



Advanced Planning Strategies

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Dear Reader,

Congress approved the “Military Family Tax Relief Act of 2003” (HR 3365) and it is expected that the President will sign the bill by the time you receive this letter. The bill includes the following provisions:

- The residency requirement for the capital gain exclusion for the sale of a personal residence can be suspended for absences due to official duty away from home.
- The tax-free death gratuity benefit to survivors of military members killed on active duty is increased to \$12,000.
- The travel expenses incurred by National Guard and Reserve members who must travel away from home more than 100 miles (and stay overnight) to attend National Guard and Reserve meetings will be allowable as an above-the-line (not subject to floors or phase-outs) income tax deduction.
- Service academy appointments will be treated as scholarships for the purposes of qualified tuition programs and Coverdell education savings accounts.
- The tax-exempt status of an organization designated or identified by U.S. federal authorities as a terrorist organization or supporter of terrorism is suspended. The bill eliminates some of the administrative hurdles in removing tax-exempt status and makes reinstatement a more difficult task.

The federal estate and generation-skipping transfer taxes were repealed for one year (2010) by tax legislation enacted in 2001. The taxes will be reinstated by a sunset provision after the year of repeal. The uncertainty created by the legislation has been highly criticized, but no effort to change the status one way or the other has been successful. It is clear that the deficit will make further tax relief difficult. Some proposals to solve the problem have been discussed. One method being discussed would keep the estate tax with higher exemptions and lower maximum rates. Another bill (introduced last year as S. 2994) would repeal the estate tax on family-owned businesses or farms. We'll keep you posted as events develop and look forward to keeping you up-to-date with tax developments again next year.

Knowledge is not power. Only knowledge in use is power.

GROWING PROBLEM OF LONG-TERM CARE EXPENSES

WHAT IS LONG TERM CARE?

A long-term care expense is defined more broadly than simply nursing home costs. Any time an individual needs care because of a prolonged illness, disability, or simply old age, long-term care expenses may be incurred. The care could vary from skilled nursing care to custodial care, which includes assistance with bathing, eating, dressing, and other routine tasks. The care could be 24 hours per day or less intensive. Long-term care is provided by home care agencies, senior centers, adult day care centers, traditional nursing homes, and continuing care retirement communities. Family members also often serve as personal caregivers to meet some or all long-term care needs.

MAGNITUDE OF LONG-TERM CARE NEEDS

Surveys reveal some interesting facts about long-term care. Seventy-five percent of individuals age 36 to 54 responded that they had no idea of the costs of eldercare in a recent survey. Most respondents have indicated great fear about the ability to fund their own care. About 20 percent of individuals over 65 need some assistance every day with daily activities. This statistic increases to 50 percent at age 85 and over. It is currently estimated that more than 40 percent of individuals will need nursing home care at some point. Although many nursing home stays are short, the average stay is 2 ½ to 3 years. These statistics could become worse as the U.S. population ages. The over-65 population is expected to be more than 20 percent of the total by 2030. Currently, the fastest growing segment of the senior population is the group over age 85: an important statistic since 25 percent of individuals who reach this age will require nursing home care. The baby boomers (born 1946 through 1964) represent one-third of the population, and this group will soon begin to reach retirement age.

The costs of long-term care are significant and will vary dramatically by the amount of care and the location of the care provider. Based on the numbers used to calculate Medicaid disqualification periods, recent average nursing home costs ranged from a high of \$8,583 per month in some counties in New York to a low of \$1,700 per month in Arkansas. Of course, the actual cost an individual who needs long-term care incurs depends on the specific facility and the amount of care provided. Assisted living (without skilled nursing care) averages \$2,159 per month nationally, again with significant variation by location. Even in-home nursing or custodial assistance a few times weekly will cost several thousand dollars each year.

COVERAGE UNDER MEDICARE

A large misconception is that Medicare will cover long-term care expenses. In fact, although Medicare provides significant comprehensive health care benefits, its long-term care coverage is fairly limited. Medicare generally pays for a nursing home in full for only 20 days. A period of up to 80 additional days may be available with a daily co-payment of over \$100. A hospital stay of at least 3 days is required within the prior 30 days before entering the nursing home. The benefit is available only if a physician certifies that skilled nursing care or rehabilitation services are required. The benefit is not available if only custodial services are required. Medicare does have extensive home care coverage for nursing or therapy services, but it does not provide coverage for assistance with normal activities of daily living.

COVERAGE UNDER MEDICAID

Medicaid is a program jointly provided by federal and state governments. However, most administration is handled at the state level, and some significant variations exist. State budgets have created a squeeze, and many programs are administered strictly. The Medicaid qualification rules are complex and vary from state to state. Before an individual can receive Medicaid benefits for long-term care in most states, he or she must “spend down” most other income or assets. What’s worse, the individual must count his or her spouse’s assets as available assets. Normally, an individual is able to keep only certain exempt assets (such as the home) and a small amount of nonexempt assets. The maximum amount of allowable nonexempt assets that can be kept by the community spouse (the spouse not receiving care) is \$90,660 in 2003. The maximum income allowable (known as the Minimum Monthly Maintenance Needs Allowance) to the community spouse is \$2,267 per month. In many states, the limits are lower. The state has a right to recover assets from the estate of an individual who received benefits, and some states have aggressively pursued such estates—even taking the family home.

That’s not the end of the story. Generally, only skilled nursing, not assisted-living, facilities are covered. Because nursing homes receive lower reimbursement per patient from Medicaid, the number of beds available for Medicaid patients may be limited. This could be a huge problem if the patient hopes to stay in a specific facility or near family. It is clearly less risky to enter a long-term care facility as a private-pay patient.

LONG-TERM CARE INSURANCE COVERAGE

Long-term care insurance (LTCI) is a contract between the buyer and an insurance company. For the required premium payments, the company promises to pay for the covered cost of long-term care when needed, up to the policy limits. LTCI helps to cover the cost of services for people who have an extended physical illness, an extended disability, or a cognitive impairment (e.g., Alzheimer's, dementia, etc.). The LTCI plan can protect personal independence and dignity by allowing the freedom of choice to receive care at home or in a facility selected by the family. LTCI policies are not limited to care in a nursing home but are designed to pay for care in an assisted-living facility or other appropriate setting (such as the insured’s home). The Health Insurance Association of America estimates the availability of LTCI benefits will reduce the probability by two-thirds that an individual will have to spend down assets to qualify for Medicaid. The coverage is attractive for those who have acquired an LTCI policy. It has been reported that less than 1 ½ percent of individuals who buy LTCI allow the policy to lapse before receiving benefits.

Some important considerations in selecting an LTCI policy include the following:

- Should coverage include both institutional and home care?
- How large a daily benefit should be purchased? (Should inflation protection be included?)
- How long a benefit period should be selected? (For example, should it be limited to 3 years, or should it have a lifetime benefit?)
- How long should the elimination period be? (An elimination period is the period of time [e.g., 90 days] that benefits must be paid out-of-pocket before the LTCI policy begins payment of benefits.)

TAX TREATMENT OF LONG-TERM CARE INSURANCE

Most LTCI policies enjoy favorable income tax treatment. Premiums paid for “tax qualified” (defined in the tax code) LTCI policies are deductible against income as a medical expense subject to certain limitations. First,

only a specific amount of the premiums paid can be deducted based on the individual's age and an inflation-indexed table. For example, a 65-year-old can deduct up to \$2,600 of LTCI premium in 2004. In addition, the LTCI premium is deducted as a medical expense (an itemized deduction) subject to the minimum floor of 7.5 percent of adjusted gross income. Moreover, LTCI benefits are generally received income tax free for expenses incurred for qualified long-term care services. If the LTCI policy provides a fixed daily benefit, it is received tax free up to an inflation-indexed per diem limit (\$230 in 2004) even if actual expenses incurred are lower. LTCI can also be offered by employers on a tax-advantaged basis.

RECENT CASES AND RULINGS

IRS RULES ON GIFT TAX IMPLICATIONS OF TRUSTEE'S POWER OF ADJUSTMENT

Settlor (S) created a trust to provide for S's son. Income would be accumulated until the son reached age 21 and then would be provided to him or for his benefit during his lifetime. The remainder at the son's death would be payable to his descendants, or if the son left no descendants, to S's other children. The trustee also had the power to distribute principal to the income beneficiary. The co-trustees are the son's two children and three other individuals who are not beneficiaries of the trust. The state of jurisdiction for the trust has a provision (available in some form in many states) for the trustee to "adjust between principal and income to the extent the trustee considers advisable to enable the trustee to make appropriate present and future distributions in accordance with risk and return objectives reasonably suited to the entire portfolio, and where such an adjustment would be fair and reasonable to all of the beneficiaries." This power permits the trustee to invest the trust fund in a total return diversified portfolio and provide the appropriate annual distribution to the income beneficiary while providing growth potential for the remainder beneficiaries.

The power to adjust principal into income was exercised by the three beneficiaries who are not direct or presumptive beneficiaries of the trust. (One trustee did have an indirect contingent interest through marriage to a contingent beneficiary.) The IRS ruled (Ltr. 20334025) that the exercise of the power to adjust some principal into income and distribute the adjusted amount to the income beneficiary did not represent a taxable gift from the two trustees who are children of the income beneficiary and, as such, have a direct interest in the principal of the trust. This ruling indicates that there may be some concern for using "interested" parties as sole trustees if the power to adjust will be employed. The IRS has issued proposed regulations concerning tax implications of the power to adjust or the power to convert an income trust into a unitrust (a trust that pays an annual percentage of trust value rather than accounting income). Unfortunately, the proposed regulations were not made immediately effective, and final regulations have yet to be released.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

*Positioning our clients
for the future*



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