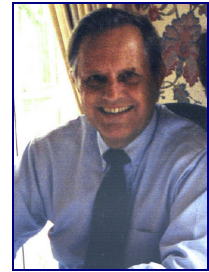


# from *Chuck's Desk*

Affordable Business Services Inc.

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*Chuck Donovan*

During the past three months I have been asked about **distributions to someone other than the spouse from IRAs and Variable Deferred Annuities and Long-Term Care Insurance**. It is worthwhile to review the rules regarding the distributions as they are quite different for a non-spouse than a spouse. Long-term care insurance is important to all seniors and discussed in this newsletter.

## Distributions from an IRA



It is generally known that, **if you inherit a traditional IRA from your deceased spouse, you have several options**. You can

1. Consider it as your own by naming yourself as the IRA's owner,
2. Roll it over into your own traditional IRA, or
3. Name yourself as its beneficiary instead of either considering or rolling it over.

### Rules for a Non-Spouse

**But, what are the options if you inherit a traditional IRA and you are not a spouse.**

It is not the same! **The rules and choices are very different.**

The IRA is now called an "inherited or beneficiary IRA". The **account title needs to be immediately changed** from traditional IRA to **"inherited or beneficiary IRA"**.

**As a non-spouse, you can not treat the traditional IRA that you have inherited as your own.** You are not allowed to make any contributions to it nor can you roll over any amounts into or out of it. Like the deceased owner, you will not owe any taxes until you receive distributions from it.



### The Five-Year Rule

**Distributions from an inherited or beneficiary IRA must begin in the year after the year of the decedent's death under the "five-year rule"**. This general rule requires that the entire amount in the beneficiary IRA must be distributed no later than December 31st of the fifth year after the decedent's death. You can select when and how to take these distributions during the five years. The decision depends on your own tax situation.

### Exception to the Five-Year Rule

**There is an exception to the "five-year rule" if the traditional IRA's owner died before taking any distributions from the IRA (i.e.; age 70½).** If so, you can take advantage of the exception and elect to receive the distributions over a period not to

**Affordable Business Services** offers accounting, income tax, and consulting services to individuals and businesses.

The **full service accounting firm** offers also innovative business solutions to small to medium size companies through specializing in the training, and consulting in the use of QuickBooks business management software.

The firm's principal **Chuck Donovan MBA** brings over 25 years of financial expertise to the business having worked as a senior financial executive with firms ranging in size from \$20 million to \$3 billion in sales.

Financial information is more than a series of numbers. The firm focuses on explaining and teaching the business owner to use the data to make more money and improve the business.

A *QuickBooks Professional Advisor* and experienced problem solver, **Chuck is a graduate of Dartmouth College and received his MBA from American International College.**

exceed your own life expectancy.



***It is critical that you make this election selecting another method of distribution very quickly after inheriting the IRA and take the first distribution by the end of the year following the year of the IRA owner's death.***

***You must do both*** - make the election and take the distribution at the appropriate time. ***If you do not***, you will lose the right to the exception and have to follow the requirements of the five-year rule.

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## Distributions from an Annuity

***An annuity has a different income tax consequence at the death of the contract owner (i.e. the annuitant) when it is passed to an heir or a beneficiary other than a spouse.***

When interest rates are low, many investors purchase an annuity that has a variable rather than a fixed rate. The selection of a ***variable rate annuity*** may provide higher returns but also increases the risk of adverse tax consequences to the beneficiary.



### Variable Rate Annuity

***A variable rate annuity has two phases*** which are the ***accumulation*** and the ***distribution*** periods. During the ***accumulation*** one the annuity grows untaxed as the investment compounds over the years. The ***distribution*** one begins on a specific start date when payments commence. They may be paid as a single amount or in a series of scheduled payments over a specific period or a lifetime.

This allows its value to grow larger each year without being diminished by taxes. Due to the tax deferral aspect of an annuity money can be moved between the investment funds without any tax consequences.



***The most attractive feature*** about such an annuity is its ***tax-deferred growth***. As long as the funds remain inside the annuity, no earnings are taxed, but all good things end eventually. Sooner or later a variable rate annuity will be subject to taxes when the funds are withdrawn.

### Designation of Beneficiaries

***The designation of the beneficiaries is usually made when the annuity is purchased.*** Purchasers often assume that the investment representative selling the annuity is including tax advice with the service, but this is not the case. Generally the investment representative recommends that they seek advice from a tax adviser. Few do. By the time the executor of the annuitant's estate discovers the tax problem, it is too late to make any corrections.

### Tax Postponed for Spouse

Millions of investors own these types of retirement accounts. ***It is a little known fact that the income tax on such an annuity can be postponed only if the annuitant's spouse is the sole beneficiary.*** The spouse is the new owner of the annuity.

### Taxable to Non-Spouse

The ***distribution to the non-spouse beneficiary*** is usually a lump sum payment

and becomes immediately taxable in the year of the annuitant's death. It is income when the value of the annuity through growth exceeds its original cost. The ***difference between its original cost and its current value could be a sizeable taxable gain*** that is taxed at an ordinary income rate. There is no capital gains tax break on the gain.

***A non-spouse beneficiary can defer any taxes only by electing within 60 days of the annuitant's death to receive the money in a series of payments stretched out over his or her lifetime rather than as a single lump sum.*** Otherwise the distribution is ordinary income taxed at the ordinary income rate and must be distributed within five years of death.



This is because the IRS has ruled that the contract is an annuity rather than an investment asset when the annuitant dies before the starting date of the distributions. It does not get the benefit of a stepped-up basis. In other words, ***the annuity is valued at its original cost and not valued as of the annuitant's date of death.***

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## Long-Term Care Insurance

I read a comment last week from another New Englander who said ***he had been thinking about long-term care insurance*** for the past two years, but, being a New England Yankee, he could not see himself spending \$5,000 to \$10,000 a year for the next 20 years to buy it.



I haven't given it much thought. His comment made me look into it. I can understand now why I am frequently asked about long-term care insurance.

I found that about ***50% of people over 65 will be admitted to a nursing home at some point in their lives.*** So why not buy the insurance? It seems many people don't insure themselves because they feel some other source such as Medicare will pay for it.

### Medicare Won't Cover Custodial Care

It turns out that ***Medicare covers short-term acute and recovery care provided by skilled medical professionals*** and is not set up to pay for the custodial care needed in cases of Alzheimer's disease, stroke, and many other chronic conditions.

The answer I found to how ***cost-effective long-term care insurance may be depends on when it is bought and how soon and how long it is used.*** Clearly the younger a person is when he or she purchases the insurance the cheaper it will be but also the longer he or she will pay the insurance premiums. Certainly it is not much of a trade-off.

### Considerations and Bewildering Options

I also found there is no one best long-term care insurance policy. There are ***three important considerations*** - stability of the insurer, conditions of the contract, and price of the insurance – ***and a number of bewildering options*** within them in selecting the coverage. Among the options are such questions as:

- what services are offered,



- when would I qualify for the benefits,
- how much coverage would I really need,
- how long a period would the insurance cover me, and
- is the insurance contract tax-qualified?

***The answers to and options selected from among them dramatically affect the cost of the insurance.*** It can vary widely based on the insurance company, current age, amount of coverage, and the options chosen.

### **Some Useful Tips**

I found ***a number of useful tips to consider*** when evaluating the coverage.

1. ***Most of claims under the policies are for home care***, so having the services broadly defined in the policy to include home health care, assisted living facilities, and adult day care centers are important.
2. ***My own doctor should determine if I would need assistance*** with daily living activities, such as eating, dressing, bathing, going to the bathroom, maintaining continence, and going from place to place rather than the insurance company's representative.
3. The best way to have the ***daily benefits calculated is having them aggregated over a month's time*** and then averaged by day. The higher the daily benefit amount selected, the higher the premium will be.
4. I should take ***as long a benefit period as I can afford*** because the average stay in a nursing home is about two and a half years.
5. Long-term care insurance contracts issued after the Health Insurance Portability and Accountability Act (HIPAA) passed in 1996 must meet specific standards to ***qualify for tax deductibility***. If it is tax qualified, the premiums can be deducted.



However, after having looked into it, I guess I am still a New England Yankee.