Wealth Management

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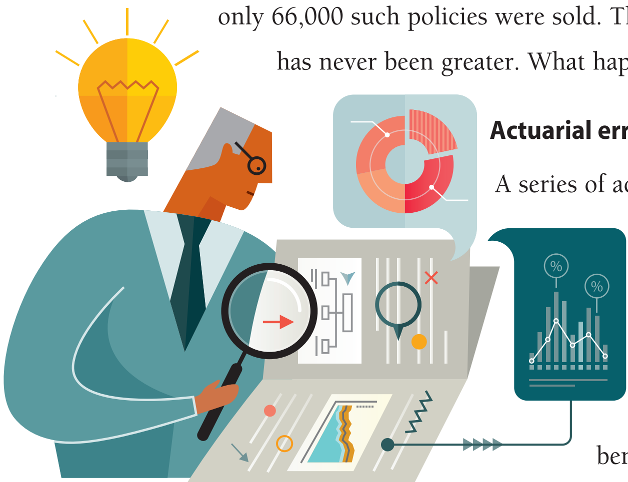
THIRD QUARTER 2018

A New Kind of Long-Term-Care Insurance

More than 400,000 long-term-care insurance policies were sold in 1992, according to figures published by *The Wall Street Journal*. These are the policies that help seniors cover the costs of nursing home stays at the end of life. At least 400,000 additional policies were purchased each year in the subsequent ten years, peaking at about 750,000 in 2002.

Then sales collapsed, and never again reached the 400,000 level. Last year, reportedly only 66,000 such policies were sold. The need for long-term-care insurance has never been greater. What happened to the market?



Actuarial errors

A series of actuarial errors were made when long-term-care insurance was first introduced. The most important of these was the "lapse rate," the number of policies that will be terminated without ever paying a benefit. This occurs either because the

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Estate settlement

Eight-year GRATs

The Grantor-Retained Annuity Trust (GRAT) has emerged as a popular strategy in the estate planner's toolkit. The idea is that a grantor places assets in a trust while retaining the right to receive payments from the trust. When the term of the trust expires, any assets remaining in the trust pass to a beneficiary, typically a family member.

The value of that future transfer is subject to the federal gift tax in the year the GRAT is funded. However, the larger the value of the retained income interest, the smaller the taxable value of the remainder becomes. In fact, it has become routine to set the retained interest high enough that the value of the remainder is zero. The future value also depends upon market interest rates, as reflected in tax code section 7520. The current 7520 rate

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Prohibited Transactions

Usually, an IRA is invested in stocks, bonds, mutual funds, and perhaps certificates of deposit. Sometimes a retiree may see this nest egg as a resource for a more unconventional investment. In that case, one needs to beware of the rules against self-dealing. Some transactions are prohibited under the tax code, and may lead to a disqualification of the IRA's tax-deferred status. Here are two examples.

A loan to the IRA owner

In December 1993, Ocean One North, Inc., was delinquent on its mortgage on certain improved real estate. Ernest Willis, a 50% owner of Ocean One, resolved the problem by purchasing the mortgage. To fund this transaction, Willis withdrew $700,000 from his IRA. The loan was for the short term, as Willis returned the money to the IRA 64 days later. If only he'd repaid the money in 60 days!

Then in 1997 Willis engaged in a check-swapping process between his brokerage account and his IRA. Eight times he simultaneously moved money between the two accounts, making total deposits of $2,022,000 into the brokerage account and $1,835,000 into the IRA. The net result

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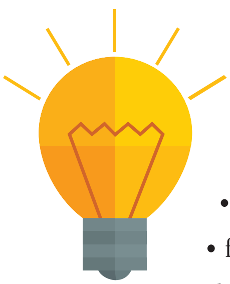
insured stops paying premiums or the insured dies without making a claim. The actuaries chose a fairly conservative lapse rate of 5%. At that rate, if 1,000 policies were sold in year one, only 400 would be in force 20 years later. As it turned out, the buyers of long-term-care insurance thought of their purchase as an investment, not as insurance, and so the lapse experience was closer to 1%, which implies that 800 of every 1,000 policies still will be in force after 20 years. That led to far higher payouts than projected.

Two more errors compounded the damage. The first is that medical advances have lengthened life expectancies, which, in turn, increases the likelihood of making a claim on a long-term-care insurance policy. The second is that the actuaries generally assumed a 7% rate of return on the invested premiums on these policies. That assumption was fine in the 1990s, but interest rates have been at historic lows since 2008.

Hybrid insurance



The new approach in this area combines life insurance with long-term-care insurance. An estimated 260,000 such policies were sold last year. There is wide variation among such policies, but they may offer:

- a death benefit;
- guaranteed level premiums;
- a return of premium feature should the buyer have a change of heart;
- fully paid-up insurance after 10 years.

When the product offers more, it will cost more. In an example published recently in *The Wall Street Journal*, coverage for a couple in their mid-50s came to over $32,000 per year for 10 years, a total of $320,000. That compares to some $8,500 per year for a traditional long-term policy, in which the premiums must continue to be paid. After 30 years, the traditional policy will require $255,000 in total premiums, assuming no premium increases, so the disparity is not as large as it may at first appear.

What's more, the minimum death benefit of the hybrid policy was $180,000 per spouse, which will be larger than the total premiums paid.

Still, the hybrid policy requires most of the premium payment early. For this couple, the policy will be paid up when they are in their mid-60s, and they may well not make a claim for another 20 years. Such coverage will be most attractive for individuals with high current income, sufficient to comfortably cover the premiums, who wish to protect a large estate from being eroded by private nursing home costs. Maximum coverage in the illustration was $1,371,891 per spouse.

Look to the future

If you already have a long-term-care policy, you probably want to hang on to it. For the most part, those who have purchased these policies have profited from them.

Planning is necessary. Despite the price increases, long-term-care insurance will prove to be an important part of that plan for many affluent families. ■

is 3.4%. That means that today a two-year zeroed-out GRAT would pay the grantor 47.9% in the first year and 57.5% in the second year, according to a recent item in *Tax Notes* magazine.

When the grantor retains an interest this large, what is actually happening is the tax-free transfer of excess appreciation in the underlying assets.

Although the use of two-year GRATs has become fairly routine, the advent of a temporary doubling of the amount exempt from federal estate tax has inspired a new approach in some quarters. The idea is to match the term of the GRAT to the expiration date of the higher exemption at the end of 2025. Increasing the term of the trust increases the amount of appreciation that may be transferred tax free.

However, if the grantor of the GRAT dies before the term ends, the entire value of the GRAT will be subject to the federal estate tax. All the hoped-for tax benefits will be lost. Lengthening the term of the trust necessarily increases that risk.

That's where the larger exemption comes in. An estate of under $5 million won't be subject to federal estate tax in any event, whereas an estate of up to $11 million and change won't be taxable until after 2025. If a person with $10 million in assets creates a GRAT and dies before the end of the trust term, the larger tax exclusion still protects the property from taxation.

Not all planners are on board with the new idea, however. Some consider it a marketing gimmick. ■

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Avoid Retirement Surprises

The latest news on retirement preparedness is not encouraging. An estimated 40% of households headed by people aged 55 through 70 are unlikely to have sufficient resources to maintain their standard of living, according to a *Wall Street Journal* analysis. The median 401(k) account balance for this group is just $135,000, which might be enough for a $600 per month joint life annuity for a couple aged 65 and 62.

More troubling, the debt for this cohort is on the rise. New York Federal Reserve data indicate that those aged 60 through 69 had about $2 trillion in total debt, an 11% increase since 2004. Car loan debt was up 25%, and student loan debt increased by a factor of 6!

More and more people will have to work longer to achieve the level of financial independence necessary for retirement security.

How long should you plan for?

At the same time, life expectancies are improving, and that raises the financial stakes still further. According to the Social Security Administration, men turning 65 this year will, on average, live to age 84.3, and women to age 86.7. Many retirements will last for 25 or 30 years. About one in four of those now 65 will live to age 90, and one in ten to age 95. You may calculate your own life expectancy with the calculator found at https://www.ssa.gov/planners/lifeexpectancy.html.

How much will you need?

Developing a realistic retirement budget is an important exercise, one that requires an examination of values as much as resources. Some people enjoy living rather modestly during retirement. But one retiree we know says, "Life is too short to drink cheap wine." The retirement budget needs to be understood from three perspectives.

Essential versus discretionary spending. Which expenditures could be curtailed, even eliminated, in the event of financial reversals? Food is essential; restaurant dining is not. Is there room in the budget for savings?

Structural versus peripheral expenses. Some costs are binding, not subject to modification, and failure to meet them means a structural change in retirement. If you own real property, you must pay the taxes. If you have a mortgage, you must make the payments. If you own a car, you have to pay for routine maintenance. Trips, vacations, and gifts, in contrast, are peripheral expenses.

Fixed versus inflation-prone costs. Inflation has been very mild in recent years, but this may not be a permanent condition. Most retirement expenses are vulnerable to inflation, while retirement income generally is fixed. The response to inflation may include cutting back on optional purchases or substituting less expensive items for those that become unaffordable.

Understand also that long, modern retirements typically include three phases:

- active retirement, filled with travel and pursuit of deferred dreams;
- passive retirement, typically beginning in the mid-70s, when activities are gradually reduced; and
- final retirement, a period often marked by failing health and a need for long-term care.

A different retirement budget applies to each of these three periods.

Put us on your team

We specialize in two areas of personal financial management:

- Helping clients to achieve financial independence, using tax-sensitive techniques as appropriate.
- Helping clients to maintain financial independence by providing unbiased investment advice and trusteeship.

For specifics on how we might help you, make an appointment to meet with one of our trust officers. He or she will help you to inventory resources, spot financial problems and opportunities, and develop an investment plan that appropriately balances risks and rewards for your circumstances. We are at your service. ■

Prohibited . . . continued

of the transactions was an increase of $186,500 in the brokerage account, done in such a way that the IRA appeared to make no taxable distributions, as all funds were restored to it within 60 days.

Fast forward to 2007, when Willis declared bankruptcy. Normally, an IRA is a protected asset in bankruptcy, but not in this case. The bankruptcy court found that Willis engaged in prohibited transactions with his IRA, and so at that moment it lost its status as a qualified retirement plan. From a bankruptcy perspective, the IRA fully was subject to the claims of Willis' creditors, the Court held.

A loan to a parent

In 2005 Stacey arranged a $40,000 loan from her IRA to her father. Another IRA loan was made in 2012, this time $60,000 to Stacey's friend. In 2013 Stacey arranged for a rollover of her IRA to a new custodian. For some reason, the promissory notes for the loans were not rolled into the new account.

The IRS spotted the transaction, and charged that the failure to roll the notes into the new account created a taxable distribution to Stacey of $98,000. Taxes on the distribution, coupled with the penalty for failing to report it plus a 10% penalty because Stacey was not yet 59½, brought the total assessment to some $42,000.

At trial, Stacey initially argued that the notes were rolled into the new account. The Court then ordered both sides to prepare additional memoranda on whether the loan to Stacey's father was a prohibited transaction under the tax code provisions of ERISA, and what the tax consequence of that would be.

Both parties concluded that the loan was a prohibited transaction, with the result that the IRA ceased being an IRA the year that the loan was made. Accordingly, the distribution of the notes, even if it occurred, would not result in additional taxable income to Stacey in 2013. Because the IRA terminated so long ago, the statute of limitations for collecting additional taxes that should have been paid in 2005 had expired.

However, Stacey may not be entirely off the hook. Presumably, she needs to refile her returns for all open years to report the investment income from the account that became an ordinary investment account in 2005. What's more, the attempted rollover in 2013 was not proper, and the entire amount may be an excess IRA contribution, subject to a 6% excise tax until it is withdrawn. ■

Collectors Corner

Image courtesy of Swann's Auction Galleries

***Peter Rabbit and His Friends* by Harrison Cady. Cover for *People's Home Journal* (April 1926). India ink and watercolor on board. 22½ X 16¼ inches.**

Harrison Cady (1877-1970) was a beloved American illustrator whose works have been dubbed "zoological extravaganzas . . . . characterized by the most meticulous execution, elaborate scenes being filled with infinite detail—something going on all over the place." Cady worked for many of the nation's most popular publications but is best known for his lengthy collaboration with author Thornton W. Burgess on dozens of books featuring such animal characters as Peter Rabbit. Cady also both wrote and drew the *Peter Rabbit* comic strip for about 30 years. This charming illustration sold at Swann's for $10,625.

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