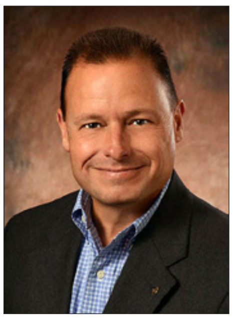
Volume 37 • Number 2

FINANCIAL Planning Strategies

A Financial Planning Update



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Mr. Kennedy's investment philosophy is the same that he has practiced over the last decade: securities markets are efficient and advisors primarily add value by coordinating the asset allocation for clients based upon risk tolerance, objectives, and time horizons. The firm has constructed 5 models for clients that vary in risk to meet the goals of each client. The firm primarily uses passive mutual funds in each model and uses select actively managed funds for bond, commodity, and real estate exposure. ITI uses several research resources, including many that were used over the last 20 years, to assist with the recommended asset allocation and the appropriate funds to utilize in each model.

Mr. Kennedy is an Investment Advisor Representative of ITI Financial Management, LLC. Investment services are offered through ITI Financial Management, LLC, a registered investment adviser with the state of Missouri.

It's Later Than You Think: Do You Know Your IRA Basis?

With the rising popularity of **Individual Retirement Accounts (IRAs)**, many people may have been making yearly contributions without giving much thought to what will happen from a *tax standpoint* when they start taking money out of their traditional IRAs. This oversight is understandable, since many IRA contributors may be years away from retirement, and *contributions*, not withdrawals, are usually the primary focus.

However, when you begin taking distributions from a traditional IRA, a variety of tax issues could arise. In general, your distributions are included in your gross income. Withdrawals made before the age of 59½ are subject to a 10% penalty, in addition to ordinary income tax. This process is relatively straightforward for those who have made only deductible contributions to their IRAs, but taxation is more complicated for nondeductible contributions.

IRA Tax Basis

If all of your contributions to a traditional IRA were deductible, then you have no **basis** in your IRA, and your distributions are fully taxable. Basis represents the after-tax balance in your account. If you made nondeductible contributions to your IRA, the amount of your contributions equals your basis, and this money is not subject to tax upon distribution.

Deductible Contribution Limits

Prior to 1987, all wage earners could make a deductible contribution of up to $2,000 annually. But, the Tax Reform Act of 1986 limits deductible contributions for employees who are active participants in qualified employer-sponsored retirement plans with **adjusted gross income (AGI)**—subject to certain modifications—exceeding specified amounts based on filing status ($62,000–$72,000 for single filers; and $99,000–$119,000 for married joint filers in 2017).

Nondeductible Contributions

While some people were aware that a nondeductible contribution was permitted without regard to active participation in an employer-sponsored plan, many who made such nondeductible contributions failed to account for them by filing Form 8606 with their annual tax returns. Form 8606 properly tracks nondeductible IRA contributions in both *current* and *prior* tax years, and is the only official record of after-tax contributions (i.e., IRA basis).

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Planning for Your Financial Future

Regardless of the path your life takes, money will play an important role at every turn. Certain events, especially graduating from college, entering the work world, getting married, having children, and retiring all require targeted financial strategies. Developing good financial habits *now* can go a long way toward helping you achieve your future financial goals.

From Campus to the Workforce

If you're just starting your career, set some goals for making the most of your disposable income. Consider the following three rules: 1) budget your money; 2) keep an emergency fund to cover three to six months' worth of living expenses; and 3) avoid unnecessary debt.

Paying off college loans is important. Also, try to avoid spending too much on housing by limiting rent or mortgage-related expenses (principal, interest, insurance, property taxes, and/or condo fees) to between 28% and 30% of your gross monthly income. When other short-term debt, such as car payments, student loans, and credit card bills are included, the debt limit guideline may rise to 36% of your gross pay.

For younger workers, retirement is often last on the list of financial concerns. However, if your employer offers a retirement plan with tax benefits, such as a **401(k)**, you may want to make the most of the opportunity. Pre-tax payroll deductions make contributing relatively painless. Try to contribute the maximum amount allowed—especially if your employer *matches* some, or all, of your contribution. If you don't have a retirement plan at work, consider opening an **Individual Retirement Account (IRA)** that can provide for *tax-deductible* contributions and *tax-deferred* earnings.

Settling Down

If settling down means marriage, you now have two financial situations to reconcile. Keep in mind that marriage establishes a *legal* relationship, and your spouse may have his or her own debt. Ideally, attempt to begin your new life together with a clear balance sheet.

Whether single or married, financial goals take on greater importance as you assume adult responsibilities. You and your spouse may choose to name each other as **beneficiaries** of **retirement accounts**, **annuities**, or **life insurance** policies. Also consider the protection offered by disability income insurance. In the event you or your spouse is unable to work due to an accident or illness, disability income insurance can provide a certain level of replacement income.

Although children present new and immediate demands on your time and financial resources, having dependents may motivate you to plan for the future. Two essentials include adequate **life insurance** and a **will** that names **guardians** for minor children.

You may also want to establish an education funding plan to help finance higher education. Many adults feel torn between saving for their children's college education and their own retirement. Being fiscally responsible and starting early may allow you to do both.

Nearing Retirement

For many people, a comfortable retirement may require 75% to 80% of their pre-retirement income. The three-tiered components of retirement income consist of Social Security, employer-sponsored plans (e.g., 401(k)s, pensions), and personal savings. If you anticipate little or no income from Social Security or a traditional company pension, you will need to prepare early to make up the difference with savings and an employer-sponsored retirement plan.

A comprehensive estate plan, to minimize potential estate tax liabilities and to help ensure that your assets are transferred to your heirs according to your wishes, is also important.

It is never too early to begin building the foundation for your financial future. Good habits developed *now* can go a long way toward helping you achieve your financial goals. Regardless of your stage in life, be sure to consult a qualified financial professional to help you determine appropriate strategies for your unique circumstances. $

Alphabet Soup: ILITs and the GST

With Federal estate taxes designed to tax assets transferred from one estate to another, planning to preserve wealth for your children, grandchildren, and future generations can be challenging. In 2017, the Federal estate and gift tax rates are as high as 40%; therefore, wealthy individuals, as well as those of modest means, need to carefully formulate their financial and estate plans in order to help *minimize* taxes and *maximize* their financial legacies. As a result, the **irrevocable life insurance trust (ILIT)** has become recognized as a straightforward mechanism for funding future estate tax liabilities and creating the potential for leveraged gifts to family or charity. However, in such cases, estate planners should also be aware of the implications of **generation-skipping transfer (GST) taxes** and take special care to ensure this additional transfer tax is not incurred.

Annual gifts by a donor to an ILIT are typically used to make premium payments on a life insurance policy insuring the life of the donor(s). The size of the gift will determine the amount of insurance the ILIT will be able to purchase. Thus, it is not uncommon for grandchildren to be included as ILIT beneficiaries in order to maximize the use of the donor's **annual gift exclusion** ($14,000 annually per donee and $28,000 for gifts made by a married couple) and Crummey withdrawal powers.[1] The proceeds of a properly executed ILIT will not be included in the estate of the donor(s).

The GST tax is an additional tax imposed on all transfers (during one's lifetime or at death), either outright or in trust, to a skip person, when the transferred assets are not subject to gift or estate taxes in the gross estate of the skipped generation. A skip person

is an individual at least two generations removed from the generation of the transferor. For example, if a grandparent is a transferor, a grandchild qualifies as a skip person. The GST tax rate is currently equal to the maximum 40% Federal estate tax rate and is applied to the entire transferred amount. However, every individual has a **generation-skipping exemption** ($5.49 million in 2017) for transfers while living, as well as those at death; the generation-skipping exemption cannot be transferred between spouses.

It should be noted that the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) has amended the GST tax exemption amount in any calendar year to equal the estate tax applicable exclusion amount in effect for that calendar year.

Dotting the *I's* and Crossing the *T's*

When properly drafted and implemented, an ILIT can be a creative tool for passing wealth to future generations while avoiding GST taxes. In many instances, this can be achieved without using the donor's generation-skipping exemption. Nontaxable gifts, such as those made under the annual gift exclusion, are excluded from the GST tax.[2] However, when nontaxable gifts are made to a trust, two additional vesting requirements must be met for the trust to be exempt from GST taxes.[3] First, the distribution of trust income and principal must be limited solely to the trust beneficiaries. Second, if a beneficiary predeceases the life of the trust, the deceased beneficiary's interest in the trust must be includable in his or her gross estate.

The use of ILITs is fairly commonplace in today's estate planning arena. However, the importance of the GST tax is typically underestimated. Thus, great care should be taken to help ensure that GST taxes do not undermine the benefits of an ILIT. $

[1] Crummey v. Comm., 397 F.2d 82 (9th Cir. 1968).

[2] IRC Sec. 2642(c)(3).

[3] IRC Secs. 2642(c)(2) and 2652(c)(3).

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Without having filed Form 8606 for years in which nondeductible contributions were made, a taxpayer will be exposed to double taxation of contributions when withdrawals are made. According to the IRS, without the proper historical record, no distinction is made between contributions made with *before*- and *after*-tax dollars, and all withdrawals are subject to taxation. In addition, there is a $50 penalty for failing to file Form 8606 for any year in which nondeductible contributions were made.

Also, consider state taxation of IRA withdrawals. Many states do not permit deductions for IRA contributions and, consequently, provide for a tax-free "return of basis." This means that contributions are not taxed when withdrawn, but that part of the IRA account, consisting of accrued interest and dividends, is then taxed as received. However, this "return of basis" works only if the individual has kept accurate records and knows what his or her IRA basis is.

Recordkeeping

One way to determine your total deductible and nondeductible contributions is to examine your tax returns over the entire period of IRA funding. If your recordkeeping has been less than ideal, account trustees (insurance companies, banks, mutual fund companies, brokerage firms) may be able to help you reconstruct your total contributions over the years. However, be advised that such trustees usually have no record of whether your contributions were deductible or nondeductible.

If you find yourself in "IRA limbo" with respect to your IRA basis, you may want to enlist the help of a qualified professional. Remember, it is important to keep organized records of your contributions and to file the appropriate forms. However, to help avoid a tax mishap at the time of withdrawal that could undo some of the annual benefits you have enjoyed from tax-deferred savings, be sure to consult your tax professional about your unique circumstances. $

When Giving, Get a Receipt

Charitable contributions can be especially important to help support an organization or a cause that's close to your heart. As an added benefit, you may be able to deduct a portion of your contributions on your Federal income tax return. However, as with all tax deductions, it's important to keep accurate records of charitable donations in the event you one day need to substantiate such gifts. Therefore, be sure to obtain a receipt to confirm your charitable contribution.

If you make a donation to a charity of cash or property valued at $250 or greater, request a *written* acknowledgment from the recipient charity. While receipts are not filed with your annual Federal income tax return (Form 1040), store receipts with other tax documents for the year in which the donations were made. $