

TOWISE

TIPS, TECHNIQUES AND STRATEGIES FOR A WELL-PLANNED RETIREMENT

COST-CUTTING TIPS FOR LONG-TERM CARE

With the aging population, the demand for long-term care will increase. The cost of providing end-of-life care can become a substantial financial burden, even for those with insurance coverage. Matching tax benefits with funding sources can provide some relief.

Medical expenses are deductible as an itemized deduction to the extent they exceed 7.5% of an individual's adjusted gross income (AGI). Generally, a substantial portion, if not all of the cost of providing long-term care, can be included as a medical expense. Therefore, individuals that have substantial long-term care expenses will also have substantial deductible medical expenses, and it becomes important to match taxable income and deductible expenses to minimize taxes and preserve wealth for future expenses.

Example: Carey's assets consist of traditional IRA accounts, appreciated stocks and cash in a savings account. To the extent that the expenses will offset the income, the IRA funds should be used first. This is because the IRA will be fully taxable to any beneficiary, while inherited stocks and cash will generally not be taxable.

In addition to conventional medical expenses, individuals with long-term care needs frequently encounter other expenses. Amounts paid for nursing services, including the employer's part of employment taxes, can be included in medical expenses. Services need not be performed by a nurse and include giving medication or changing dressings, as well as bathing and grooming. These services can be provided in the home or another care facility. Medical expenses also include amounts paid for the cost of inpatient care at a hospital or similar institution if the main reason for being there is to receive medical care. Amounts paid for meals and lodging are included, making the entire cost of a nursing home generally deductible.

When funds are not readily available to pay for the care, the following may be alternate sources of additional funding. These options should be considered carefully since they can be costly.

- **Sell or Mortgage the Home** – If the family member receiving long-term care will never return to the home, it can be sold to finance the care. If he or she meets the two-out-of-five ownership and use tests, then all or a portion of the gain can be excluded from taxation. If the care is being provided at home, a reverse mortgage can be used to finance the care. Typically, a bank commits itself to a principal amount, not to exceed 80% of the appraised value of the property, which is loaned to the borrower in installments over a period of months or years. Repayment of the loan is due when the principal amount has been fully paid to the borrower, when the residence that secures the loan is sold, or if the borrower dies or ceases to use the home as his or her principal residence.



- **Life Insurance Proceeds** – Generally, life insurance only provides cash payment after death. However, there are ways to receive cash from a life insurance policy while the insured is still alive. One method is referred to as a viatical settlement, where the policyowner sells a life insurance policy to a third party. The buyer is responsible for future premium payments and will receive the proceeds of the policy when the insured dies. Group life insurance may be eligible for a viatical settlement, depending on the terms of the policy. Alternatively, the insurance company may directly provide an accelerated death benefit. Insurers usually have a requirement that the insured only has a short time to live (generally six months to one year).

In both situations, the early settlements will be substantially less than the face value of the policy

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COST-CUTTING TIPSCONTINUED

(generally 60% to 80%). If the patient is certified by a physician to be terminally ill (death expected within 24 months), the payments are also tax-free.

There is a wide range of long-term care services available, which may be provided in nursing facilities, community residential care settings, or an individual's own home. The location depends greatly on the severity of the patient's needs and the types of financial resources available to provide that care. Through careful planning, we can help preserve and maximize your resources.

IS A LIVING TRUST THE ANSWER TO PROBATE?

Millions of Americans are turning to the living trust as the most effective way to avoid the trouble and expense of probate. Assets held by a trust pass to the beneficiaries without going through the lengthy and expensive probate process. However, leaving some assets out of the living trust may cause a probate at death. If a taxpayer passes away and has assets in his or her own name (i.e., not in the living trust) worth more than the state will allow, these assets will be subject to the probate process. The fact that there is a living trust containing some or most of the assets will not avoid probate in this case. An exception to this rule is assets held in Joint Tenancy, which revert to the joint tenant and generally also avoids probate.

Example: Jackie was a resident of San Diego and passed away in January 2005 from a fatal car accident. She had a living trust in place, but she kept some of her assets under her own name. These assets were worth more than the California threshold of \$100,000 and will be subject to the probate process.

Another thing to consider is that retirement assets, such as 401(k) plans and IRAs, must remain in the individual's own name and cannot be owned by the living trust. These assets pass upon death in accordance with the beneficiary designation. If that is the case, why not make the living trust the beneficiary of the retirement account? The answer is quite simple. Naming the trust as the beneficiary can cause extra administrative hassle after death and can lead to a loss of income tax deferral for the beneficiaries. In certain cases, however, it is prudent to name the living trust as the beneficiary (for example, when minor children are the intended beneficiaries). It is also important to name proper contingent beneficiaries in the event that the primary beneficiary predeceases the retirement plan owner.

If you have a living trust, make sure all of your assets, with the exception of retirement assets such as 401(k) plans and IRAs, are in the name of the trust. This will help eliminate the need for probate.

For more information on the benefits of a living trust, consult an estate planning attorney.

USING YOUR TAX RETURN TO YOUR ADVANTAGE

Where can you find a record of all your financial transactions throughout the year? In a place you least expect: your tax return. With some comparison and analysis of prior tax returns, a taxpayer can learn a lot about his or her financial well-being. Use your tax return to develop a one- to five-year plan for the future. Start off by reviewing Schedule D (Capital Gains & Losses) from the past three or four years. Were the stocks held long enough to qualify for the long-term capital gains rate? Did you succeed in balancing short-term gains with short-term losses? Would you consider your mutual funds to be "tax smart"? Asking these questions will help you evaluate your existing investment strategy.

In addition, your tax return will help you decide if your current investment vehicles are achieving your long-term goals. Determine where your money should be invested in order to satisfy your individual risk strategy.

Your tax return analysis will also help with retirement planning. Look at your W-2 and the retirement contribution deductions allowed in determining adjusted gross income. Are you maximizing the amount that you are allowed to save tax-free for retirement? Doing an analysis will help you save enough so that, between social security benefits and your savings, you can keep your annual withdrawals under 5% per year and still afford living expenses.

Take a look at your interest deductions next. Find ways to have Uncle Sam pay off some of your loans through tax deductions. Have you maximized or overused the advantages of borrowing on margin? Since consumer debt is a given these days, smart borrowing on an after-tax basis can keep things in check. But be careful if you are subject to the alternative minimum tax. You may not be getting any benefit from your equity debt interest and should consider reducing it.

Now what about the medical expense deduction? Since the premiums for long-term care insurance are now considered a medical expense, some taxpayers are realizing that along with other health insurance premiums, deductibles and timing of elective treatments, the medical tax deduction is at their fingertips. On the other hand, if your income (AGI) is so high that the 7½% floor wipes out your medical deduction, check to see if your employer has a medical cafeteria plan or if you qualify for one of the new Health Savings Accounts.

What about your employee business expenses? Are those expenses being substantially reduced or eliminated by the 2% floor for miscellaneous deductions? If so, it would benefit you to consult with your employer to establish an accountable plan so you can be reimbursed with tax-free dollars.

The longer you keep your tax returns, the more documentation you have of your financial history for analysis. Review your tax return and start the critical planning toward financial independence and a comfortable retirement.

AVOIDING OR MITIGATING THE EFFECTS OF THE AMT

AMT is the acronym for Alternative Minimum Tax. It is a different (alternative), and generally punitive, method of computing income tax when either certain types of income receive preferential tax treatment or there are excessive deductions in certain categories. The AMT was originally designed to impose a minimum tax on higher income taxpayers who were avoiding taxes. However, years of inflation without corresponding adjustment to the AMT components have caused an increasing number of taxpayers to be subject to the AMT. The following six items routinely affect the average taxpayer:

Medical Deductions – These are allowed for the AMT computation, but only to the extent that they exceed 10% of a taxpayer's income. In contrast, the regular tax computation limit is a lesser 7.5%. Sometimes it is possible to defer or accelerate medical expenses from one year to another, such as paying the orthodontist in installments or all at once. If your employer offers one, consider participating in a flexible spending plan. It allows you to pay medical expenses with pre-tax dollars and avoid both the regular tax and AMT deduction limitations.

Tax Deductions – When itemizing deductions, a taxpayer is allowed to deduct a variety of taxes, including real property, personal property and state income tax. But for AMT purposes, none of the itemized taxes are deductible. For most taxpayers, this represents one of their largest tax deductions and frequently triggers the AMT. If you are affected by the AMT, conventional wisdom would dictate deferring tax payments to a subsequent year when the AMT may not apply. When deferring, care should be exercised in regards to late payment penalties and interest on underpayments for certain taxes. In addition, taxpayers can annually elect to capitalize taxes on unimproved and unproductive real estate. This means foregoing the deduction currently and adding the tax paid to the cost basis of the real property.

Home Mortgage Interest – For both the regular tax and AMT computations, interest paid on a debt to acquire or substantially improve a home or second home is deductible as long as the debt limit (generally \$1 million) isn't exceeded. This is true of refinanced debt, except that any increase in debt is treated as equity debt. For regular tax purposes, the

interest on up to \$100,000 of equity debt on the two homes can also be deducted. However, equity debt is not deductible against the AMT; neither is the acquisition or equity debt interest on a motor home or boat that qualifies as a second home. Therefore, taxpayers should exercise caution when incurring home equity debt. Generally, loan brokers are not aware of these limitations, and there are numerous pitfalls.

Miscellaneous Itemized Deductions – The category of miscellaneous deductions that includes employee business expenses and investment expenses is not deductible for AMT purposes. For certain taxpayers with deductible employee business expenses, this can create a significant AMT. Employees with significant employee business expenses should attempt to negotiate an "accountable" reimbursement plan with their employer. Under this type of plan, the reimbursement for qualified expenses is tax-free. Because the employee has been reimbursed, he or she no longer claims a deduction for the expenses, thus eliminating the miscellaneous deduction. Another strategy would be to defer the expenses to a year not affected by the AMT.

Personal Exemptions – Personal exemptions for dependents provide no benefit when taxed by the AMT method. Therefore, divorced or separated parents should carefully consider which party should claim the exemption for a dependent child.

Standard Deduction – Since the regular tax standard deduction is not allowed as an AMT deduction, taxpayers affected by the AMT should always itemize. Granted that the benefit of some deductions will be lost, there is still a partial advantage. Even the smallest of charitable deductions will benefit at a minimum of 26% (the lowest bracket for the AMT).

The AMT is an extremely complicated area of tax law that requires careful planning to minimize its effects. Please contact our office for further assistance.

Caution: Although not frequently encountered, incentive stock options (ISO) can have a profound impact on the AMT, and clients are strongly encouraged to seek our advice prior to exercising incentive stock options.

REFUND VS. UNDERPAYMENT: IT'S ALL ABOUT YOUR WITHHOLDING!

What did Uncle Sam surprise you with this year – a big tax refund or a huge debt to pay? The ideal situation is to owe a small amount at tax time. If you have a large refund coming your way, you just gave the government an interest-free loan. That money could have definitely been put to better use!

Instead of celebrating your good fortune, find a way to avoid giving the government free use of your money this year. Increasing the number of exemptions claimed on your W-4 or reducing your estimated tax payments should do the trick. You may even consider doing both! Just be careful not to go overboard and find yourself stuck with a tax underpayment. Your payments for the 2005 tax year should generally be enough to cover whichever of the following is the lower amount:

- 90% of your 2005 tax liability, or
- 100% of your 2004 tax if your 2005 income (adjusted gross income) is \$150,000 or less (110% if your AGI was over \$150,000).

For those taxpayers that end up owing more than 10% of their total tax

bill, an interest-charge penalty could be imposed for not paying enough before filing. This scenario is the exact opposite of those receiving a refund. To avoid falling into this category, examine your paycheck to see how many exemptions you claimed. If too many exemptions were claimed, correct your withholding amount to ensure that it will cover this year's tax bill. File a new W-4 with your employer and claim fewer exemptions to withhold more from each paycheck.

Are you also receiving income from self-employment or through investments? This could be another reason for your tax underpayment. To fix this problem, start making estimated tax payments for this year or increase the amount of your payments if you already plan to make them. Keep in mind that estimated payments for the 2005 tax year are due on April 15, June 15, September 15, 2005 and January 16, 2006. Form 1040-ES must be filed with each payment.

By taking the appropriate course of action, you can avoid any unexpected blows next tax season. Please call our office to assist you with your 2005 tax projections, W-4 adjustments and safe harbor estimates.

Tax

CALENDAR



June 15, 2005:

- U.S. citizens living abroad on April 15, 2005 must file a 2004 Income Tax Return (if not already filed) or file for an extension.
- Second installment of 2005 Individual Estimated Taxes due. If your income or deductions have significantly changed, you should call this office to determine if any adjustment in estimates is appropriate.

June – July 2005:

- Time to review 2005 year-to-date income and expenses to ensure estimated tax payments and withholding are adequate to avoid underpayment penalties.

August 1, 2005:

- Due date for self-employed individuals and employers to file 5500 Series Returns for 2004 calendar year benefit

plans (including Keogh/HR-10 plans). This due date is extended to August 1, 2005, since the normal July 31 due date falls on a Sunday.

August 15, 2005:

- Extended 2004 Individual Returns due (if four-month automatic extension was filed).
- Last day to file for an additional extension of time to file the extended 2004 Return. The additional extension, if granted by the IRS, can extend the filing date to October 17, 2005.

September 15, 2005:

- Third installment of 2005 Individual Estimated Taxes due.

To The Wise is published as a service to our clients and friends. The content is general in nature and should not be acted upon without further guidance.

TO the WISE

SINCE YOU ASKED...

Question: My husband and I are planning to sell our home in the near future. This home was purchased for us by my parents a few years back, and its current value is significantly more than what they paid for it. Even though they held the title, we have been paying the mortgage and property taxes for the last several years. In addition, there was a verbal agreement between us that we could sell at any time. Is it true that we will be heavily taxed if we go through with the sale? Will this still apply if we purchase a home in our new neighborhood?

Answer: Since verbal agreements are insignificant in real estate (or to Uncle Sam), it was a big mistake not to hold the home's title in your names. The fact that you made the mortgage and property tax

payments does not entitle you to claim the tax deductions for the payments you made all those years. Only individuals who have an ownership interest in the property can deduct the interest and taxes on their tax return. Your parents are not entitled to the interest and taxes deductions either. They may have held the title, but the payments came from your pocket.

Selling the home has another major drawback. If, after the sale, your parents honor the verbal agreement and give the proceeds to you, they will not only be responsible for the huge capital gains tax but may be faced with gift tax consequences. You should seek professional advice since the tax implications are quite complicated.