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Client Bulletin

Smart Tax, Business & Planning Ideas *from your* Trusted Business Advisor℠

July 2013

What's Inside

The Paradox of Long-Term Care Insurance

Eyeing 21st century America rationally, long-term care (LTC) insurance would seem to be an idea whose time has come. Life expectancy is increasing, so more people will reach a point where they'll decline physically or mentally and, thus, will require constant help. One recent study found that direct health care expenses for dementia, including nursing home stays, were $109 billion in 2010—greater than the cost of care for heart disease or cancer.

Medicare covers medical but not custodial care; Medicaid is available only to the impoverished. That should leave a need for LTC insurance, a need that companies in a free enterprise economy would rush to meet.

Logical or not, LTC insurance seems to be sputtering. Major insurance companies are trimming policy features or raising prices—or both. Some insurers are dropping out of the LTC market altogether.

For consumers, though, the need for LTC insurance still exists. Indeed, this year may be the time to buy, while certain policy attributes are still available.

Age-old problems

Some of the woes now facing LTC insurance can be traced to the relative newness of this coverage. The first policies were introduced in the 1960s, with some major insurers launching their product lines in the 1970s and even the 1980s. They expected substantial "lapse rates," meaning that many consumers

continued on page 2

The Best of Times

Although U.S. stocks have had excellent long-term results for nearly a century, a majority of the return was posted in four decades: the 1920s, 1950s, 1980s, and 1990s.

continued from page 1

Trusted Advice

Proper Policies

- "Qualified" long-term care (LTC) insurance policies can deliver tax benefits.
- To be qualified, the policy must meet several criteria. It must be guaranteed renewable, for instance.
- Qualified LTC policies also cannot have a cash surrender value, must contain certain restrictions on refunds of premiums, and generally cannot cover expenses that Medicare covers.
- You can include some or all of the premiums you pay for a qualified LTC policy as medical expenses on your tax return. Age-based limits apply. In 2013, the per-person caps on includible expenses range from $360, if you are 40 or younger, up to $4,550, if you're 71 or older.

would pay premiums for a few years and then stop paying before collecting any benefits. In practice, lapse rates have been scant because aging consumers held onto their policies, so insurers are facing a future in which they'll be obligated to pay more claims than they anticipated.

With LTC insurance, companies face claims many years in the future. Therefore, they primarily invest the premiums they collect in high quality, long-term bonds. Today, long-term Treasuries yield a meager 2%–3%, whereas the costs of long-term care are increasing in the neighborhood of 5% a year. Insurers caught in this squeeze essentially see three choices: raise premiums that consumers pay, trim the benefits offered in LTC policies, or drop out of the LTC business.

Final fling?

None of the choices mentioned in the previous paragraph are good news for consumers. If fewer companies offer LTC policies, the lack of competition is likely to keep prices high and policy benefits low. Nevertheless, some observers believe that this is a good time to buy LTC insurance.

Why? Because policy changes typically must be approved by state regulators, and such approval might take many months. For example, LTC policies now are usually gender neutral. That is, men and women pay the same price for comparable coverage. However, women live longer than men, on average, and industry data shows that women have been more likely to receive benefits from LTC policies.

Therefore, LTC insurers are applying for rate changes that would charge women more than men. According to the American Association for Long-Term Care Insurance, women probably will pay 20%–40% more than men for coverage once the new rates are in effect, so women in the market for this coverage might want to act soon. (Men, on the other hand, may decide to wait to see if their premiums come down.)

Beyond gender-based pricing, future LTC policies may be more expensive with fewer benefits than those currently on the market. Insurers are starting to require physical exams for applicants, which could make LTC insurance more costly for people with medical conditions. This year could be a window of time to buy LTC coverage at a relatively modest price before new rules take effect. ■

Trim Steep New Taxes With a Charitable Trust

High-income taxpayers face escalated effective tax rates as a result of new tax laws (see the *CPA Client Bulletin* for April 2013). Moreover, the higher rates are not limited to athletes, entertainers, and corporate CEOs who regularly collect substantial paychecks and bonuses. Taxpayers who ordinarily are in moderate tax brackets may trigger the new premium rates, surtaxes, and deduction phaseouts in any year when they sell a business, sell investment property, or take portfolio profits.

One strategy can defer these extraordinary gains for years or even decades. This tactic allows you to spread the gains over many years, so you may be able to keep your annual income down and, thus, avoid the extra taxes aimed at the top earners. If you might face such a situation in the future, consider setting up a charitable remainder trust (CRT) for the asset sales.

Convert gains into income

With a CRT, you transfer assets you own into an irrevocable trust. Often, you'd transfer appreciated assets that you plan to sell. For a CRT, you name an income beneficiary or beneficiaries, who will receive cash flow for a specified time period. The beneficiaries could be yourself and your spouse, for example. You also name one or more charities to receive the remainder interest in the trust—the assets left in the CRT after the income payout period.

Example 1: Matt Reese is about to sell investment property he has owned for many years. He expects to sell the property for $1 million and owe around $350,000 in various federal and state taxes, leaving him $650,000 to invest in securities for his retirement.

Instead, Matt transfers the property to a CRT he has created, and the CRT sells the property for $1 million. As a charitable trust, the CRT will owe no tax on the sale. Thus, the CRT has the full $1 million to reinvest in securities.

The 5% Solutions

When creating the CRT, Matt names himself and his wife, Janice, as income beneficiaries; he instructs the attorney drawing up the trust to have the CRT pay out income as long as either of them is alive. Matt can choose between two modes of payments:

- Matt can select an *annuity trust*, which will pay out a fixed amount each year. That amount must be at least 5% of the initial trust fund. If Matt sets up the CRT with $1 million of real estate, the trust can pay out at least $50,000 a year to Matt and Janice or to the surviving spouse. When they both die, the assets still in the trust will pass to charities Matt has named.
- Alternatively, Matt can structure his CRT as a *unitrust*, which will pay out a fixed percentage of the net fair market value of the trust's assets, valued annually, each year. Again, the minimum is 5%.

Example 2: Suppose Matt decides on a unitrust with a 6% payout rate. The first year, Matt and Janice will receive $60,000: 6% of $1 million. In future years, the CRT payout will be more or less than $60,000, depending on whether the trust's assets have appreciated or lost value. Thus, the unitrust structure offers the potential for more income, over time, but also the risk of reduced income if the CRT value falls.

Deducting the donation

Besides future cash flow, the creator of a CRT also will receive an upfront tax deduction. The deduction will be the present value of the remainder interest in the trust donated to charity after all the payouts to the income beneficiaries. This calculation is based on several factors, including the ages of the income beneficiaries and the CRT payout rate.

Under federal law, for a CRT to be treated as a charitable trust, the value of the expected donation must be at least 10%. If Matt Reese funds a CRT with a $1 million asset transfer, his deduction (the present value of the remainder interest in the trust) must be $100,000. This provision effectively caps a CRT's income payout—Matt might be able to stipulate a 6% or 7% unitrust lifelong payout for himself and Janet but not a 12% lifelong payout, if the larger payout leads to a projected remainder interest under $100,000.

Tax relief

If Matt and Janice Reese receive $50,000 a year from their CRT, that's the amount of income they will report. Such a relatively modest payout may keep this couple below the annual thresholds for higher taxes, whereas selling the investment property for $1 million in their own names might trigger a much more painful tax bite on the sale.

How will the CRT payout be taxed? That depends on how the money is invested inside the trust. If the trustee buys corporate bonds, for example, the taxable interest income will pass through to the trustee, taxed at high rates. On the other hand, if the trustee invests in growth stocks that generate no income for the trust, the taxable payout will retain the favorable capital gains tax treatment of the investment property sale. ■

Did You Know?

Crowdfunding websites, which solicit funds online for various ventures, raised $2.7 billion worldwide in 2012, up 81% from 2011. Massolution predicts that $5.1 billion will be raised via crowdfunding in 2013. The research and advisory firm sees a shift towards funding startup businesses and small firms rather than social projects, which is currently the most popular category.

Source: Reuters

Funding a Small Business Succession Plan

The June 2013 issue of the *CPA Client Bulletin* described the two key elements of a succession plan for a privately held company: putting a value on the business and finding the right successor. Even with those two ingredients, however, a succession plan can't be considered a success unless you get paid a fair price for your company. A viable small business might be worth $1 million, $10 million, or more; where will the buyer be able to get that much money?

Worst case scenarios

To start considering this issue, you might think of two types of business

continued on page 4

continued from page 3

succession: voluntary and involuntary. The latter could be caused by your death or severe disability. In case of such an involuntary departure from your role as head of the company, you'll want to have someone lined up to take over right away. You'll also want your heirs to be compensated for your equity in the company (in the event of your death), or you'll want some ongoing cash flow in your forced retirement (due to disability).

These risks should be addressed with a buy-sell agreement between you and a business partner, a key employee, or an outsider. Funding can come from insurance. In the event of your death, the policy beneficiary can use life insurance proceeds to buy your stake from your heir; if you are disabled, a disability income policy can provide the cash you'll receive after you're no longer able to run the business.

Dollars on departure

A buy-sell agreement may not cover situations where you want to retire or just leave the company for another line of work.

Example: Kay Turner reaches age 66 and decides she has worked enough, building her company to the point where it's worth $3 million, according to a reliable appraisal. Potential buyers include relatives, employees, other companies in her industry (sometimes known as strategic buyers), and outsiders (often called financial buyers) who hope to eventually sell Kay's company for more money than they pay her.

It's possible that the buyer will have $3 million to pay Kay and bid her farewell, but that's often not the case. In some situations, the buyer will borrow the money. Then the buyer will have to pay off the loan plus interest, probably from the company's future earnings. In this situation, Kay should see if "clawbacks" are in the contract—will she have to repay money she has already received if the company fails to meet certain future levels of earnings or revenues?

In many cases, the buyer might offer to pay Kay over a period of years, rather than make one upfront $3 million payment. Frequently, an extended payment plan will be structured as an earnout, meaning that Kay will continue to work for the company during a transition period with some financial incentive to maintain revenues or earnings.

Other forms of business succession funding may include the sophisticated use of trusts, often in pursuit of tax advantages. No matter how you intend to sell your business, you should read the contract carefully, evaluating all the devilish details. You also should have professional guidance for such a crucial transaction, and our office can help you determine that you're really getting a fair deal. ■

TAX CALENDAR

JULY 2013

July 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in June if the monthly rule applies.

July 31

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2013. Deposit any undeposited tax. If your tax liability is less than $2,500, you can pay it in full with a timely filed return. If you deposited the tax for the quarter in full and on time, you have until August 12 to file the return.

For federal unemployment tax, deposit the tax owed through June if more than $500.

If you maintain an employee benefit plan with a calendar year end, file Form 5500 or 5500-EZ for calendar year 2012.

AUGUST 2013

August 12

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the second quarter of 2013. This due date applies only if you deposited the tax for the quarter in full and on time.

August 15

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in July if the monthly rule applies.

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