxes if not rolled over to a traditional IRA. IRS Notice 2014-54 clarifies the rules regarding rollovers of non-Roth after-tax plan contributions to a Roth IRA.

For more information specific to your situation, consult a qualified tax professional. (Working with a tax or financial professional cannot guarantee financial success.)

If your employer-sponsored retirement savings plan allows pretax, after-tax, and/or Roth contributions, which should you choose?

Pretax: Tax benefits now

With pretax contributions, the money is deducted from your paycheck before taxes, which helps reduce your taxable income and the amount of taxes you pay now. Consider the following example, which is hypothetical and has been simplified for illustrative purposes.

Example(s): *Mark earns $2,000 every two weeks before taxes. If he contributes nothing to his retirement plan on a pretax basis, the amount of his pay that will be subject to income taxes would be the full $2,000. If he was in the 25% federal tax bracket, he would pay $500 in federal income taxes, reducing his take-home pay to $1,500. On the other hand, if he contributes 10% of his income to the plan on a pretax basis--or $200--he would reduce the amount of his taxable pay to $1,800. That would reduce the amount of taxes due to $450. After accounting for both federal taxes and his plan contribution, Mark's take-home pay would be $1,350. The bottom line? Mark would be able to invest $200 toward his future but reduce his take-home pay by just $150. That's the benefit of pretax contributions.*

In addition, any earnings made on pretax contributions grow on a tax-deferred basis. That means you don't have to pay taxes on any gains each year, as you would in a taxable investment account. However, those tax benefits won't go on forever. Any money withdrawn from a tax-deferred account is subject to ordinary income taxes, and if the withdrawal takes place prior to age 59½ (or in some cases, 55 or 50, depending on your plan's rules), you may be subject to an additional 10% penalty on the total amount of the distribution.

Roth: Tax benefits down the road

On the other hand, contributing to an employer-sponsored Roth account offers different benefits. Roth contributions are considered "after-tax," so you won't reduce the amount of current income subject to taxes. But qualified distributions down the road will be tax-*free.*

A qualified Roth distribution is one that occurs:

- After a five-year holding period and
- Upon death, disability, or reaching age 59½

Nonqualified distributions are subject to regular income taxes and a possible 10% penalty tax. However, because Roth contributions are made with after-tax dollars, a distinction is made between the portion of the distribution that represents contributions versus earnings on those contributions. If at some point you need to take a nonqualified withdrawal from a Roth 401(k)--due to an unexpected emergency, for example--only the proportion of the total amount representing earnings will be taxable.

Example(s): *In order to meet an unexpected financial need of $8,000, Tina decides to take a nonqualified hardship distribution from her Roth 401(k) account. Of the $20,000 total value of the account, $18,400 represents after-tax Roth contributions and $1,600 is attributed to investment earnings. Because earnings represent 8% of the total account value ($1,600 ÷ $20,000 = 0.08), this same proportion of Tina's $8,000 distribution--or $640 ($8,000 x .08)--will be considered earnings subject to both income taxes and a 10% penalty tax.*

However, keep in mind that tapping your account before retirement defeats its purpose. If you need money in a pinch, try to exhaust all other possibilities before taking a distribution. Always bear in mind that the most important benefit of a Roth account is the opportunity to build a nest egg of tax-free income for retirement.

After-tax: For those who are able to exceed the limits

Some plans allow participants to make additional after-tax contributions. This plan feature helps those who want to make contributions exceeding the annual total limit on pretax and Roth accounts (in 2016, the limit is $18,000; $24,000 for those age 50 or older). As with a traditional pretax account, earnings on after-tax contributions grow on a tax-deferred basis.

If this option is offered (check your plan documents), keep in mind that total employee and employer contributions cannot exceed $53,000, or $59,000 for those 50 and older (2016 limits).

Another benefit of making after-tax contributions is that when you leave your job or retire, they can be rolled over tax-free to a Roth IRA, which also allows for potential tax-free growth from that point forward. Some higher-income individuals may welcome this potential benefit if their income affects their ability to directly fund a Roth IRA.[1]

[1] In addition to rolling the proceeds to a Roth IRA, participants may also (1) leave the assets in the original plan, (2) transfer assets to a new employer's plan, or (3) withdraw the funds (which in some cases could trigger a taxable event).

Five Things to Know About Inherited IRAs

You are generally not the "owner" of an inherited IRA. The practical result of this fact is that you can't mix inherited IRA funds with your own IRA funds, and you can't make 60-day rollovers to and from the inherited IRA. Spousal beneficiaries, however, may be able to assume actual ownership of an inherited IRA.

****If the traditional IRA owner died after age 70-1/2 and did not take an RMD for the year of his or her death, you must also withdraw any remaining RMD amount for that year.***

When an IRA owner dies, the IRA proceeds are payable to the named beneficiary--or to the owner's estate if no beneficiary is named. If you've been designated as the beneficiary of a traditional or Roth IRA, it's important that you understand the special rules that apply to "inherited IRAs."

It's not really "your" IRA

As an initial matter, while you do have certain rights, you are generally not the "owner" of an inherited IRA. The practical result of this fact is that you can't mix inherited IRA funds with your own IRA funds, and you can't make 60-day rollovers to and from the inherited IRA. You also need to calculate the taxable portion of any payment from the inherited IRA separately from your own IRAs, and you need to determine the amount of any required minimum distributions (RMDs) from the inherited IRA separately from your own IRAs.

But if you inherited the IRA from your spouse, you have special options. You can take ownership of the IRA funds by rolling them into your own IRA or into an eligible retirement plan account. If you're the sole beneficiary, you can also leave the funds in the inherited IRA and treat it as your own IRA. In either case, the IRA will be yours and no longer treated as an inherited IRA. As the new IRA *owner* (as opposed to *beneficiary*), you won't need to begin taking RMDs from a traditional IRA until you reach age 70½, and you won't need to take RMDs from a Roth IRA during your lifetime at all. And as IRA owner, you can also name new beneficiaries of your choice.

Required minimum distributions

As beneficiary of an inherited IRA--traditional or Roth--you must begin taking RMDs after the owner's death.* In general, you must take payments from the IRA annually, over your life expectancy, starting no later than December 31 of the year following the year the IRA owner died. But if you're a spousal beneficiary, you may be able to delay payments until the year the IRA owner would have reached age 70½.

In some cases you may be able to satisfy the RMD rules by withdrawing the entire balance of the inherited IRA (in one or more payments) by the fifth anniversary of the owner's death. In almost every situation, though, it makes sense to use the life expectancy method instead--to stretch payments out as long as possible and take maximum advantage of the IRA's tax-deferral benefit.

You can always elect to receive more than the required amount in any given year, but if you receive less than the required amount you'll be subject to a federal penalty tax equal to 50% of the difference between the required distribution and the amount actually distributed.

More stretching...

What happens if you elect to take distributions over your life expectancy but you die with funds still in the inherited IRA? This is where your IRA custodial/trustee agreement becomes crucial. If, as is sometimes the case, your IRA language doesn't address what happens when you die, then the IRA balance is typically paid to your estate--ending the IRA tax deferral.

Many IRA providers, though, allow you to name a successor beneficiary. In this case, when you die, your successor beneficiary "steps into your shoes" and can continue to take RMDs over your remaining distribution schedule.

Federal income taxes

Distributions from inherited IRAs are subject to federal income taxes, except for any Roth or nondeductible contributions the owner made. But distributions are never subject to the 10% early distribution penalty, even if you haven't yet reached age 59½. (This is one reason why a surviving spouse may decide to remain as beneficiary rather than taking ownership of an inherited IRA.)

When you take a distribution from an inherited Roth IRA, the owner's nontaxable Roth contributions are deemed to come out first, followed by any earnings. Earnings are also tax-free if made after a five-calendar-year holding period, starting with the year the IRA owner first contributed to any Roth IRA. For example, if the IRA owner first contributed to a Roth IRA in 2014 and died in 2016, any earnings distributed from the IRA after 2018 will be tax-free.

Creditor protection

Traditional and Roth IRAs are protected under federal law if you declare bankruptcy. The IRA bankruptcy exemption was originally an inflation-adjusted $1 million, which has since grown to $1,283,025. Unfortunately, the U.S. Supreme Court has ruled that inherited IRAs are not covered by this exemption. (If you inherit an IRA from your spouse and treat that IRA as your own, it's possible that the IRA won't be considered an inherited IRA for bankruptcy purposes, but this was not specifically addressed by the Court.) This means that your inherited IRA won't receive any protection under federal law if you declare bankruptcy. However, the laws of your particular state may still protect those assets, in full or in part, and may provide protection from creditors outside of bankruptcy as well.

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Do I need to make any changes to my Medicare coverage for next year?

During the Medicare Open Enrollment Period that runs from October 15 through December 7, you can make changes to your Medicare coverage that will be effective on January 1, 2017. If you're satisfied with your current coverage, you don't need to make changes, but you should review your options before you decide to stay with your current plan.

Your Medicare plan sends two important documents every year that you should review. The first, called the Evidence of Coverage, provides information about what your plan covers and its cost. The second, called the Annual Notice of Change, lists changes to your plan for the upcoming year that will take effect in January. You can use these documents to evaluate your current plan and decide whether you need different coverage. You should also review the official government handbook, *Medicare & You 2017,* which is available electronically or through the mail. It contains detailed information about Medicare that should help you determine whether your current plan is right for you.

As you review your coverage, here are a few points to consider:

- What were your health costs during the past year, and what did you spend the most on?
- Will your current plan cover all the services you need and the health-care providers you need to see next year?
- Does your current plan cost more or less than other options? Consider premiums, deductibles, and other out-of-pocket costs such as copayments or coinsurance costs; are any of these costs changing?
- Do you need to join a Medicare prescription drug plan? When comparing plans, consider the cost of drugs under each plan, and make sure the drugs you take will still be covered next year.

If you have questions about Medicare, you can call 1-800-MEDICARE or visit the Medicare website at medicare.gov. You can use the site's Medicare Plan Finder to see what plans are available in your area and check each plan's overall quality rating.

What changes can I make during this year's Medicare Open Enrollment Period?

Each year, current Medicare beneficiaries can make changes to their Medicare coverage for the following year during the Medicare Open Enrollment Period that starts on October 15 and runs through December 7. Because this period is the only time during the year that *all* people with Medicare can make changes to their health and prescription drug plans for the following year, you should carefully consider your options. During this annual enrollment period, you can:

- Change from Original Medicare to a Medicare Advantage Plan
- Change from a Medicare Advantage Plan back to Original Medicare
- Switch from one Medicare Advantage Plan to another Medicare Advantage Plan
- Switch from a Medicare Advantage Plan that doesn't offer prescription drug coverage to a Medicare Advantage Plan that does offer it
- Switch from a Medicare Advantage Plan that offers prescription drug coverage to a Medicare Advantage Plan that doesn't
- Enroll in a Medicare Part D prescription drug plan if you didn't enroll when you were first eligible (a late enrollment penalty may apply)
- Switch from one Medicare Part D prescription drug plan to another
- Drop Medicare prescription drug coverage

Your new coverage, or changes to your existing coverage for the new year, will take effect on January 1.

If you're currently in (or join) a Medicare Advantage Plan, you have another opportunity to leave your plan and switch to Original Medicare (with or without a Part D prescription drug plan) during the Medicare Advantage Disenrollment Period that occurs every year from January 1 to February 14. However, if you have Original Medicare you cannot make any changes during this period. In certain circumstances, if you're enrolled in a Medicare Advantage Plan or Part D prescription drug plan, you may also qualify to make changes during Special Enrollment Periods. Visit medicare.gov for more information.