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McNEES INSIGHTS
Asset Planning and Federal Taxation

ATRA 2012 – HOW DOES IT AFFECT YOU? *by Vance E. Antonacci*

The American Taxpayer Relief Act of 2012 (the "Act") was signed into law on January 1, 2013. Among other things, the Act amended the federal estate, gift, and generation skipping transfer tax laws. The amendments of the Act will impact client estate plans in a variety of ways.

The Act makes permanent the estate, gift, and generation skipping tax laws that existed in 2012, except that the top tax rate is now 40% instead of 35%. In addition, the exemption amount for estate, gift, and generation skipping tax will be $5,250,000 in 2013. The exemption amount will be increased annually based on inflation. The Act also provides for the continued "portability" of a deceased spouse's unused exemption amount, the deduction (instead of a credit) against estate tax for the payment of inheritance tax, and the continuation of favorable rules regarding the generation skipping transfer tax and the payment of estate tax related to family business interests.

Many clients are concerned with whether their estate plans are "current" because of the Act, or if changes are necessary. Every estate plan – regardless of the tax laws – should be reviewed periodically to ensure that the plan carries out the client's objectives while at the same time addressing any necessary tax planning.

With the passage of the Act, clients should consider the following:

- Many clients will be able to simplify their estate plans given the increased estate tax exemption amount. For example, "disclaimer" planning and the funding of trusts upon the death of the first spouse may no longer be necessary for the sole purpose of avoiding taxes.
- Clients who are still impacted by the estate tax will want to consider additional estate planning techniques which avoid or mitigate estate tax exposure. For example, Grantor Retained Annuity Trusts ("GRATs") are attractive in a low interest rate environment as are transactions involving Intentionally Defective Grantor Trusts ("IDGTs").
- Clients who made large gifts in 2012 should review their estate plan to ensure the plan functions properly with the reduced exemption amount that is available to the clients after the large gifts.
- Due to the higher income tax rates, the 3.8% Medicare tax on investment income, and the limitation on itemized deductions, some clients may want to consider shifting income to children and grandchildren who are in lower income tax brackets.
- Clients who own assets with significant unrealized gains will want to consider using charitable remainder trusts to avoid the federal capital gains tax and the Medicare tax. Funding a charitable remainder trust also provides a charitable income tax deduction.
- Certain clients may want to consider unwinding trusts or taking other steps to own highly appreciated assets so there is a basis step up at death (clients will need to weigh the creditor protection offered by a trust against the tax consequences of no basis step up).
- Clients older than 70.5 years of age may want to contribute up to $100,000 from an IRA to a charity without recognizing any income (this particular aspect of the Act expires at the end of 2013).
- Clients with Irrevocable Life Insurance Trusts may want to unwind these trusts or take steps to pay up the life insurance policies owned by the trust.

Every estate plan and estate planning client are unique, so the Act will impact each client differently. Some clients, for example, will want to retain income producing assets while gifting non-income producing assets. Other clients, however, may want to unwind trusts while clients may want to continues trusts for tax planning or asset protection reasons.

We recommend a periodic review of any estate plan because the law and the client's circumstances and planning goals change. ■

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PLANNING AND PAYING FOR LONG-TERM CARE (PART 6 IN A SERIES: MEDICAID/ MEDICAL ASSISTANCE) *by Scott Alan Mitchell*

In Part 5, I discussed the issue of "excess" assets and the "spend-down" process in Medical Assistance. Apart from a couple's exempt assets (house, one car, household furnishings, etc.), the remaining assets are "countable" assets for purposes of Medical Assistance. If a couple has countable assets of $350,000, the community spouse (i.e., spouse living at home) can retain one-half of the countable assets, up to a current (as of January 1, 2013) maximum of $115,920. The nursing home spouse can retain $2,400 or $8,000 in assets (depending upon the nursing home spouse's income). If the couple can protect a combined amount of $123,920 ($115,920 + $8,000), the remaining "excess" assets total approximately $226,000. This means that the couple cannot become eligible for Medical Assistance unless and until (1) the excess is exhausted by paying for nursing care for 2+ years – and then applying for Medical Assistance after 2+ years, or (2) the excess is protected or spent in other categories of assets, as discussed in Part 5 (pre-paid funerals, paying off debt, repairs to a house, household furnishings, new car, spousal annuity, gifting, etc.). In this Part 6, gifts will be addressed.

Subject to the exceptions discussed below, the general rule is that gifts of assets made within five years of applying for Medical Assistance (generally referred to as the "lookback" period) will result in a person being ineligible for Medical Assistance benefits for a certain number of months – based upon the amount of the gift made. Specifically, the person will be ineligible for Medical Assistance benefits for as long as the gifted assets would have paid for the person's nursing care. In Pennsylvania, the current average monthly cost of skilled nursing care is approximately $8,407. Thus, if a person made a gift of $100,000 two years before applying for Medical Assistance, the person would be ineligible for Medical Assistance benefits for approximately twelve months ($100,000 divided by $8,407 per month equals 11.89 months of ineligibility).

It should be noted that two drastic changes were made to the lookback rules under the federal Deficit Reduction Act of 2005 (which went into effect in Pennsylvania in March 2007). First, under the prior law, the lookback period was three years (except for certain transfers involving trusts, which were subject to a five year lookback). Second, under the prior law, the period of ineligibility began to run from the date of the gift. Thus, if an individual gave away $100,000 two years ago and applies for Medical Assistance today, the twelve month period of ineligibility would have already expired a year ago, and so the person would be eligible for Medical Assistance benefits today. However, under the current law, the period of ineligibility only begins to run when the person otherwise is eligible for Medical Assistance. Thus, under the above example, under current law, the twelve month period of ineligibility would only begin to run when the person applies for Medical Assistance (and **not** when the gift was made), and the person would be ineligible for assistance for twelve months **after** applying.

There are various transfers or gifts that are excepted from the above penalties. The most obvious exception is a gift made at least five years before applying for Medical Assistance. Thus, if a person does not expect to need nursing care within five years, or if a person retains sufficient assets to pay for five years of nursing care ($500,000, for example), a person may transfer assets to children (and such gifts also avoid Pennsylvania inheritance tax as long as they are made at least a year before death). As long as the gifts are made at least five years and one day before applying for Medical Assistance, those gifts are outside of the five-year lookback and result in no penalty.

The following are additional transfers or gifts that specifically are excepted from the above penalties:

1. Gifts of $500 or less per month. It should be noted that the annual gift tax exclusion of $14,000 per person does not apply in the Medical Assistance context. If an individual gives away more than $500 per month within five years of applying for Medical Assistance, the transfer(s) will result in a penalty for Medical Assistance.

2. Transfers to a spouse. Recall that countable assets of both spouses – regardless of how titled - are considered for Medical Assistance purposes. Therefore, it is not the case that all assets simply can be transferred into the community spouse's name – and the nursing home spouse can then become eligible for Medical Assistance. Nonetheless, there are various other planning reasons to re-title assets in the community spouse's name, and those transfers are not penalized as gifts.

3. Transfer of a house to a child who resided in the parent's home for at least two years before the parent entered nursing care and who provided care to the parent which permitted the parent to reside at home rather than in an institution or facility (often referred to as the "caregiver" exception).

4. Transfer of a house or other assets to a child who is under twenty-one, or blind, or disabled – or to a trust for the child's benefit, such as a special needs trust.

5. Transfer of assets to a special needs trust for any disabled individual under age sixty-five.

6. Transfer of assets that later were returned to the individual

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(i.e., gifted assets can always be returned to the individual to reverse any Medical Assistance penalty).

7. Transfers made for a purpose other than Medical Assistance eligibility. For example, routine Christmas or birthday gifts or gifts to one's church generally would be made for a purpose other than becoming eligible for Medical Assistance. Also, large gifts made to children three or four years before an unexpected health crisis could be shown to have been made for a purpose other than Medical Assistance eligibility.

8. Transfers in which the Department of Public Welfare determines that imposing a penalty for Medical Assistance would cause undue hardship.

As can be seen above, because gifts made within five years of applying for Medical Assistance often make an individual ineligible for Medical Assistance benefits for a certain amount of time, and because there are numerous fact-specific exceptions in which gifts may not be penalized, it is important for families considering making gifts to consult with a knowledgeable elder law attorney to discuss the ramifications of any desired gifts.

In Part 7, I will discuss "spousal impoverishment" and what happens to a nursing home spouse's and a community spouse's income after the nursing home spouse is approved for Medical Assistance. ■

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OBAMA REVENUE RAISING PROPOSALS *by Vance E. Antonacci*

The Obama Administration recently released its budget proposal for the federal government's upcoming fiscal year of October 1, 2013 to September 30, 2014. The budget proposal contains a variety of changes to the tax laws designed to raise revenue.

Estate Tax, Gift Tax, and Generation Skipping Transfer Tax
The most notable proposed tax law change is for the estate tax, gift tax, and generation skipping tax laws to apply as they did in 2009. In 2009, the top marginal tax rate for each of these taxes was 45% and the exemption amounts were $3,500,000 for the estate tax and generation skipping transfer tax. The exemption amount for the gift tax, however, was only $1,000,000. Currently, the top marginal tax rates are 40% and both exemption amounts are $5,250,000, which will increase based on inflation. In 2009 there was not "portability" of a deceased spouse's estate tax exemption amount but the proposal provides for portability to continue. The budget proposes for this change to occur in 2018. Another important feature of the proposal is that prior gifts of more than $3,500,000 would not be recaptured so that any lifetime gifts in excess of $3,500,000 would not result in an increase in estate tax for a decedent dying in 2018 or after.

Our belief is that there is little appetite in Congress to reduce the exemption amounts for these taxes or to increase the tax rates. This proposal is perhaps a bargaining chip for the President and an issue he can concede in exchange for another proposed change.

Dynasty Trusts
Some clients have recently engaged in long-term planning involving "Dynasty Trusts". Dynasty Trusts are designed to continue in perpetuity for the benefit of family members (and possibly spouses of family members). Dynasty Trusts have become popular in the last few years with the significant increases in the exemption amounts for estate tax, gift tax, and generation skipping transfer tax and the repeal of the "rule against perpetuities" that prevented perpetual trusts.

The President's proposal includes a change to the generation skipping transfer tax that would terminate the generation skipping transfer tax exemption amount allocated to a trust on the 90th anniversary of the trust's creation. In essence, the generation skipping transfer tax will be applied to a trust every ninety years and (under the current rates) 40% of the trust's assets would be lost to tax. Trusts created prior to this proposed change in the law would be exempt from the tax.

It is difficult to predict whether this proposal will gain any traction. Nonetheless, a client who implemented a Dynasty Trust may want to consider contributing additional assets to the trust if the client has any unused gift tax exemption amount. Clients who are considering long-term planning may want to act in the near future to make sure any trust that is established is exempt from this proposed tax.

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OBAMA REVENUE RAISING PROPOSALS *continued from page 3*

Defective Grantor Trusts
Some clients have engaged in transactions involving Intentionally Defective Grantor Trusts ("IDGTs"). An IDGT is a trust that does not exist for income tax purposes, but does exist for estate tax purposes. Therefore, a client can "sell" an asset to the IDGT and not realize a capital gain while at the same time excluding the "sold" from the client's estate. IDGTs work well (a) in a low interest rate environment, (b) with assets that can be discounted for valuation purposes, such as fractional interests in real estate or limited partnership interests, and (3) with assets that will appreciate substantially after the sale. The President's budget proposal provides that the assets of an IDGT would be subject to estate tax, which would essentially end the utility of this planning tool.

Individual Retirement Accounts
Under current law, when an IRA owner dies, a non-spouse beneficiary, such as a child or grandchild, generally is required to take withdrawals from the IRA based on the beneficiary's life expectancy. The President's budget proposal seeks to amend this rule so that all non-spouse beneficiaries must withdraw the IRA in full within five years following the IRA owner's death. For many clients, an IRA is the most significant or one of the most significant assets of their estate. The proposed restriction will eliminate the ability to stretch out an IRA over the lifetime of a child or grandchild. This proposed change would take effect on January 1, 2014, and has the obvious impact of raising additional income tax revenue. If this proposal is adopted, then clients may consider designating young beneficiaries to mitigate the income tax consequence or perhaps funding Charitable Remainder Trusts to avoid this rule (assuming this is possible).

The President's budget proposal is just that – a proposal. It is difficult to predict the substance of the next budget and the tax law changes given the anticipated lobbying of interested parties and the negotiations that will take place between the executive and legislative branches. We do not expect a "grand bargain" and instead expect that "sausage will be made" once again. Regardless of the tax law changes, we will seek to identify planning opportunities for clients. ■

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