# The COMPASS Chronicle

Fall 2018

*Highlighting important wealth management issues*


## Pre-Retirees To Convert To IRAs More Often

The tax burden of Americans was already among the lowest in the world, even before the tax cut that went into effect at the start of 2018.

But the cost of Social Security, Medicare and borrowing are likely to force the U.S. government to raise tax rates in the years ahead.


As a result, if you're nearing retirement or already retired, that makes this a good time to consider converting a traditional individual retirement account into a Roth IRA.

Here's a short lesson on a long-term tax bracket management strategy to increase tax-efficiency in a retirement portfolio, and it sidesteps a new snag in the Tax Cut And Jobs Act that penalizes widows.

Analysis from the non-partisan Congressional Budget Office shows the interest on the U.S. debt will become unsustainable in the mid-2020s.

The $21 trillion U.S. debt surges in the next few years and interest owed on the debt accelerates, along with the risk of default.

As 2023 nears, running trillion-dollar budget deficits annually becomes increasingly untenable policy, and tax rates are likely to rise.

With a traditional individual retirement account, taxes on gains reinvested are deferred. An IRA grows with no taxes owed. When you retire, withdrawals are taxed as income.

A Roth IRA is different. You pay income tax up front and Uncle Sam promises tax-free withdrawals when you're retired.

Inflation has been low for many years.

While it is not expected to rise sharply, the real cost of the federal debt would be reduced if inflation rises.

Many surviving spouses will face a tax penalty after losing a mate under tax brackets enacted by the Tax Cuts And Jobs Act.

For example, a couple with $170,000 of adjusted gross income is in the 24% top bracket, but after one spouse dies the survivor would fall into the 32% bracket.

Retired married couples converting a traditional IRA to a Roth account can avert the widow penalty with proper planning.

Since Roth accounts generate tax-free income, converting to a Roth places a surviving spouse in a lower tax bracket.

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## *COMPASS Corner*

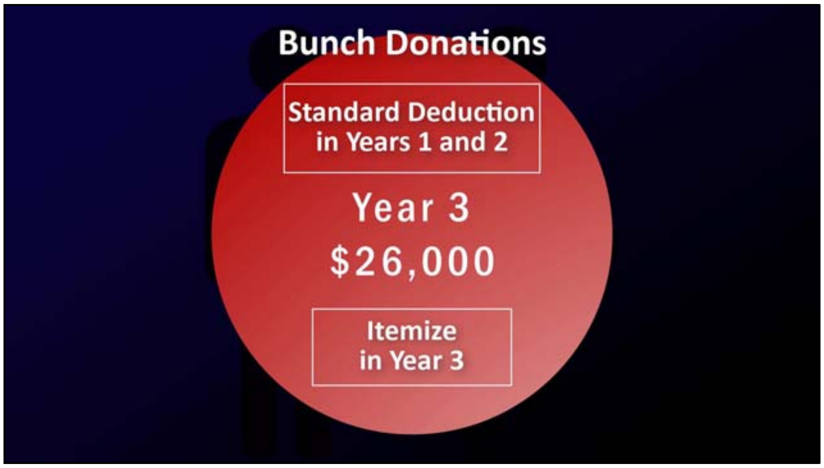
### *Louis E. Conrad II, CFA®*

The stocks of the largest U.S. companies were the star performers during the third quarter, far outpacing international stocks. The Russell 3000 Index, a broad representation of the U.S. stock market, gained 7.1% for the third quarter, while international stocks, as represented by the MSCI EAFE Index, produced a return of 1.3%.

In response to higher interest rates, U.S. bonds generally lagged stocks, though certain areas of the bond market, where COMPASS has strategically allocated client assets, continued to perform well. The Bloomberg Barclays U.S. Aggregate Bond Index generated a return of 0.02% for the third quarter as the increase in interest rates led to a decline in bond prices. The yield on the 10-Year U.S. Treasury began the quarter at 2.85%, but ended at 3.05%. COMPASS' clients continued to benefit from allocations to floating rate debt and high-yield bonds in this rising interest rate environment.

Though the U.S. stock market appears to be on firm footing for now, as we move into late 2019 and 2020, the odds of a recession and stock market correction increase. The annual year-over-year earnings comparisons for companies will become more of a challenge as the positive effects of the tax cuts subside. Interest rates are likely to continue their upward trend as inflation rises, the U.S. Treasury increases the supply of treasuries, and the Federal Reserve becomes less accommodative.

# Sidestepping New Limits On Charitable Donations




If you think you're no longer allowed to deduct items like charitable donations on your income tax return, think again.

The new tax law doubled the standard deduction, slashing the number of Americans eligible to itemize deductions from 37 million to 16 million.

However, if you are among those who will lose your ability to deduct charitable donations, there is a simple strategy for managing the new limits on charitable giving, and it enables you to continue doing good while doing well for yourself by reducing your tax bill.


The strategy is simple: bunch a few years of donations into a single tax year instead of making them annually.

Rather than report charitable donations on your tax return every year, you bunch two or more years of contributions into a single tax year — enough to boost the charitable total above that year's standard deduction.

Say you're married and you give $10,000 in Year 1, $6,000 in Year 2 and $10,000 in Year 3. Your $26,000 total surmounts the $24,000 eligibility. If you deduct the total donations of $26,000 in Year 3, you can take the standard deduction in Years 1 and 2 and itemize in Year 3.

Instead of giving in dribs and drabs, you will need to plan your giving strategy, but this will allow you to give as much as you used to before the limits without losing the tax benefits.

And if you can plan to make the larger donations in a year when you expect higher income, bunching charitable donations can be even more effective in lowering your tax bill.

We'll be speaking with clients about this in the months ahead because this tactic does take some planning in advance.

If you have any questions about your personal situation, please do not hesitate to give us a call. ●

# Ask About Personal Residence Trusts

By using a qualified personal residence trust (QPRT), you might be able to sidestep potential estate tax pitfalls while transferring a home to family members. You can continue to live in the home for a term of years, after which ownership passes from the trust to the designated beneficiaries. Your gift of the home to the trust is taxable, but rather than being based on the home's value when it goes into the trust, that value is reduced by the amount of your "retained interest," which is calculated according to a complicated formula based on interest rates, the term of the trust, and other factors.

But this unique estate planning technique is often misunderstood. Here are answers to several common questions about QPRTs.

Q. What are the estate and gift tax consequences?

A. When your home goes into a QPRT, it comes out of your taxable estate. Although the transfer of the remainder interest—the home's value minus your retained interest—is subject to federal gift tax, the resulting tax from this future gift tends to be low, especially while interest rates remain depressed. The IRS relies on the Section 7520 rate, which is updated monthly, to calculate the tax.

Q. What happens if I die before the end of the trust term?

A. Then the home goes back into your taxable estate. This defeats the purpose of the trust, but your family is no worse off than before the trust was created.

Q. Do I have to transfer my principal residence?

A. That's normally the home used in a QPRT, but it can also be set up for a second home. In fact, you can have multiple personal residence trusts.

Q. How long should the trust term last?

A. There's no set period of time. Note that the longer the term, the smaller the value of the remainder interest that's subject to taxes. But a longer term also

# Protect Yourself Against Spearphishing

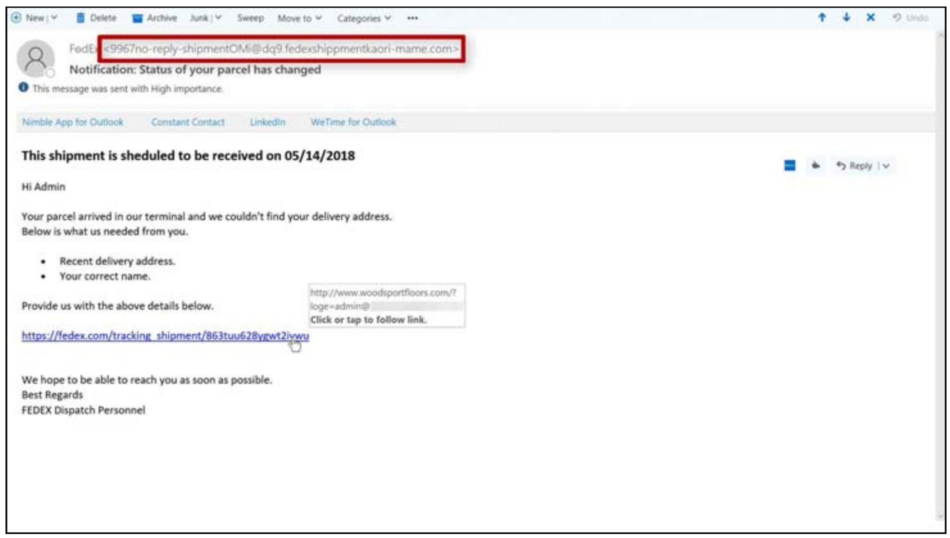

The Russian conspiracy to meddle in the 2016 presidential campaign relied on a common scam called "spearphishing." While the history-making scam may sound sophisticated, this form of digital fraud is running rampant. Anyone using email is likely to be attacked these days. Here are some tips to protect yourself.

In a spearphishing attack, a hacker sends you an email message to trick you into disclosing your username and password to a secure account. The message looks like it's from a legitimate source you trust.

You click on the link and, unbeknownst to you, you install a program that records your next 100 keystrokes. The email from a trusted source was a Trojan Horse, malicious software that sends your password and user ID to the hackers.

New variants of the scam are appearing so fast that anti-virus software can't keep up, which puts you on the front line in defending yourself from attack. Perhaps the most important way to thwart an attack is by looking at links in emails before clicking.

In this popular spearphishing scam, hovering over the link in the email displays a website address that is absolutely, positively not Federal Express. And the email address from which this message was sent is plainly NOT a legitimate Federal Express dot-com account. Often the "From" address will tip you off to a fraud.




Phishing emails, until recently, were easy to spot because they commonly contained misspellings, grammatical errors and company branding mistakes. A scan of hundreds of recent phishing messages indicates fewer of these telltale signs. The scammers are getting smarter.

While the cat versus mouse game has of late been won by the evildoers, software solutions are growing stronger. For example, Microsoft Office 365 online users now have a way of designating a message as "Phishing." This new feature for "blacklisting" a malicious message prevents a scam from hitting you twice and gives Microsoft information about its origin. Of course, updating your anti-virus software is always a must. If you ever have any questions about emails you receive from us, please do not hesitate to call us. ●

increases the chance that you'll die before it ends and the home will be returned to your estate.

Q. Can I sell the home during the trust term?

A. You can, but you'll have to reinvest the proceeds in another home that will be owned by the QPRT and subject to the same trust provisions.


Q. Who pays for the upkeep of the home?

A. As long as you still live there, you do, for instance, you might pay the costs of monthly maintenance and repair, insurance, and property taxes to the trustee. But you get to deduct qualified expenses on your tax return.

Q. Can I back out of the deal?

A. No, the trust is irrevocable. However, if you want to stay in the home after the trust term, you can set up a rental agreement with the beneficiaries. They will have to pay income tax on the rent they receive.

Q. Are there any other drawbacks?

A. There are costs associated with a QPRT, including attorneys' fees, appraisal fees, and titling expenses. And you can't take out a mortgage on a home that has been transferred to a QPRT. (An existing mortgage is permitted but it complicates matters.) ●

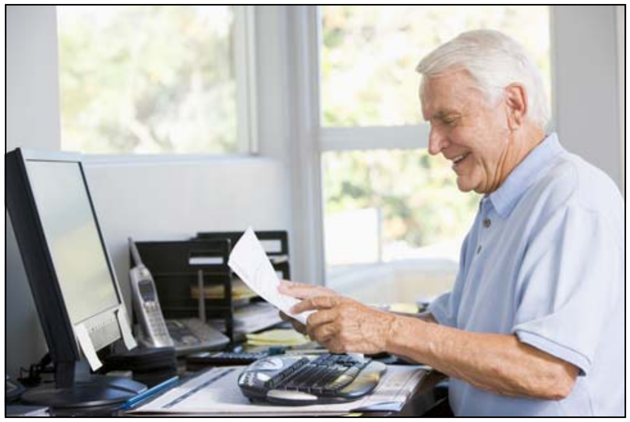
# Key Facts On Deducting Medical Expenses

Medical expenses can run up your expenses a lot. For that reason, the new tax law gives people a break by sweetening the long-time tax deduction for health care, at least for a couple of years.

Before the Tax Cuts and Jobs Act (TCJA), you could deduct medical expenses that exceeded 10% of your adjusted gross income (AGI). For the tax years of 2017 and 2018, the TCJA lowered the threshold to 7.5%. AGI is taxable income minus all deductions, IRA contributions and student loan interest. Of course, the medical tax break is available only to people who itemize.

The trouble is the more generous deduction expires after 2018, when the threshold rises back to 10%. Groups like AARP are lobbying in Washington to get the 7.5% level extended or made permanent, and that could factor into your timing and decisions about medical expenses in the months ahead.

Say your AGI is $45,000 and you rack up $5,475 in medical costs. You multiply $45,000 by 0.075 (7.5 percent) to get your deduction threshold of $3,375. Only medical expenses above $3,375 would be deductible. Result: your medical expense deduction is $2,100 ($5,475 minus $3,375).



Some big-ticket items are deductible medical expenses, like long-term care insurance premiums, nursing home payments and Medicare costs — including Medicare Part B, Medigap policies, Medicare Advantage programs and Part D Prescription plans.

In addition, any health insurance you pay out of pocket can be deducted. But that can't include coverage you pay for with before-tax dollars, which is often the case with employer-sponsored medical plans.

Another big deductible item is co-payments for prescription drugs — and also out-of-pocket fees for doctors, dentists, physical therapists and other health-care professionals not covered by Medicare or any other health insurance. Add in prescription eyeglasses, hearings aids and wheelchairs, and transportation costs to and from medical appointments, as well as alcohol and drug treatment programs.

Medical expenses are deductible only if they alleviate or prevent a physical or mental defect or illness, including dental and vision. So, you cannot deduct a gym membership if it is to promote your general wellness. However, if a doctor diagnoses you with a specific medical condition, such as obesity or hypertension, then the expense of the prescribed treatment may indeed be tax-deductible, including a gym membership. ●

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## Convert To IRAs More Often

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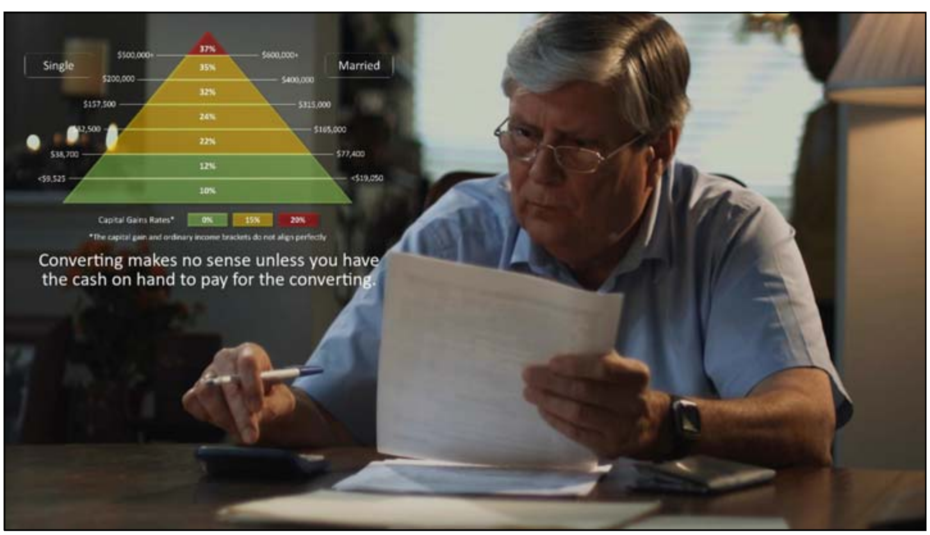
For example, a couple with $170,000 of income would convert from a traditional IRA to a Roth IRA, lowering their income to less than $157,500.

If one spouse dies, the survivor would be in the 24% bracket applied to singles with up to $157,500 of income.

Coming up with the cash to pay the one-time conversion tax is not for everyone.




However, converting makes no sense unless you have cash on hand to pay the income tax on withdrawals from your traditional IRA.

Withdrawing a larger amount to pay the taxes usually is a bad idea.

Tax-sensitive investing tactics like this can reduce a tax bill by a material amount all throughout a surviving spouse's lifetime.

But tax-managed investing is complicated.

We evaluate tax planning opportunities for clients.

Please contact us with any questions about your personal situation. ●