

# Insight on **estate planning**

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attorney isn't HIPAA-compliant



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# Take my retirement benefits, please

## Tax considerations when naming retirement plan beneficiaries

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ou've worked hard for your wealth, and an impressive retirement plan is one of the fruits of your labor. You're fortunate enough that you don't need to depend on this nest egg to support your retirement, so you want to determine how you can best use it to benefit your family.

Whom should you select as your beneficiary? Among the most important considerations is the income and estate tax impact of your choice.

### A double-edged estate planning tool

IRAs and employer sponsored "qualified" plans, such as 401(k)s, can effectively build wealth for your family because no taxes are due until funds are withdrawn, which allows you to take advantage of tax-deferred compounding. (In the case of Roth accounts, no taxes are *ever* due on growth — as long



as all distributions are qualified. Your estate planning advisor can tell you more.)

When it comes to estate planning, though, tax-deferred retirement plans are a double-edged sword. Most inherited assets, such as stocks and real estate, receive a step-up in basis on the death of the owner of the assets, which means that heirs will owe income tax only on income or capital gains generated *after* they inherit the asset. (Note that, during the estate tax repeal scheduled for 2010, the step-up in basis will be limited.)

But for family members who inherit funds from your traditional 401(k) plan, traditional IRA or most other qualified plans, that isn't the case: The beneficiaries will have to pay income tax on 100% of the distributions they receive, except to the extent that you used nondeductible contributions to fund the account.

For example, if one of your children inherits your \$1 million traditional IRA and another child inherits your \$1 million brokerage account, their actual inheritances after taxes could be drastically different. If each liquidates his or her account immediately upon inheriting it, the child receiving the IRA could owe as much as \$350,000 in federal income tax alone, whereas the child receiving the brokerage account could owe no tax.

### Minimizing the income tax bite

To minimize the income tax bite — and maximize the wealth-building power of a tax-deferred retirement plan — consider how long the beneficiary will be able to defer distributions, how large any required minimum distributions (RMDs) will be and

## Other beneficiaries to consider — or avoid

You aren't limited to naming a family member — or even a person — as beneficiary; you can name just about anyone or anything as the beneficiary of your retirement benefits, such as:

**A trust.** If you're married or your major asset is your retirement plan and you have a taxable estate over \$2 million, including your retirement plan, naming a trust could be a viable option because it can help you maximize what ultimately goes to your heirs without negatively affecting your spouse's inheritance. If you're single and wish to manage and protect your retirement plan assets for the benefit of your children or other young beneficiaries, a trust may also be a viable option. Bear in mind that you must adhere to special tax rules when naming a trust as a beneficiary to ensure that the RMD is based on the beneficiary's age. Otherwise, the distribution requirements will be treated as though your estate were the named beneficiary.

**Your estate.** When you name your estate, you're essentially not naming a beneficiary. If you die *before* you're required to start to take RMDs, all of the money in the plan will have to be paid out to the beneficiaries of your estate by Dec. 31 of the fifth year after you die. If you die *after* you've started taking RMDs, all of the funds in the plan will have to be paid out to the beneficiaries of your estate over what would have been your remaining life expectancy. Either scenario accelerates the payment of income tax on the plan balance so generally should be avoided.

**A charity.** If you're charitably inclined, this can be a great way to cut your family's income and estate taxes. Neither your estate nor the charity will owe income tax on the retirement plan assets, and your estate should be eligible for a charitable deduction for estate tax purposes. However, if the charity is a beneficiary along with any individuals, it could affect the tax-deferral opportunities of the noncharitable beneficiaries. This will depend on how soon after your death the charity receives its share of the benefits.

the beneficiary's likely tax bracket.

Generally, for inherited retirement plans, annual RMDs must begin immediately. (An employer-sponsored plan may require the beneficiary to take a lump sum distribution of the plan's balance, but the Pension Protection Act of 2006 now allows most beneficiaries to roll the funds into an IRA, which will be treated as an inherited IRA.)

The size of the RMDs will depend on the size of the account and the age of the beneficiary — the younger he or she is, the smaller the RMDs will be. Because the account will be depleted more slowly with smaller RMDs, there's a greater opportunity for tax-deferred growth. Plus, a younger beneficiary may well be in a lower tax bracket, at least for the early years of RMDs.

However, there also may be deferral benefits to naming your spouse as beneficiary. Your spouse has more flexibility in deferring distributions because he or she can treat your IRA as his or her own and delay any

distributions until age 70½. Although this rule doesn't generally apply to other retirement plans, your spouse can roll the plan into an IRA for him- or herself and then take advantage of this deferral.

### Estate tax considerations

From an estate tax perspective, however, naming your spouse as the beneficiary may or may not make sense. The advantage is that you'll avoid any estate tax liability on the retirement plan assets at your death because transfers to your spouse (provided he or she is a U.S. citizen) are free of estate tax. However, the IRA will increase the size of your spouse's estate, which may result in increased estate tax at his or her death.

If you name a beneficiary other than your spouse, the retirement plan generally will be included in your estate. Whether it will cause any estate tax liability will depend on a variety of factors, such as the size of the plan, the size of your estate, and the estate

tax exemption available for the year of your death.

It's also important to consider the potential estate tax consequences for the beneficiary. For example, Tom, recently widowed with no children, wants to name his sister, Julie, as beneficiary of his IRA. He and Julie discuss the idea with his estate planning professional, and they determine that it makes more sense to name Julie's son, Eric, as beneficiary.

Why? Julie's net worth is already close to the \$2 million estate tax exemption, so inheriting the retirement plan could cause estate tax

liability at her death. She doesn't need the funds, and she'd name Eric as beneficiary after she inherited the account anyway. Plus, because Eric is 30 years younger than Julie, his RMDs will be smaller, so there will be greater opportunity to enjoy tax-deferred growth in the account.

### Not a one-time decision

Once you've determined your beneficiaries, review them regularly. Major life events such as marriages, divorces, births and deaths may require you to revise your beneficiary choices. ■

# Should you have long-term care insurance?

**P**roviding for your future health care needs is an important part of estate planning. The high cost of long-term care (LTC) — such as an assisted living facility or home health care — can quickly erode your estate, eating up wealth you intended to pass to your heirs.

The cost of LTC is staggering, and Medicare and other government programs provide little, if any, assistance. Recent studies estimate that the national average cost of nursing-home

care is more than \$66,000 per year for a semiprivate room and more than \$75,000 for a private room. In addition, for those who choose to stay at home, licensed in-home health care can exceed \$200,000 per year.

And it's not just *your* health you need to worry about. LTC expenses for a parent or spouse can rapidly deplete assets you were counting on to finance a comfortable retirement and provide for your family.

One effective way to protect yourself and your family against these risks is to obtain LTC insurance.

## LTC insurance personal premium deduction for 2007

<u>Insured's age at close of tax year</u>	<u>Eligible premium deduction</u>
40 or younger	\$ 290
41 to 50	\$ 550
51 to 60	\$1,110
61 to 70	\$2,950
71 or older	\$3,680

### LTC insurance 101

LTC insurance won't pay your medical bills or replace lost income — those are jobs for health and disability insurance — and an LTC policy isn't a substitute for those types of insurance. Also, LTC insurance won't pay the cost of a retirement facility



that provides a residence and activities for people who are able to live independently.

What LTC insurance does cover are services that help people with “activities of daily living” which will be specifically defined by the policy. These activities typically include eating, bathing, dressing, using the bathroom, and, if applicable, transferring from a wheelchair as necessary. These services may be provided by a skilled nursing facility, an assisted living facility or a home care provider.

Each LTC policy is different, so familiarize yourself with their terms, conditions and features. Be sure you know a policy’s benefit amounts, covered services and term (five years is typical). Most LTC policies are reimbursement arrangements, meaning the benefits are based on your actual expenses. Less common indemnity or “per diem” policies provide you with a stated amount per day regardless of your actual expenses.

An LTC policy defines the conditions that trigger the payment of benefits. Is it based on an inability to perform certain activities of daily living (ADLs) without substantial assistance? If so, how are ADLs defined, and how many activities must be impaired before you’re entitled to benefits? How does the policy define substantial assistance? Is a physician’s certificate required?

Most policies have an elimination period, which requires you to wait a specified amount of time after care begins (30, 60, 90 or 120 days, for example) before benefits are paid. Electing a longer elimination period will help lower the policy’s cost.

## Reduce the policy's premium

To minimize the cost of LTC insurance, you may buy a tax-qualified policy. If a policy is tax qualified, a portion of your premium payments is, at least potentially, tax deductible. And, any benefits you receive are tax free. To qualify, the policy must:

- Be guaranteed renewable and noncancelable regardless of your health (provided you pay the premiums),
- Not delay coverage of pre-existing conditions for more than six months,
- Not condition eligibility on prior hospitalization,
- Not exclude coverage based on a diagnosis of Alzheimer’s disease, dementia, or similar conditions or illnesses, and
- Require you to obtain a certification from a licensed health care practitioner stating that you’re either unable to perform at least two of six ADLs or you have a severe cognitive impairment and that this disability has lasted or is expected to last at least 90 days.

The income tax deduction is limited. You may deduct your premiums as medical expenses, but only up to a specified amount. (See “LTC insurance personal premium deduction for 2007” on page 4.) Medical expenses are deductible only if you itemize and then only to the extent they exceed 7.5% of your adjusted gross income (AGI).

If, however, you purchase the policy through your C corporation (or an S corporation of which you own less than 2%), the company is eligible to deduct 100% of the premiums.

## Review your options

LTC insurance can be a valuable tool for protecting your wealth against health risks and preserving your estate for your family. To determine whether LTC insurance is right for you, consider its cost as well as other alternatives, such as life insurance, personal savings or the availability of family members to provide care. ■

# Gifts that keep on giving

## Helpful tools for deathbed estate planning

**C**oping with failing health or terminal illness is one of the hardest things anyone ever has to do. And when time is limited, you're also faced with making immediate end-of-life decisions, including how to best provide for your family's financial future.

Take comfort in knowing that there are "deathbed" strategies that you can implement at the last minute to minimize estate taxes and ensure the best for your family after you're gone.

### Tax-free giving

Giving gifts is an effective strategy for deathbed estate planning. Although the government taxes your gifts, there are exclusions from the gift tax that let you make tax-free lifetime gifts without tapping your \$1 million gift tax exemption, and without the gift being added back to your estate (if given within three years of your death) for estate tax purposes:

**Annual exclusion gifts.** Using your annual exclusion, you can make an unlimited number of \$12,000 current interest gifts, such as gifts of cash or property, per recipient each year. Married couples can combine their gift-giving power and give away \$24,000 worth of property tax free, per year, per recipient. Using the annual exclusion repeatedly over a number of years can greatly reduce the size of your estate, which in turn reduces your estate tax bill.

Keep in mind that gifts are considered incomplete until the recipient actually has the cash in hand. For example, in some states checks aren't considered gifts until they've been cashed and the amount has been debited from the originating account. To be safe, give assets in the form of cash or cashier's checks.

**Gifts for medical or educational expenses.** You can give away an unlimited amount to pay someone's medical or educational expenses, without regard to the relationship. You must make these payments directly to the institution (the school or hospital) and not to the beneficiary. When gifting your child's or grandchild's educational expenses, only payments for tuition are covered for the exemption, not books or room and board. Medical expenses reimbursed by insurance aren't eligible for this exemption.

### Deathbed estate planning pitfalls

When considering deathbed strategies, be aware of several pitfalls, such as:

**Gifting your appreciated assets.** For tax purposes, rental properties and your home and stocks should be left as inheritances for your children and grandchildren. The cost basis of inherited assets is the fair market value of the property on the date of death. The cost basis of gifted assets usually is the same cost basis that the giver has.



For example, you have 300 shares of XYZ stock that you purchased for \$5,000 15 years ago that are now worth \$40,000. If you gift the shares to your grandchild, Jim, his cost basis in the stock will be \$5,000.

If Jim receives the XYZ stock as an inheritance, and it has a value of \$40,000 on the date of your death, Jim's cost basis in the stock will be \$40,000.

**Gifting stocks that have lost value.** Don't gift your children or grandchildren stock that has lost value since you purchased it.

Consider selling the stock so you can take the loss on your tax return, and gift the cash to family members instead. If you gift stocks or other property that has lost value, neither you nor your giftee will be able to deduct the losses on your tax returns.

**Establishing a family limited partnership (FLP).** The IRS might determine that an FLP was established to avoid paying taxes, rather than for legitimate business purposes.

**Setting up an irrevocable life insurance trust (ILIT).** To achieve its intended tax benefits,

an existing insurance policy must have been transferred to the ILIT at least three years before the insured's death. If the policy is purchased by the ILIT, however, you could avoid the three-year rule.

*It's never too late*

Ideally, the best time to plan your estate is when you're in good health and before serious illness strikes. But you can have peace of mind knowing there are some last-minute steps that you can take to ensure the financial welfare of your loved ones tomorrow. ■

## Estate Planning Pitfall



### Your medical power of attorney isn't HIPAA-compliant

Because of the personal nature of health care decisions, you recognize the importance of having a durable medical power of attorney (also commonly referred to as a “health care proxy”) as part of your estate plan. This document authorizes your spouse or another representative to make medical decisions on your behalf in the event you become unable to make them yourself.

But unless your medical power of attorney is compliant with the federal Health Insurance Portability and Accountability Act of 1996 (HIPAA), you could end up in a situation where your designated representative is forced to make a medical decision on your behalf without having complete access to your personal health information. Or your representative could have to petition a court for the appointment of a guardian who could then give the representative access, which could be time-consuming and costly.

Typically, a medical power of attorney requires a physician to certify in writing that you're unable to make your own medical decisions before your representative can step in. But according to HIPAA, health care providers are prohibited from disclosing your personal health information without first obtaining your written permission, and they could face severe penalties for unauthorized disclosures. Many physicians would consider certifying your incapacity to be a disclosure of personal health information. Of course, if you were incapable of making decisions, you likely would also be unable to provide written permission, leaving you in a “catch-22” situation.

That's why it's critical to carefully craft your medical power of attorney document to contain an express, HIPAA-compliant authorization. Then be sure to periodically review the document and update it as necessary to ensure it's current in relation to changing laws.

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Vaughan, Fincher & Sotelo, PC is dedicated to providing estate planning, estate administration and elder law services to individuals, families and their businesses. Our attorneys and legal professionals are experienced in developing estate plans tailored to your clients' individual needs and assisting clients and their families with

comprehensive estate administration services after a loved one has died. We also represent beneficiaries and fiduciaries on trust and estate matters, serve as trustee, executor and attorney-in-fact and provide business succession planning solutions. We employ a team approach to provide clients with high quality and cost-effective legal services.

**We are committed to providing the very best service. To achieve that end, you can expect the following when working with us:**

#### **Dedication**

Assistance from attorneys, legal assistants and other support staff who specialize in estate planning and administration and who continually receive training to provide the very best services.

#### **Continuity**

A team of professionals who will assist your clients, so that the absence of one particular individual will not prevent you or your client from receiving advice on any urgent matter and that we will be available to handle their legal matters promptly and efficiently.

#### **Commitment**

A continuing relationship with us so that we can help clients and their families in the years to come in preserving their current plans, making changes to their existing plans, and addressing any other issues that may arise. We are truly dedicated to growing with clients and helping them adjust and follow through with their planning arrangements over time.

#### **Full Service Solutions**

Guidance not only in the preparation and administration of estate plans generally, but support and guidance in more specific areas such as the funding of revocable and/or irrevocable trusts, full service estate administration services, coordination with financial planners, CPAs and other professionals and all other assistance necessary to provide the most comprehensive services available.

#### **A Helping Hand**

In the event a legal, tax or other matter arises for which we are unable to provide proper advice, we will ensure that clients are provided with referrals to the most capable and trustworthy advisors who are committed to the same standard of excellence to which we dedicate ourselves.

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