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Hello!

We would like to send out a welcome to our new clients who recently came on board with us. We look forward to working with you!

Have a great month!

March 2020

GERHART FINANCIAL SERVICES, INC.

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VISION.LEADERSHIP.VALUES

Five Red Flags That Raise the Odds of an Audit

The IRS audited about 1 million tax returns in fiscal year 2018, and nearly 75% of those examinations were conducted entirely through correspondence.[1] Taxpayers selected for an official audit are notified by mail.

Confusing matters, the IRS also mails other types of compliance notices, which may propose additional tax based on math errors, the automated detection of underreported income, or other factors. The National Taxpayer Advocate calls these notices "unreal" audits, because the IRS doesn't count them as audits. But their impact is real — so the frequency and effectiveness of IRS compliance contacts are somewhat understated. About 8.5 million taxpayers experienced "unreal" audits during fiscal year 2016, and if they were included the audit rate would jump from 0.7% to more than 6.0%.[2]

When the IRS gets real

If selected for a correspondence audit, you may be asked to mail specific information to the IRS. Some examinations require an in-person interview, which could take place in an IRS office (referred to as an office audit). A comprehensive field audit would be conducted at your home, place of business, or accountant's office.

How is a return selected for examination? When your federal income tax return is processed, a computer program called the Discriminant Inventory Function System (DIF) screens for anomalies, compares deductions to those of taxpayers with similar incomes, and assigns a DIF score. The higher the DIF score, the greater the potential that an audit will result in the collection of additional taxes. In some cases, a return is examined because it's related to a transaction with another taxpayer who has been audited.

Risky returns

There's no way to know exactly what will trigger an audit, but one or more of the following red flags could make it more likely that the IRS will take a closer look at your tax return.

1. Missing income. Don't forget sources of income not reported on a Form W-2, which might include investment income, interest, royalties, rent, compensation as an independent contractor, forgiven debt, alimony, tips, gambling winnings, health insurance reimbursements for expenses deducted in a previous year, and proceeds from selling goods online. These types of income may or may not be reported by the payer to the IRS, but you must include all income, whether you receive a Form 1099 or not.

2. Overdoing deductions. Even if they are allowed by law, deductions that are unusually large for your income level can appear suspicious. For this reason, high-value charitable donations require specific documentation.

3. Filing a Schedule C. Thorough recordkeeping is critical for self-employed taxpayers, especially when claiming deductions for a home office or vehicle expenses (which require a written log).

4. Keeping money in foreign accounts. Foreign assets worth at least $50,000 at year-end or greater than $75,000 at any time during the year must be reported. (These thresholds are $100,000 and $150,000, respectively, for married joint filers.) Other complicated rules apply. Many overseas financial institutions are required to provide information about U.S. asset holders to the IRS, so even though the reporting of foreign assets (by you or the institution) may invite IRS scrutiny, noncompliance can result in penalties or legal problems.

5. Reporting a high (or very low) income. Audit rates are higher for wealthier taxpayers as well as for those with little or no income (possibly due to questionable tax deductions). Even though these situations are more complicated, they are often perfectly valid. Still, it might be wise to consult a trusted tax or legal professional if you receive any type of compliance-related communication from the IRS.

1 Internal Revenue Service, 2019

2 Taxpayer Advocate Service, 2018

See disclaimer on final page

Is It Time to Review Your IRA Estate Planning Strategies?

The SECURE Act ushered in changes that may have a dramatic impact on IRA estate planning strategies. Account owners may want to review their plans with their financial professionals.

There are costs and ongoing expenses associated with the creation and maintenance of trusts.

The Setting Every Community Up for Retirement Enhancement (SECURE) Act, which was passed in December 2019 as part of a larger federal spending package, included a provision that warrants special attention from those who own high-value IRAs. Specifically, the "stretch" IRA provision — which permitted nonspouse beneficiaries who inherited IRAs to spread distributions over their lifetimes — has been substantially restricted. IRA owners may want to revisit their estate planning strategies to help prevent their heirs from getting hit with higher-than-expected tax bills.

The old "stretch" rules

Under the old rules, a nonspouse beneficiary who inherited IRA assets was required to begin minimum distributions within a certain time frame. Annual distributions could be calculated based on the beneficiary's life expectancy. This ability to spread out taxable distributions over a lifetime helped minimize the annual tax burden on the beneficiary. In the past, individuals could use this stretch IRA strategy to allow large IRAs to continue benefiting from potential tax-deferred growth for possibly decades.

Example: *Consider the hypothetical case of Margaret, a single, 52-year-old banking executive who inherited a million-dollar IRA from her 85-year-old father. Margaret had to begin taking required minimum distributions (RMDs) from her father's IRA by December 31 of the year following her father's death. She was able to base the annual distribution amount on her life expectancy of 32.3 years. Since she didn't really need the money, she took only the minimum amount required each year, allowing the account to continue growing. Upon Margaret's death at age 70, the remaining assets passed to her 40-year-old son, who then continued taking distributions over the remaining 13.3 years of Margaret's life expectancy. The account was able to continue growing for many years.*

The new rules

As of January 2020, the rules for inherited IRAs changed dramatically for most nonspouse beneficiaries.[1] Now they generally are required to liquidate the account within 10 years of the account owner's death. This shorter distribution period could result in unanticipated and potentially large tax bills for high-value inherited IRAs.

Example: *Under the new rules, Margaret would have to empty the account, in whatever amounts she chooses, within 10 years. Since she stands to earn her highest-ever salaries during that time frame, the distributions could push her into the highest tax bracket at both the federal and state levels. Because the account funds would be depleted after 10 years, they would not eventually pass to her son, and her tax obligations in the decade leading up to her retirement would be much higher than she anticipated.*

Notable exceptions

The new rule specifically affects most nonspouse designated beneficiaries who are more than 10 years younger than the original account owner. However, key exceptions apply to those who are known as "eligible designated beneficiaries" — a spouse or minor child of the account owner; those who are not more than 10 years younger than the account owner (such as a close-in-age sibling or other relative); and disabled and chronically ill individuals, as defined by the IRS. The 10-year distribution rule will also apply once a child beneficiary reaches the age of majority and when a successor beneficiary inherits account funds from an initial eligible designated beneficiary.

A word about trusts

In the past, individuals with high-value IRAs have often used what's known as conduit — or "pass-through" — trusts to manage the distribution of inherited IRA assets. The trusts helped protect the assets from creditors and helped ensure that beneficiaries didn't spend down their inheritances too quickly. However, conduit trusts are now subject to the same 10-year liquidation requirements, so the new rules may render null and void some of the original reasons the trusts were established.

What can IRA account owners do?

IRA account owners should review their beneficiary designations with their financial or tax professional and consider how the new rules may affect inheritances and taxes. Any strategies that include trusts as beneficiaries should be considered especially carefully. Other strategies account owners may want to consider include converting traditional IRAs to Roths; bringing life insurance, charitable remainder trusts, or accumulation trusts into the mix; and planning for qualified charitable distributions.

[1] For account owners who died prior to December 31, 2019, the old rules apply to the initial beneficiary only (i.e., successor beneficiaries will be subject to the 10-year rule).

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Spring Cleaning Your Way to Better Finances

When it comes to your personal finances, reducing debt should always be a priority.

All investing involves risk, including the possible loss of principal, and there is no guarantee that any investment strategy will be successful.

Spring is a good time to clean out the cobwebs, and not just in your home or apartment. Your personal finances can benefit from a good spring cleaning, too. Here are some questions to ask yourself regarding your budget, debt, and taxes.

Is there room in my budget to save more?

A budget is the centerpiece of any good personal financial plan. After tallying your monthly income and expenses, you hopefully have money left over to save. But... is there room to save even more? Review your budget again with a fine-tooth comb to see if you might be able to save an additional $25, $50, $100, or $200 per month. Small amounts can add up over time. If you participate in a workplace retirement plan, you might not even notice your slightly smaller paycheck after you increase your contribution amount.

If your expenses are running neck and neck with your income, try to cut back on discretionary spending. If that's not enough, look for ways to lower your fixed costs or explore ways to increase your current income. Budgeting software and/or smartphone apps can help you analyze your spending patterns and track your savings progress.

Do I have a strategy to reduce debt?

When it comes to your personal finances, reducing debt should always be a priority. Whether you have debt from student loans, credit cards, auto loans, or a mortgage, have a plan to pay down your debt as quickly as possible. Here are some tips.

- **Credit cards.** Keep track of your credit card balances and be aware of interest rates and hidden fees; manage your payments so you avoid late fees; pay off high-interest debt first; and avoid charging more than you can pay off at the end of each billing cycle.
- **Student loans.** Are you a candidate for income-based repayment? You can learn more at the Federal Student Aid website.
- **Additional payments.** Making additional loan payments above and beyond your regular loan payments (or the minimum payment due on credit cards) can reduce the length of your loan and the total interest paid. Online calculators can help you see the impact of making additional payments. For example, if you're halfway through a 30-year, $250,000 mortgage with a fixed 4.5% interest rate, an additional principal payment of $150 a month can shave two years off your mortgage. An extra $250 a month can shave off three years!
- **Refinancing.** If you currently have consumer loans, such as a mortgage or auto loan, take a look at your interest rate. If you're paying a higher-than-average interest rate, you may want to consider refinancing. Refinancing to a lower interest rate can result in lower monthly payments and potentially less interest paid over the loan's term. Keep in mind that refinancing often involves its own costs (e.g., points and closing costs for mortgage loans), and you should factor these into your calculation of how much refinancing might save you.
- **Loan consolidation.** Loan consolidation involves combining individual loans into one larger loan, allowing you to make only one monthly payment instead of many. Consolidating your loans has several advantages, including saving you time on bill paying and record keeping and making it easier for you to visualize paying down your debt. In addition, you may be able to get a lower interest rate.
- **Paying down debt vs. investing.** To decide whether it's smarter to pay down debt or invest, compare the anticipated rate of return on your investment with the interest rate you pay on your debt. If you would earn less on your investment than you would pay in interest on your debt, then using your extra cash to pay off debt may be the smarter choice. For example, let's say you have $2,000 in an account that earns 1% per year. Meanwhile, you have a credit card balance of $2,000 that incurs annual interest at a rate of 17%. Over the course of a year, your savings account earns $20 interest while your credit card costs you $340 in interest. So paying off your credit card debt first may be the better choice.

Do my taxes need some fine-tuning?

Spring also means the end of the tax filing season. You might ask yourself the following questions:

- Am I getting a large tax refund or will I owe taxes? In either case, you may want to adjust the amount of federal or state income tax withheld from your paycheck by filing a new Form W-4 with your employer.
- What else can I learn from my tax return? Now is also a good time to assess tax planning opportunities for the coming year, when you still have many months left to implement any strategy. You can use last year's tax return as a reference point, then make any anticipated adjustments to your income and deductions for the coming year.

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Whether it's a helpful announcement from your child's school or an appointment reminder from a doctor's office, getting robocalls has become an everyday occurrence. Unfortunately, robocalls are also used by criminals to collect consumers' personal and financial information and/or conduct various scams.

The good news is that consumers have won additional protections against unwanted robocalls under the Telephone Robocall Abuse Criminal Enforcement and Deterrence (TRACED) Act. One of the main goals of the law is to make it easier for consumers to avoid unwanted robocalls by:

- Requiring all carriers to implement caller-ID technology at no additional cost to consumers
- Making it easier for law enforcement to prosecute illegal robocallers and increasing penalties for robocall violations
- Creating an interagency task force to study and improve government prosecution of robocall violations

Even when these new protections are implemented, it will take some time to eliminate unwanted robocalls. In the meantime, here are some things you can do to protect yourself:

- Don't answer calls when you don't recognize the phone number.
- If you pick up an unwanted robocall, hang up right away and avoid answering "yes" or "no" questions, providing personal information, or pressing a number to "opt out."
- Consider signing up for a robocall blocking service. Many phone service providers now offer robocall blocking solutions at no additional charge, or you can download additional robocall protection through a third-party app.
- Register your phone number on the National Do Not Call (DNC) Registry, which removes your number from the call lists used by legitimate telemarketing companies. Keep in mind that registering with the DNC Registry will result in your getting fewer calls from legitimate telemarketers, but it won't stop illegal robocallers from contacting you.

It depends. Powerful storms, inadequate drainage, melting snow, and hurricanes can all cause serious flooding damage, even if you don't live in a high-risk flood area. According to the National Flood Insurance Program (NFIP), approximately 20% of all flood insurance claims come from areas outside high-risk flood zones. Since standard homeowners insurance generally does not cover damage directly caused by flooding, you may want to consider purchasing flood insurance, especially if you live in an area of the country that is prone to severe weather systems that could result in flood damage to your home.

If you plan on purchasing flood insurance, it is important to note that you can't simply buy flood insurance as an endorsement to your current homeowners policy. Instead, if eligible, you can purchase a separate flood insurance policy through an insurance company that participates in the NFIP.

A flood insurance policy can provide flood protection for both your home and its contents. You can purchase up to $250,000 of coverage for the building itself and up to $100,000 of coverage for the contents. If the value of your home exceeds the amount available through the federal program, you may be able to buy excess flood insurance through a private insurer. Excess flood insurance covers amounts above the $250,000 federal limit and, unlike NFIP coverage, may cover your home for its full replacement cost.

Keep in mind that even though flood insurance offers some degree of protection for flood-related basement damage, it doesn't cover all types of damage. It also doesn't cover events such as seepage or failure of a sump pump and damage caused by sewer backups unless it is directly related to a flood. For more information on flood insurance, visit floodsmart.gov.

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