

Insight on Estate Planning

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How to fund long-term care insurance with a tax-free exchange

For many people, the possibility that they'll incur significant long-term care (LTC) expenses is one of the biggest threats to their estate plans. These expenses — for nursing home stays, assisted-living facilities, home health aides and other care — can quickly deplete funds you've set aside for retirement or to provide for your family. For example, according to the *Genworth 2012 Cost of Care Survey*, the median rate for a private nursing home room is a staggering \$81,030 per year.

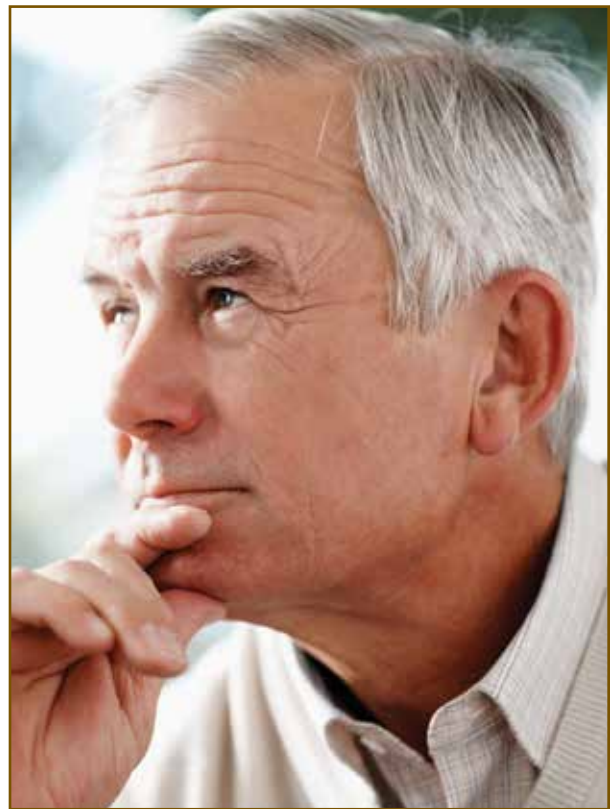
One of the most effective ways to defray these costs is by purchasing LTC insurance. But LTC insurance also is a major expense, especially for someone who purchases it at or after retirement age. One potential source for funding LTC insurance premiums is a total or partial tax-free exchange of an existing life insurance policy or annuity contract.

A glance at exchanges

For many years, Internal Revenue Code Section 1035 has permitted taxpayers to exchange one life insurance policy for another, one annuity contract for another, or a life insurance policy for an annuity contract without recognizing any taxable gain. (Sec. 1035 doesn't permit an exchange of an annuity contract for a life insurance policy.)

In the late 1990s, the U.S. Tax Court approved *partial* tax-free exchanges, finding that these exchanges satisfy the requirements of Sec. 1035. A partial exchange might involve using a portion of an annuity's balance or a life insurance policy's cash value to fund a new contract or policy. In order for the transaction to be tax-free, the exchange must involve a *direct* transfer of funds from one carrier to another.

The Pension Protection Act of 2006 expanded Sec. 1035 to include LTC policies. So now it's possible to make a total or partial tax-free exchange of a life insurance policy or annuity contract for an LTC policy (as well as one LTC policy for another). Keep in mind that, to avoid negative tax consequences after making a partial exchange of an annuity contract for an LTC policy, you must wait at least 180 days before taking any distributions from the annuity.



Benefits for LTC funding

A tax-free exchange provides a source of funds for LTC coverage and offers significant tax benefits. Ordinarily, if the value of a life insurance policy or annuity contract exceeds your basis, lifetime distributions include a combination of taxable gain and nontaxable return of basis. A tax-free exchange

Tax treatment of LTC insurance

Generally, if a long-term care (LTC) policy is “tax-qualified,” benefits are excluded from income and the premium payments are partially deductible as medical expenses. For 2013, federal deductions are subject to the following limits. (State deductibility varies by state.)

Taxpayer’s age at year end	Deduction limit
40 or less	\$360
41 to 50	\$680
51 to 60	\$1,360
61 to 70	\$3,640
Over 70	\$4,550

A tax-qualified policy is one that:

- Covers only “qualified” long-term care services,
- Requires certification from a licensed health care practitioner that you’re unable to perform at least two activities of daily living — or that you have a “severe cognitive impairment” — and that this condition has lasted or is expected to last at least 90 days,
- Is guaranteed renewable and has no cash surrender value,
- Doesn’t cover expenses paid by Medicare, and
- Complies with certain consumer protection laws.

Like other medical expenses, the deduction is available only if you itemize and only to the extent that all your total medical expenses exceed 10% of your adjusted gross income (7.5% for taxpayers age 65 and over, through 2016).

allows you to defer taxable gain and, to the extent the gain is absorbed by LTC insurance premiums, eliminate it permanently.

Consider this example:

Tony, age 75, is concerned about possible LTC expenses and plans to purchase an LTC insurance policy with a premium of \$10,000 per year. He owns a nonqualified annuity (that is, an annuity that’s not part of a qualified retirement plan) with a value of \$250,000 and a basis of \$150,000 and wishes to use a portion of the annuity funds to pay the LTC premiums. Under the annuity tax rules, distributions are treated as “income first.” In other words, the first \$100,000 Tony withdraws will be fully taxable and then any additional withdrawals will be treated as a nontaxable return of basis.

To avoid taxable gain, Tony uses partial tax-free exchanges to fund the \$10,000 annual premium payments. In an exchange, each distribution includes taxable gain and basis in the same proportions as the annuity: In this case, the gain is $(\$100,000/\$250,000) \times \$10,000 = \$4,000$. Thus, each partial exchange used to pay LTC premiums permanently eliminates \$4,000 in taxable gain.

Partial tax-free exchanges can work well for standalone LTC policies, which generally require annual premium payments and prohibit prepayment. Another option is a policy that combines the benefits of LTC coverage with the benefits of a life insurance policy or an annuity.

Typically, with these “combo policies,” the death or annuity benefits are reduced to the extent the policy pays for LTC expenses. Often, premiums on these

policies can be paid in a lump sum, in which case a total tax-free exchange of an existing life insurance policy or annuity contract may be appropriate.

In an exchange for a combo policy, any gains used to fund LTC premiums will permanently avoid tax. But gains that become part of the policy's cash value or are used to fund annuity payments may eventually be taxed.

Weigh your options

LTC insurance can be an effective way to protect your nest egg against LTC expenses and preserve it for the next generation. And a tax-free exchange can be a cost-efficient strategy for funding LTC premiums. To determine whether this strategy is right for you, compare the costs, benefits and tax implications of various LTC insurance options, and assess the impact on benefits under the policy or annuity being exchanged. ■

Should a CRT be part of your estate plan?

It brings a great deal of satisfaction to Joe that he has the ability to make substantial gifts to his favorite charity. However, after the last few years of economic uncertainty, he's become concerned that he may encounter cash-flow problems in the future if he continues to donate. Joe's estate planning advisor explains how a charitable remainder trust (CRT) can benefit his situation.

What's a CRT?

A CRT allows you to support a favorite charity while potentially boosting your cash flow, shrinking the size of your taxable estate, reducing or deferring income taxes, and enjoying investment planning advantages.

How does a CRT work? You contribute stock or other assets to an irrevocable trust that provides you — and, if you desire, your spouse — with an income stream for life or for a term of up to 20 years. (You can name a noncharitable beneficiary other than yourself or your spouse, but there may be gift tax implications.) At the end of the trust term, the remaining trust assets are distributed to one or more charities you've selected.

When you fund the trust, you're entitled to claim a charitable income tax deduction equal to the

present value of the remainder interest (subject to applicable limits on charitable deductions). Your annual payouts from the trust can be based on a fixed percentage of the trust's initial value — known as a charitable remainder annuity trust (CRAT). Or they can be based on a fixed percentage of the trust's value recalculated annually — known as a charitable remainder unitrust (CRUT).

A CRT is particularly effective for selling highly appreciated assets that would otherwise generate substantial immediate capital gains.

Generally, CRUTs are preferable for two reasons. First, the annual revaluation of the trust assets allows payouts to increase if the trust assets grow, which can allow your income stream to keep up with inflation. Second, you can make additional contributions to CRUTs, but not to CRATs.

The fixed percentage — called the unitrust amount — can range from 5% to 50%. A higher rate increases the income stream, but it also



reduces the value of the remainder interest and, therefore, the charitable deduction. Also, to pass muster with the IRS, the present value of the remainder interest must be at least 10% of the initial value of the trust assets.

The determination of whether the remainder interest meets the 10% requirement is made at the time the assets are transferred — it's an actuarial calculation based on the terms of the trust. If the ultimate distribution to charity is less than 10% of the amount transferred, there's no adverse tax impact related to the contribution.

What are the investment advantages?

CRTs facilitate tax-efficient investment strategies. To manage investment risk, diversification is critical. Ordinarily, to diversify your portfolio, you liquidate more-concentrated holdings and reallocate the proceeds to a broader range of investments. But portfolio rebalancing typically generates taxable income. By contributing assets to a tax-exempt CRT, however, you're essentially free to reallocate the assets to achieve your investment objectives without concern about immediate tax consequences.

A CRT is particularly effective for selling highly appreciated assets that would otherwise generate substantial immediate capital gains. Instead of selling those assets outright, you contribute them to a CRT. The trustee then sells them, unburdened by capital gains taxes, and reinvests the proceeds in more diversified assets that provide greater returns.

Annual payouts from a CRT are taxable — generally as a combination of ordinary income, capital gains and tax-exempt income (if any), and tax-free return of principal. But because you pay tax only as you receive the annual payouts, you can defer much of the tax on a large capital gain for a potentially significant period of time (depending on the trust's term).

Seek advice before taking action

After listening to his advisor, Joe decides a CRT can help him to continue making substantial contributions to his favorite charity while alleviating his concerns about his future cash flow. Before taking action yourself, it's important to know that a CRT requires careful planning and solid investment guidance. Your estate planning and financial advisors can help you determine if a CRT is right for you. ■

The key to an effective trust is education

A trust is a versatile estate planning tool. It's a vehicle for transferring wealth to the next generation in a tax-efficient manner. It can also provide incentives for your beneficiaries, serve as a financial "safety net" for your family, protect assets from creditors, achieve your philanthropic goals and leave a lasting legacy.

But no matter how well it's designed and drafted, a trust won't reach its full potential unless all of the stakeholders — grantor, trustee and beneficiaries — understand the trust's goals and their roles in achieving them.

Grantor

No one understands the goals of a trust better than you, the grantor. But it's critical that you communicate your goals to your advisors and understand how the trust will achieve them.

It's important to consider potential conflicts between the trustee and the beneficiaries, particularly if the trustee is a family member.

You should also educate yourself about the trustee's duties and responsibilities to ensure that you select the right person for the job. You want to be sure, for example, that your trustee possesses the requisite financial, business, organizational and interpersonal skills.

It's also important to consider potential conflicts between the trustee and the beneficiaries, particularly



if the trustee is a family member. To avoid conflicts and ensure the trustee is qualified, it may be desirable to engage a professional trustee, such as a bank, trust company, attorney or financial advisor.

Trustee

Once you've identified potential trustees, you should educate them about what's involved so they can make an informed decision about whether to accept the job. Some people, for example, may feel that they're not qualified to manage investments or that they're too close to the family to make objective decisions regarding distributions and other matters.

It's also critical to educate the trustee about what you hope to accomplish with the trust. Although it's possible to include very specific instructions in the trust document, often trusts are more effective if the trustee has broad discretion in managing and distributing trust assets. Educating the trustee helps ensure that he or she will exercise this discretion with your goals and principles in mind.

Beneficiaries

Don't underestimate the importance of educating a trust's beneficiaries. So long as they're old enough, they shouldn't be simply passive recipients of your wealth. Make sure they understand your goals and how the trust will provide financial security for them and their dependents down the road.

This is particularly critical if the trust is required to provide beneficiaries with withdrawal rights in order to qualify contributions for the \$14,000 annual gift tax exclusion. Although you can't ask your beneficiaries to agree not to exercise their withdrawal rights, you should educate them about the long-term benefits of keeping assets in the trust.

Providing beneficiaries with financial training and educating them about their rights will enable them to monitor trust performance (particularly after you're gone) and, if necessary, replace the trustee. It's also a good idea to set up periodic meetings between the trustee and beneficiaries to keep the lines of communication open.

Read the owner's manual

A trust is a powerful estate planning tool. But like any other tool, it won't produce the best results unless all stakeholders learn how to use it properly. ■

Estate Planning Pitfall

You've named a minor as beneficiary of your life insurance policy or retirement plan

A common estate planning mistake is to designate a minor as beneficiary — or contingent beneficiary — of a life insurance policy or retirement plan. Insurance companies and financial institutions won't pay large sums of money directly to a minor. Instead, they'll require costly court proceedings to appoint a guardian to manage the child's inheritance. And there's no guarantee the guardian will be the person you'd choose.



Suppose, for example, that you're divorced and appoint your minor children as beneficiaries. If you die while the children are still minors, a guardian for the assets will be required. The court will likely appoint their mother — your ex-wife — which may be inconsistent with your wishes.

There's another problem with naming a minor as a beneficiary: The funds will have to be turned over to the child after he or she reaches the age of majority (18 or 21, depending on state law). Generally, that isn't the ideal age for a child to gain unrestricted access to large sums of money.

A better strategy is to designate one or more trusts as beneficiaries of the policy or plan. This approach provides several advantages: Not only does it avoid the need for guardianship proceedings but it also gives you the opportunity to select the trustee who'll be responsible for managing the assets. And it allows you to determine when the child will receive the funds and under what circumstances.

Estate Planning You Can Trust

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