

## Life Insurance as a Source of Funds for the Terminally Ill

An individual who is terminally or chronically ill and lacks funds to cover significant medical (e.g. experimental treatments) and other family expenses may find the solution through his or her life insurance policies. Although insurance policies have historically been held for the death benefits, some policies now include an accelerated death benefit (or living benefit) rider. Where accelerated death benefits are not an option, it may be possible to sell the life insurance policy to a viatical settlement provider. Either way, individuals can secure some much-needed cash while they are still living. Better yet, the proceeds will usually be tax-free.

The accelerated death benefit available is normally payable when certain conditions are met and is usually a percentage of the face amount. The use of the proceeds is typically not restricted to the payment of health costs. The cash value and face value of the policy are reduced when the benefit is paid.

If the life insurance policy does not have such a rider, it may be possible to negotiate with the insurance company to offer these benefits through a



contractual arrangement. The insurer may be willing to cooperate since total death benefits are likely to be payable in the near future.

Viatication allows a terminally ill person to sell an existing life insurance policy for more than its cash surrender value but less than its net death benefit to someone who is buying it as an investment (i.e., the buyer continues to pay the premiums and receives the life insurance proceeds upon the death of the insured). Many companies currently either buy the policies themselves or serve as brokers to match buyers and sellers for a fee.

In identifying a potential seller, many viatical companies limit their selection to terminally ill individuals with a certain remaining life expectancy (e.g., 24 months or less). This is because the company wants to minimize its risk that the individual will outlive his or her life expectancy, resulting in a lower return from the purchase of the life insurance policy for the company.

The insured must determine whether it would be advantageous to sell his or her policy, considering (a) the individual's cash needs, (b) the discount in

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the value of the death benefit, (c) the possibility the payments will disqualify the individual for Medicaid benefits, and (d) access to the payments by the insured's creditors. (The cash value while it remains in a life insurance contract may not be subject to the claims of creditors.)

Amounts received under a life insurance contract (i.e., accelerated death benefits) on the life of terminally ill (or within limits, chronically ill) individuals are excluded from gross income for federal income tax purposes. A similar exclusion applies to the sale or assignment of any portion of a death benefit to a viatical settlement provider if the insured is chronically or terminally ill and the payments in question are funded by and diminish the life insurance policy's death benefit. However, the exclusion does not apply if the accelerated death benefits are paid to someone other than the insured individual if the recipient has a business or financial relationship with the insured

## Tax Calendar

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### January 15

- Individual taxpayers' final 2013 estimated tax payment is due unless Form 1040 is filed by January 31, 2014, and any tax due is paid with the return.

### January 31

- Most employers must file Form 941 (Employer's Quarterly Federal Tax Return) to report Medicare, social security, and income taxes withheld in the fourth quarter of 2013. (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 February 10 to file the return.
- Give your employees their copies of Form W-2 for 2013. If an employee agreed to receive Form W-2 electronically, have it posted on the website and notify the employee.
- Give annual information statements to recipients of certain payments you made during 2013. You can use the appropriate version of Form 1099 or

other information return. Form 1099 can be filed electronically with the consent of the recipient.

- File Form 940 [Employer's Annual Federal Unemployment (FUTA) Tax Return] for 2013. If your undeposited tax is \$500 or less, you can either pay it with your return or deposit it. If it is more than \$500, you must deposit it. However, if you deposited the tax for the year in full and on time, you have until February 10 to file the return.
- File Form 945 (Annual Return of Withheld Federal Income Tax) for 2013 to report income tax withheld on all nonpayroll items, including backup withholding and withholding on pensions, annuities, IRAs, etc. 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 year in full and on time, you have until February 10 to file the return.
- File Form 943 (Employer's Annual Federal Tax Return for Agricultural Employees) to report social security and Medicare taxes and withheld income tax for 2013. 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 year in full and on time, you have until February 10 to file the return.

### February 28

- The government's copy of Form 1099 series returns (along with the appropriate transmittal form) should be sent in by today. However, if these forms will be filed electronically, the due date is extended to March 31.
- The government's copy of Form W-2 series returns (along with the transmittal Form W-3) should be sent in by today. However, if these forms will be filed electronically, the due date is extended to March 31. March 17 n 2013 income tax returns must be filed or extended for calendar-year corporations. If the return is not extended, this is also the last day for calendar-year corporations to make 2013 contributions to pension and profit-sharing plans.

## 2014 Social Security Wage Base

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The Social Security Administration announced the wage base for computing social security tax

for 2014 will increase to \$117,000 from the 2013 wage base of \$113,700. This means that for 2014, the maximum OASDI portion of the FICA tax an employee will pay is \$7,254 (\$117,000 × 6.2%), and employers will match the employee's contribution. There is no wage base on the Medicare portion of the tax, so both employers and employees will pay Medicare tax on all wages at a rate of 1.45%. Employees with wages greater than \$200,000 will pay an additional Medicare tax of 0.9%. It is estimated that of the 165 million workers who will pay social security taxes in 2014, about 10 million will pay higher taxes because of the increased wage base.

## IRS Modifies FSA "use-it-or-lose-it" Rule

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IRS Modifies FSA "use-it-or-lose-it" Rule Health Flexible Spending Account (FSA) contributions left over at the end of a plan year are forfeited to the employer under the "use-it-or-lose-it rule," although a plan can provide a grace period extending the period for incurring expenses for qualified benefits to the 15th day of the third month after the end of the plan year (i.e., March 15th for a calendar-year plan). However, the IRS will allow employers, for the first time, to amend their Section 125 cafeteria plan to allow up to \$500 of unused amounts remaining at the end of a plan year to be paid or reimbursed to plan participants for qualified medical expenses incurred during the following plan year, provided the plan does not also have the grace period rule.

## Additional .9% Medicare Tax

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Individuals must pay an additional 0.9% Medicare tax on earned income above certain thresholds. The employee portion of the Medicare tax is increased from 1.45% to 2.35% on wages received in a calendar year in excess of \$200,000 (\$250,000 for married couples filing jointly; \$125,000 for married filing separately). Employers must withhold and remit the increased employee portion of the Medicare tax for each employee whose wages for

Medicare tax purposes from the employer are greater than \$200,000.

There is no employer match for this additional Medicare tax. Therefore, the employer's Medicare tax rate continues to be 1.45% on all Medicare wages. An employee is responsible for paying any of the additional 0.9% Medicare tax that is not withheld by an employer. The additional tax will be reported on the individual's federal income tax return.

Because the additional 0.9% Medicare tax applies at different income levels depending on the employee's marital and filing status, some employees may have the additional Medicare tax withheld when it will not apply to them (e.g., the employee earns more than \$200,000, is married, filing jointly, and total annual compensation for both spouses is \$250,000 or less). In such a situation, the additional tax will be treated as additional income tax withholding that is credited against the total tax liability shown on the individual's income tax return.

Alternatively, an individual's wages may not be greater than \$200,000, but when combined with a spouse's wages, total annual wages exceed the \$250,000 threshold. When a portion of an individual's wages will be subject to the additional tax, but earnings from a particular employer do not exceed the \$200,000 threshold for withholding of the tax by the employer, the employee is responsible for calculating and paying the additional 0.9% Medicare tax. The employee cannot request that the additional 0.9% Medicare tax be withheld from wages that are under the \$200,000 threshold. However, he or she can make quarterly estimated tax payments or submit a new Form W-4 requesting additional income tax withholding that can offset the additional Medicare tax calculated and reported on the employee's personal income tax return.

For self-employed individuals, the effect of the new additional 0.9% Medicare tax is in the form of a higher self-employment (SE) tax. The maximum rate for the Medicare tax component of the SE tax

is 3.8% (2.9% + 0.9%). Self-employed individuals should include this additional tax when calculating estimated tax payments due for the year. Any tax not paid during the year (either through federal income tax withholding from an employer or estimated tax payments) is subject to an underpayment penalty.

The additional 0.9% Medicare tax is not deductible for income tax purposes as part of the SE tax deduction. Also, it is not taken into account in calculating the deduction used for determining the amount of income subject to SE taxes.

Please contact us if you have questions about the additional 0.9% Medicare tax or any other tax compliance or planning issue.

## Structuring a Tax Free Incorporation

When forming a corporate entity, one method of capitalization is through a tax-free (actually, taxdeferred) exchange. Properly transferring property to a corporation delays the recognition of any gain on that property until a taxable event occurs (e.g., sale of the property or stock of the corporation, or liquidation of the corporation).

Generally, the transfer of assets and liabilities to a newly formed corporation solely in exchange for stock does not result in recognition of gain or loss by the transferor/ shareholder or transferee/corporation. The nonrecognition of gain or loss is mandatory rather than elective.

There are four requirements for a tax-free incorporation: 1. Property must be transferred to the corporation by one or more persons (including individuals, trusts, estates, partnerships, associations, companies, or corporations). 2. The transfer must be solely in exchange for the stock of the corporation. 3. The persons making the transfer, taken as a group, must own at least 80% of the transferee corporation immediately following the exchange. 4. The transfer of property to the corporation must be for a business purpose.

The IRS has proposed, but not finalized, a fifth requirement that the property have net value; i.e., the property's value exceeds any debt on the property. Property transferred to the corporation can include items such as cash, fixed assets, corporate stock, partnership or LLC interests, oil and gas interests, goodwill, and patents. However, property cannot include services rendered or to be rendered. Stock does not include securities (debt obligations), stock warrants or rights, or nonqualified preferred stock. If any shareholder receives property other than stock in exchange for property transferred to the corporation, a taxable gain may need to be recognized by that shareholder. Please contact us if you have questions concerning a tax-free incorporation or a related matter.

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Cathleen M. Petersen, E.A.

Cathleen@cathleenpetersen.com

Phone: 408-741-1412 • Fax: 408-741-1158

For more information visit:

[www.cathleenpetersen.com](http://www.cathleenpetersen.com)

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