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Estate Planning BULLETIN

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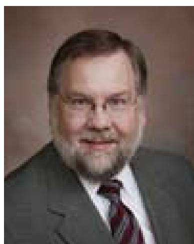
important tax developments



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The following is a summary of the most important tax developments that have occurred (or in some instances not occurred) in the past months that may affect you, your family, your business, your investments, and your livelihood. Please call us for more information about any of these developments and what steps you should implement to take advantage of favorable developments and to minimize the impact of those that are unfavorable.

1. *Income & Capital Gains Taxes* – Tax cuts passed in 2001 are set to expire in 2011. The administration and the Democratic leadership in Congress proposed extending the middle class tax cuts and allowing the top two income tax brackets to increase to 36% and 39.6%, respectively. Also, there were proposals to increase the capital gains tax from 15% to 20%. Most Republicans and several Democratic House members would extend all of the 2001 tax cuts and keep the capital gains rate at 15%. Agreement was not reached and Congress adjourned for the campaign season without passing any extension or modification of the 2001 income and capital gains tax laws. With the potential for higher income tax rates in 2011, some will consider it advantageous to take/report income in 2010 rather than defer it to 2011 if at all possible.

2. *New law gives tax breaks to small business.* The Small Business Jobs Act of 2010, which was signed into law on September 27, 2010, included a number of important tax provisions, including liberalized and expanded expensing for 2010 and 2011, revived bonus depreciation for 2010, five-year carryback of unused general business credits for eligible small businesses, removal of cell phones from the listed property category, and liberalized tax shelter penalty rules. Business owners and managers should consider how and when they can take advantage of these enhanced deductions and credits in the coming months.

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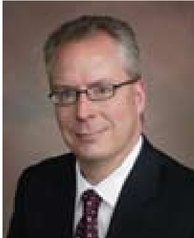
Fall 2010

Mom will need medical assistance.

Is it too late to save some of her assets for the next generation?



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Unlike some estate planning activities which concentrate on avoiding estate taxes and probate, medical assistance planning deals in large part with trying to preserve family assets if public medical assistance may be necessary. Since medical assistance eligibility is based upon need, one strategy to qualify for the assistance is to transfer assets owned by the medical assistance applicant to others through gifting or for less than fair market value so that the applicant's wealth is reduced to a level which makes the applicant eligible for medical assistance. The government realized these transfers were occurring and enacted laws to limit the effectiveness of this strategy if the transfers were made within a certain period of time before the application for medical assistance benefits. Many people, when reaching the later years of their lives, ultimately need to rely on assisted living, nursing home care, or have a significant need for medical and health care benefits. Many times these individuals have reduced their retirement savings and other assets through their retirement years to a relatively low level. The high costs of the assistance and medical care needed for these individuals makes them and their families quickly realize that the remaining assets in their estates will not be sufficient to pay for all the care and expenses which will be incurred. Since some form of public assistance may be necessary, the initial reaction is to attempt to transfer what assets are left to their children or grandchildren through gifting or less than fair market value transfers. Prior to 2005, there were many different rules and time periods in which the various government entities providing medical assistance benefits could attempt to void certain transfers in order to pay for the assistance provided. In 2005, Congress passed the Deficit Reduction Act ("DRA") which made two important changes to medical assistance eligibility. First, the DRA lengthened the period of time the governmental entity could review prior transfers. This period is known as the "look-back period." Second, the DRA delayed the start of the period of time during which medical assistance applicants who transfer assets for less than fair market value are ineligible for medical assistance. This date is known as the "penalty period." While the penalty period previously started at the time of the transfer, the DRA makes the penalty period begin on the date the applicant applies for and is otherwise eligible for medical assistance benefits. These changes brought about by the DRA made planning for potential medical assistance necessary at a much earlier stage in the aging process.

The DRA lengthened the look-back period for a transfer made on or after February 8, 2006 to 60 months. The DRA phases in the 60 month look-back period one month at a time so that until January, 2011, the look-back period always goes back to February, 2006. Beginning in January, 2011, the full 60 month look-back period will be completely phased in. Because the start of the penalty period for a transfer of assets for less than fair market value is the month of application for the benefits, a good planning strategy is to apply for medical assistance benefits 61 months after a suspect transfer in order to prevent any period of ineligibility for medical assistance benefits.

As with many rules, there are exceptions and exemptions to what will constitute assets available for consideration at the time of application for medical assistance.

Most significant among these assets is the homestead which will not be counted at the time of application if the applicant or another protected relative is still living there. For purposes of medical assistance, protected relatives includes spouses, children under 21, a child of any age who is blind or permanently and totally disabled, a sibling who lived in the house for at least one year immediately before the application and who has an equity interest in the home, or a child or grandchild who has lived in the house for at least two years and has provided verified care that has allowed the applicant to remain at home during that two-year period. Household goods and personal effects are exempt.

One motor vehicle, regardless of value if it meets certain qualifications; proceeds from the sale of a homestead if they are used to purchase another homestead within three months; and certain other types of insurance, funeral benefits, and burial funds also may be exempt. In light of this long list of assets which are considered unavailable for medical assistance purposes, a second medical assistance planning strategy is to use assets which are considered available to purchase assets which are considered unavailable. For example, using cash (which is considered an available asset) to purchase a pre-paid burial policy (which is considered an unavailable asset) is a good planning strategy.

While medical assistance planning focuses on available assets of the applicant, estate planning often focuses on probate or estate tax avoidance. Accordingly, the strategies typically used for estate planning purposes may not be appropriate for medical assistance planning purposes. In order for asset transfers to effectively make the asset unavailable for medical assistance purposes, the medical assistance applicant must give up all rights to the assets. However, transfers to revocable trusts which are made to avoid probate, for example, typically permit the grantor to revoke or modify the transfers and therefore will not qualify to render those assets as unavailable. Additionally, transfers of the homestead while retaining a life estate if done outside the look-back period may render the remainder interest unavailable for satisfaction of a medical lien, but the life estate value will still be included as an asset for which a potential lien may be asserted after the death of the applicant.

The rules and general principles set forth in this article deal with the most common types of medical assistance programs available under State of Minnesota and Federal law. Other look-back periods of rules apply to different types of benefits such as Veterans Administration programs. Each plan and situation must be particularly analyzed to determine the eligibility and best course of action.

Deferred Charitable Giving

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If you are charitably inclined, there are tax-advantaged ways to make a gift to a favorite charity while receiving a charitable deduction and enjoying the income from that gift for your lifetime. Many educational and charitable organizations offer plans that combine the benefits of an immediate income tax deduction and lifetime income from the charitable gift. In most cases, you can make the gift in cash or securities. Here is a brief overview of the major types of deferred charitable gifts.

(1)

A pooled income fund is probably the most common type of deferred giving plan. It closely resembles a mutual fund. When you make a gift to a pooled income fund, it is merged with gifts from other donors, and you receive your allocable share of the income earned by the fund. Distributions from the fund are usually made quarterly and are taxable as ordinary income. There is no guarantee as to the rate of earnings; that depends on the fund's success.

You get an immediate income tax deduction in the year in which you make a gift to a pooled income fund.

The amount of your deduction depends on a combination of your age and the fund's highest rate of earnings in the previous three years. The deduction will be less than the full value of your contribution, because it represents the present value of the funds that the charity will withdraw from the fund after your death.

(2)

In a charitable remainder unitrust (CRUT), a separate fund is set up to hold your gift until your death, at which time it will become the charity's property. You decide at the outset on the annual percentage of the fair market value of the assets that you are to receive as income for life. For example, you may make a $50,000 gift to a CRUT and specify an 8% return. Your annual income will be $4,000. If the value of the CRUT assets drop in the next year to only $40,000, your income that year will be $3,200. If the value goes up to $60,000 in the following year, your income that year will be $4,800. Unlike a pooled income fund, a CRUT is handled individually. Therefore, the charity may require a much larger initial contribution to a CRUT than to a pooled income fund.

Just as with a pooled income fund, your deduction for a gift to a CRUT will be less than the full value of your contribution.

(3)

A charitable remainder annuity trust (CRAT) is similar to a CRUT in that your gift to the charity is placed in an individual trust. The CRAT provides an annual payment of a fixed dollar amount for your lifetime. This differs from a CRUT, which provides a fixed percentage of the asset value.

For example, say that you make a $50,000 gift to a CRAT that will pay you $4,000 a year for life, after which the trust principal passes to the charity. If the CRAT earns less than $4,000 a year, it will sell assets to make up the difference. If it earns more than $4,000, it will pay you $4,000 and add the excess to the trust principal.

Your income tax deduction from a gift to a CRAT is based on your age and the amount of your annual payment. As a rule of thumb, the older you are, the larger the deduction, and the greater the annual payment, the smaller the deduction.

(4)

In a charitable gift annuity, you make a gift to charity in exchange for a guaranteed income for life. This is very much like buying an annuity in the commercial marketplace, except that you get an immediate charitable deduction equal to the difference between what you paid and what the annuity is worth, based on IRS tables. Unlike the pooled income fund, CRUT, and CRAT, your income from the charitable gift annuity is an obligation of the charity that does not depend on investment results. The rate of return on your gift annuity is not variable, as in a pooled income fund, or negotiable, as in a CRUT or CRAT. Instead, it is most likely to come from a table based on your age at the time of the gift.

A portion of each year's payment is tax-free, because the tax law allows you to recover your original payment over your life expectancy. In the year when you buy the annuity, you get a charitable deduction for a portion of the purchase price, determined from an IRS table geared to your age.

If the idea of deferred charitable giving appeals to you, please give one of us a call. We would be happy to discuss the pros and cons of the various types of deferred giving, and arrive at an arrangement that is right for you.

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3. *Estate Tax* –The White House and House Democratic leaders have generally supported an exemption of $3.5 million with a maximum rate of 45%. The last proposed bi-partisan compromise by Sen. Jon Kyl (R-AZ) and Sen. Blanche Lincoln (D-AR) included an exemption of $5 million with a rate of 35%. A group of Republican Senators introduced a bill that would retroactively raise the estate tax applicable exclusion amount and GST exemption to $5 million, repeal the carryover basis rules, reunify the estate and gift tax exemptions, reduce the top estate and gift tax rate to 35%, permit a surviving spouse to take advantage of the unused applicable exclusion amount of the first spouse to die, and allow the executors of estates of decedents who die in 2010 to elect whether to be taxed under this new regime or under the present 2010 rules. The Republican bill did not advance. If no action is taken by Congress when they return for the "lame-duck" post-election session, the estate tax exemption returns to $1 million and the tax rate will be as high as 55%.

Many whose estates would not have paid any estate tax under recent law would, in the absence of an estate tax change, potentially face much higher taxes. Some in this situation have considered making substantial gifts before December 31, 2010 so that assets can be passed to later generations at lower effective tax rates (gift tax rates are currently 35%). Because of the 2010 repeal of the GST tax, gifting to grandchildren has particular appeal for many. Also, because of very low applicable interest rates, grantor retained annuity trusts ("GRAT's") continue to be an attractive way for many to transfer anticipated future appreciation in assets to the next generation. For those whose asset base (whether in the form of a small business interest, a portfolio of investments, or both) is currently at an historically low value the GRAT technique can be a powerful tool to potentially save estate taxes, especially if the estate tax exemption amounts and rates revert to 2001 levels.

Please contact us to discuss how your planning can be adjusted and updated to respond to the changes and the current uncertainty in the applicable tax laws.

Our Estate Planning Services:

- Drafting wills, trusts, codicils, and Powers of Attorney
- Preparing Health Care Directives and Living Wills
- Creating Family Business Succession Plans with emphasis on each family's particular goals and values
- Evaluating estate and gift tax issues and structuring planning options to minimize tax obligations
- Administering and assisting clients with probate proceedings, conservatorships and guardianships
- Advising on Medicaid, Medicare, Nursing Home and Elder Law issues
- Handling disputed estate and probate matters in litigation, arbitration, or mediation formats
- Assisting with solutions to tax questions
- Administering wills, trusts, conservatorships, and guardianships

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