April 2018

Hello Financial Formula newsletter readers and MF Advisers clients!

We hope you all survived this past tax season!

Please read the following newsletter and forward/share with any people you think might be interested in its content (it's got some great articles).

If you need help with anything, please let us know - thank you!

Martin A Federici Jr
marty@mfadvisers.com
Financial Advisor & CEO
MF Advisers, Inc.
91 Franklin Street
Dallas, PA 18612
O: 570-760-6524

MF Advisers

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Wealth management, investment advice, and financial planning with a purpose in mind — YOURS

Get in touch with us on the web:

RETIREMENT, BUSINESS & REAL ESTATE TIPS

A Vacation Home: The Ultimate Hideaway

Are you dreaming of a mountain cabin or an oceanfront bungalow hideaway? Then you may want to consider that a vacation home can offer some tax savings. Whether you choose to use the home solely for enjoyment or combine business and pleasure by renting the property part-time, it is important to understand the tax laws for a second home.

As long as the combined debt secured by the vacation home and your principal residence does not exceed $750,000 under the new tax law, you can deduct all of the interest paid on a mortgage used to buy a second home. This advantage is restricted to two homes. Should you purchase a third home, interest on that mortgage is not deductible. However, regardless of how many homes you have, you may be able to deduct all of the property tax paid.

One break enjoyed by homeowners—the right to immediately deduct points paid on a mortgage—applies only to a principal residence. Points paid on a loan for a second home must be deducted gradually, as the mortgage is paid off.

Personal Residence

Your vacation home is considered a personal residence if you rent it for no more than 14 days a year. In such a situation, you may retain the rent tax free without jeopardizing your mortgage interest and tax deductions. However, you may not deduct any rental-related expenses. If you rent out the house on a continual basis, things may become more complicated. Depending on the breakdown between personal and rental use, different rules may apply.

If you buy primarily for pleasure but rent for 15 days or more, the rent you receive is taxable. Because the house is still considered a personal residence, you may deduct all of the interest and property tax. You may also be able to deduct other rental-related expenses, including the cost of utilities, repairs, and insurance attributable to the time the house is rented. In some cases, you may be able to deduct depreciation. When the house is considered a personal residence, rental deductions cannot exceed the amount of rental income you report. In other words, your second home cannot produce a tax loss to shelter other income. In most cases, the interest and taxes assigned to the rental use of the house combined with the operating expenses more than offset rental income, thus limiting your ability to write off depreciation.

Rental Property

Now consider your tax situation if you buy a property primarily as an investment and limit your personal use of the property to 14 days a year (or 10% of the number of rental days, whichever is greater). Because the house is a rental property according to the Internal Revenue Service (IRS), your deductions can exceed the amount you receive in rental income.

If your rental income does not cover the cost of renting the house, you may be able to claim a taxable loss. Rental losses are classified as passive and can be deducted only against passive income, such as that from another rental property that realizes a gain. If you do not have passive income to shelter, the losses have no immediate value; however, unused losses can be used in the future when you have passive income.

There's an exception to this rule, however, that permits taxpayers with adjusted gross income (AGI) under $100,000 ($50,000 if married filing separately) to deduct up to $25,000 ($12,500 if married filing separately) of passive losses against other kinds of income, including salaries. To qualify, you must actively manage the property. The $25,000 allowance is gradually phased out for taxpayers whose AGI is between $100,000 and $150,000.

The Tax Cuts and Jobs Act of 2017 creates a new tax deduction for individuals who earn income through pass-through entities. If your rental activity qualifies, you may be eligible to deduct 20% of qualified income, with some limitations and qualifications.

If your vacation home is considered a rental property, the mortgage interest attributable to the time the premises are rented is a business deduction. The remainder cannot be deducted as home mortgage interest since the house doesn't qualify as a personal residence.

These tax laws also apply to apartments, condominiums, mobile homes, or boats with basic living accommodations. Generally, these are considered rental properties if they include a sleeping space, bathroom, and cooking facilities. If you are considering the purchase of a vacation home, keep in mind that, from a tax perspective, that mountain cabin or oceanfront bungalow may be the ultimate dream home.

How to Avoid Becoming a Victim of Identity Theft

Identity theft is one of the fastest growing crimes in the United States, with as many as 17.6 million victims every year, according to the latest statistics from the Bureau of Justice Statistics (BJS). Identity theft is a type of fraud in which a thief uses your personal information to conduct transactions in your name. Thieves may, for example, steal your identifying information to open or empty bank accounts, obtain credit cards, or take out loans.

There are steps you can take to reduce the risk of having your personal information stolen, as well as ways to detect a theft early and minimize the damage to your credit.

Monitor your credit reports, checking regularly for any suspicious transactions. Under Federal law, each of the three major credit bureaus, Experian, Equifax, and Trans-Union, must provide consumers with a free annual credit report, upon request. You can access the reports through one website co-sponsored by the agencies, **annualcreditreport.com »**. A thorough review of these reports, also known as credit file disclosures, can reveal any unusual activity.

Do not provide sensitive data in response to e-mail or telephone solicitations. If you are interested in an offer, take down the caller's contact information and verify that the company is legitimate before revealing your identifying information. You can bar telemarketers from calling you by registering your phone number with the Do Not Call Registry at **donotcall.gov »**.

Filter unwanted e-mail by installing anti-spam software on your computer. For further protection, install firewall and antivirus software programs that include automatic updates. Use a secure browser when conducting online transactions.

Invest in a mailbox with a lock or rent a P.O. box. Thieves have been known to intercept confidential correspondence and offers from financial services companies. Be sure to store sensitive information in a secure place in your home.

Destroy records containing private financial information by tearing or shredding, and do not dispose of credit card receipts or ATM statements in public trash receptacles. Thieves have been known to "dumpster dive" to obtain the details they need to commit fraud.

Protect your accounts with passwords or access numbers that cannot be easily deduced. Avoid using your Social Security number, your birth date, your phone number, your mother's maiden name, your children's names, or a series of consecutive numbers. Never carry your Social Security number or passwords with you.

Before disclosing identifying information to businesses, employers, or other institutions, ask how the information will be handled and stored.

If your license or another form of identification is stolen, contact the appropriate agency immediately to cancel the identification and order a new one.

Keep close track of your credit and ATM cards. Check your credit card and bank statements carefully for any suspicious purchases or withdrawals.

If you have reason to believe your identity has been misused, report the theft immediately to the fraud department of one of the three major credit bureaus and ask them to place a "fraud alert" on your file. This alert will prompt creditors to contact you before allowing a new account to be opened in your name or an existing account to be altered. Calling just one bureau is sufficient, as the company you contact will report the problem to the other two bureaus. After placing the fraud alert on your file, you will be entitled to request one free copy of your credit report from each of the credit agencies, even if you have already received reports that year.

Also, immediately contact creditors or other companies with accounts in your name that may have been affected by the fraud, instructing them to close the accounts immediately. The next step is to file a report of the theft with the police in the community where the crime was committed. Finally, file a complaint with the FTC, which maintains a database used by police and other law enforcement officials for identity theft investigations. Be sure to keep detailed records of your communications with creditors and other authorities regarding the theft. To learn more about identity theft, visit the FTC website at **ftc.gov »**.

Taking Annual Gifts to the Next Level

You've probably worked a lifetime to build an adequate nest egg, live in a comfortable home, and accumulate an array of other assets. You may also realize that your finances could create unfavorable estate tax consequences. Perhaps you already have the compulsory legal documents, such as wills, trusts, etc. in place, and know that giving away assets may help reduce the size of your taxable estate. But, even though many people make occasional gifts to their children or other family members, few actually take advantage of the benefits offered through a regular gifting program.

Gifting Made Simple

Current tax laws allow you to give away $15,000 ($30,000 if married) in 2018 to as many people as you wish without incurring any gift taxes. This **annual gift tax exclusion** can be an effective means for gradually passing wealth to future generations. In fact, systematically making such a gift can create a rather sizable long-term result.

Let's look at this scenario: Suppose 60-year-old Mark starts a gifting program for his newborn grandson, Todd. Each year, Mark makes a gift of $15,000. After 25 years, Todd will have accumulated $375,000, assuming 0% growth. In addition, suppose Debbie, Mark's wife, age 60, also chooses to make a $15,000 gift to Todd, bringing the total annual gift to $30,000. In this case, Todd will have accumulated $750,000 in 25 years (assuming 0% growth). In this win-win situation, the couple helps Todd accrue a nest egg, while, at the same time, lowering the value of their estate. This strategy may help Debbie and Mark minimize their estate tax liabilities.

One Step Beyond

Using the annual gift tax exclusion to fund a **life insurance policy** creates the potential to turn gifts into a substantial death benefit. Once again, suppose Mark (the donor) sets up an **irrevocable life insurance trust (ILIT)** for the benefit of Todd. The ILIT then purchases life insurance on Mark. Upon Mark's death, the life insurance death benefit proceeds are payable to the ILIT. Since the policy is owned by and payable to the ILIT, there are **no transfer** tax consequences to Mark's estate.

Life insurance may provide an ideal mechanism for leveraging annual gifts. In the short term, it offers an immediate death benefit that generally outweighs the total premium outlay (gifts). While over the long term, life insurance offers a unique opportunity to potentially leverage annual gifts into a significant benefit for selected beneficiaries. This can be achieved by taking advantage of the tax-deferred buildup of policy values, which in some cases may indirectly increase the life insurance policy's death benefit over time.

The use of a regular gifting program may be advantageous to individuals seeking to gradually reduce the size of their estates. In addition, it affords these individuals the opportunity to pass wealth to children, family members, and others with reduced tax consequences. For specific guidance, be sure to consult your qualified tax and legal professionals about your unique circumstances.

Creating a Business Dress Code

What employees wear and how they present themselves to customers and shareholders influence not only the company reputation, but the culture within the organization. Employees who are appropriately dressed make a good impression on the public; at the same time, they inspire confidence within the company.

Human resource managers charged with creating and upholding the dress code for their companies should clearly outline their expectations. Use the following business attire guidelines as you form or refine your office policy:

If your company is frequently visited by customers, clients, and the public, it may choose a **formal** dress code. While over the years fewer and fewer workers dress this way for work, it is the favored attire in conservative professions such as finance. Formal business attire for men includes dark tailored suits, ties, button-down dress shirts, sports jackets, dress pants, and dark leather shoes. For women, formal attire may include coordinated pant and skirt suits (skirts are knee or calf length), blouses with high necklines, blazers, and closed-toe shoes with low heels. Your image to clients should be the most important factor in determining what is appropriate formal business attire. Hosiery is preferred, and perfume and jewelry are not encouraged.

The conservative look extends to personal grooming too. Facial hair should be groomed and tattoos covered.

Like formal dress, **business casual** dress is often the chosen style when the company serves customers, but it can include suits of lighter but conservative colors, dress pants, khakis, sports jackets, button-down shirts, skirts, and dresses. Less formal footwear is also acceptable, such as loafers and athletic shoes. Other acceptable examples include a polo shirt and pressed pants, a sweater and shirt with pressed pants, and a jacket, sweater, and skirt. Items such as jeans, t-shirts, shorts, shirts without collars, flip flops, sun dresses, and sandals are not appropriate.

Last but not least, the **casual** dress code encourages employees to dress comfortably for work keeping in mind appropriate casual dress for a business setting. Appropriate dress includes anything from the categories above and jeans, t-shirts, shorts, shirts without collars, flip flops, sun dresses, and sandals. Avoid clothing that other employees would find offensive or that would make them uncomfortable, such as a t-shirt with a cause imprinted on it or a skirt that is too short. Even if they are dressing casually, employees are expected to demonstrate good judgment and taste.

The above business attire guidelines can help as you form your company policy. You might want to include actions that human resource personnel should take if an employee does not adhere to the dress code. When an employee does not comply with the dress code, an HR representative should have a private conversation with him or her.

Employee Bonuses: What's the Bottom Line?

A bonus is a positive way to recognize and reward valued employee contributions without increasing ongoing payroll costs. However, it is important to keep in mind that the net value of a bonus may be less than the full bonus because the employee is required to pay income taxes on it.

Because the size of a bonus is reduced by the taxes on it, many companies pay bonuses along with additional money to help cover the cost of the income tax. This arrangement is commonly referred to as a "double bonus." For example, suppose a company pays a bonus of $6,500 to a key employee. The employee won't actually receive the full $6,500 because of the necessary income tax. Assuming the employee's combined Federal and state income tax rate is 41% (35% Federal and 6% state), the tax on the $6,500 would be $2,665, which leaves only $3,835 for the employee. If a corporation wants an employee to receive the full $6,500 after taxes, the bonus would have to be $11,016. This is calculated by dividing the desired net bonus by 1 minus the tax rate; in this case, it would be $6,500 divided by (1.00 — 0.41). That's the bottom line.

Divorce and Retirement Plan Proceeds

Divorce can be "taxing" enough, but need not be made more difficult by the mismanagement of the division of assets in a retirement plan. As more Americans participate in 401(k) plans and other defined contribution retirement plans, dividing vested retirement plan assets in divorce situations can be complicated. In addition, defined benefit plans can involve numerous concerns, such as the participant's death before retirement, and the form of the benefit payments at retirement.

A Qualified Domestic Relations Order (QDRO) is a legal document that enables a retirement plan to transfer money or other plan assets to the non-employee former spouse. A QDRO must meet very specific requirements of the Internal Revenue Service (IRS) and the Employee Retirement Income Security Act of 1974 (ERISA). Note that without a QDRO, a transfer of retirement plan assets cannot occur.

Entitlement to your former spouse's retirement plan benefits depends on the type of plan. For a defined contribution plan, whereby each plan participant has his or her own individual account, a former spouse may be entitled to 50% of the vested and non-vested benefits that were credited or accrued during your marriage. Depending on the type of defined benefit plan, you can receive a portion of the retirement benefit based on the amount of time of your marriage during plan participation and the total amount of time the employee former spouse participates in the plan through retirement.

Since many issues need to be thoroughly discussed regarding divorce and retirement plan benefits, be sure to consult your tax and legal professionals for guidance about your unique circumstances.

It's Later Than You Think:
Do You Know Your IRA Tax 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. ($63,000—$73,000 for single filers; and $101,000—$121,000 for married joint filers in 2018).

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).

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.

Tips for Home Buyers and Sellers

The recent real estate market left both prospective buyers and sellers on edge. While sellers once had the advantage and could sit back and wait for buyers to outbid each other, buyers now seem to have the upper hand. However, with lending tight, buyers must meet specific financial criteria to have their loan approved and have the sale to go forward.

Sellers may be concerned that they won't be able to sell their homes for what they're worth, and buyers may be worried that their loan applications will be denied because of tighter qualification rules. However, there seems to be opportunities for both sides now and both buyers and sellers can take steps to achieve their goals.

For Buyers

Get prequalified by an FHA lender. Prequalification demonstrates you are serious about buying and that you are creditworthy. FHA support adds extra value to your offer.

If you are planning to sell your home and move into a new one, consider listing it immediately. On average, it takes at least three months for a house to sell. Don't wait to list it until you find the right property to buy.

Once you do find the right property, be flexible about your offer. Avoid making any offer so rigid that it leaves you no choice but to walk away if it isn't accepted. Many owners are emotionally invested in their homes and have already discounted the price based on falling real estate values. Be realistic and keep the seller's perspective in mind.

Remember, there are many houses on the market. So try to keep your enthusiasm to a minimum when you find the "perfect" home. Recognize that being able to walk away may be the best bargaining chip you hold in a buyer's market.

For Sellers

Prepare yourself for low-ball offers that may seem more like insulting bluffs than valid offers. These offers will come your way, and the best defense may be to tactfully refuse them and politely encourage the buyer to come back with a more realistic offer.

Hire a home inspector. Having a home inspection report in hand is a good way to handle negotiations and prevent unpleasant surprises. You can get problems fixed or factor the price of repairs into the price of the home.

Be prepared to move quickly if you get an offer. A seller who needs two or three months to move out may put the sale at risk.

With the simple strategies outlined here, both buyers and sellers can be in a better position to achieve their goals, whatever the state of the real estate market.

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