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# THE PLANNER

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A monthly newsletter for Accounting, and Financial Professionals with a focusing on Estate Planning, Elder Law, and Special Needs Persons.

The Planner is a newsletter to inform and educate Accounting and Financial Professionals of the ever changing areas of estate taxes, and elder law to better service their clients.



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## Motivating Clients to Plan Now: Taking Advantage of Low Interest Rates and More

With lingering uncertainty as to the economy and the federal estate tax, many clients - and their advisors - are wondering what planning they should do now, if any. No one can predict how quickly we will experience an economic turnaround or whether Congress will act on the estate tax. However, there are many non-tax reasons why clients should plan today, irrespective of the economy or their estate tax. And for those clients who may be subject to estate tax, we know that it is generally better for clients to act now rather than to wait, particularly given our historically low interest rates and some of the structural estate and gift tax changes proposed by the IRS.

In this issue we explore some reasons why it is in clients' best interest to act now and discusses strategies that may create the biggest opportunities for clients - and you - today.

### Planning Needs Unrelated to the Economy or Estate Tax

Many planning needs are unrelated to the economy or the estate tax. They include:

- Disability and retirement planning;
  - Special needs planning;
  - Divorce protection;
  - Spendthrift protection;
  - Creditor protection; and
  - Second marriage protection.
- These planning needs may be even more significant for clients with fewer assets than for wealthier clients.

### Disability Planning

As America's population ages, disability planning takes on ever-increasing importance. Here are some sobering

statistics about Americans age 65 and older:

- 43% will need nursing home care;
- 25% will spend more than a year in a nursing home;
- 9% will spend more than 5 years in a nursing home; and
- The average stay in a nursing home is more than 2.5 years.

Plus, the rate of nursing home cost increases greatly exceeds the inflation rate. Clients with estates that would not have been taxable in 2009 are, or should be, very worried about how they will pay for that kind of care if they need it.

**Planning Tip:** Careful consideration of long-term care insurance is critical for most clients.

Also of concern is who will care for your clients and whether they will care for them in the way your clients desire. For many, there is a strong desire to stay at home as long as possible. For others, the companionship found in an assisted living facility makes that choice preferable. Still others need care that cannot be provided at home at all or only at prohibitive cost. Incapacity will deprive a client of the ability to implement his or her goals and objectives.

**Planning Tip:** A trust with carefully drafted disability provisions is the best way to ensure that each client's planning meets his or her personal goals and objectives.

### Special Needs Planning

This is another area unrelated to the economy or the estate tax. According to the U.S. Census Bureau, in 2000:

- 51.2 million Americans reported having a disability;
- 13-16% of U.S. families had a child with special needs;
- 15 out of every 1,000 children born in the U.S. had an Autism spectrum disorder; and between 1 and 1.5 million Americans had an Autism spectrum disorder.

Because of medical care advances many special needs that used to mean shortened life expectancy no longer do, so many more special needs children are outliving

their parents. Planning that fails to properly plan for a special needs person can have disastrous consequences, including loss of means-tested government benefits. A Special Needs Trust that incorporates specific care provisions is a critical component of the planning for a special needs person who requires ongoing support.

Insurance on the life of a special needs person's parents or grandparents can provide the trust funds necessary to pay for the care of a special needs beneficiary that is not provided by means-tested and other government benefits.

**Planning Tip:** Clients with special needs children or grandchildren are typically very motivated to plan for them.

### Beneficiary Protection Planning

Protecting an inheritance from being lost in a divorce or to a beneficiary's creditors is a serious client concern. The potential for creditor attack or for beneficiary dissipation of an inheritance is greater during difficult economic times. Many older generation clients fear that their children and grandchildren lack strong financial decision-making skills.

Divorce rates exceed 50% nationally. Many clients today express concern about their children and grandchildren divorcing - they don't want the assets they worked so hard to accumulate winding up in the hands of a former daughter- or son-in law, etc. Divorce rates increase in difficult economic times, making this planning even more important now.

### Blended Family Planning

A higher divorce rate leads to more second and subsequent marriages - each with a higher statistical probability of ending in another divorce. With blended families (i.e., with potentially his, her, and their kids), it is critical that each parent's planning protect his or her children in the event that parent leaves a surviving spouse. Failure of blended-family parents to do this type of planning practically guarantees that somebody's kids will be disinherited or a messy probate will result.

**Planning Tip:** Carefully drafted estate plans protect beneficiaries from divorce, creditors and themselves.

Such plans can also provide for children from prior marriages, which is often the only way to ensure that these beneficiaries actually receive any inheritance.

## Reasons for Estate Tax Planning

### Certainty as to the Federal Estate Tax

The prospect for a repeal of the federal estate tax in the foreseeable future is essentially zero and, in half of the U.S. jurisdictions, there is a state estate tax (the threshold for which is as low as \$338,000 per person in one jurisdiction, and \$675,000 in several others). Nobody knows whether Congress will act anytime soon - especially in light of the recent federal spending developments. If Congress does nothing, the federal estate tax exemption will be \$1 Million, with a maximum 55% rate, for clients dying on or after January 1, 2011. Therefore, clients who are not likely to die in 2010 should plan for estate taxes.

Moreover, the IRS and many in Congress see this as an opportunity to eliminate several wealth transfer planning techniques, such as value adjustments for family-owned entities and zeroed-out grantor retained annuity trusts (GRATs).

**Planning Tip:** The more time that passes in 2010 without Congressional action on the estate tax, the less likely there will be any change in 2010. This is because both Republicans and Democrats apparently wish to make this an issue for the mid-term elections in November.

Because of the virtual certainty that we will continue to have an estate tax, many of your clients must plan if they wish to avoid paying it. As the U.S. Supreme Court said: Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. Therefore, if what was done here was what was intended by [the statute], it is of no consequence that it was all an elaborate scheme to get rid of [estate] taxes, as it certainly was.

For clients who may be subject to federal or state estate tax, there is a significant benefit to plan sooner rather than later, particularly given today's historically low interest rates.

### Utilizing Estate Freeze Techniques

From a tax perspective it is far better for clients to give assets away during lifetime than to have the same assets be subject to estate tax at death - particularly if the gift falls within the \$1 Million lifetime exclusion or the gift tax annual exclusion, currently \$13,000.

For example, suppose Rachel Donor transfers \$1 Million today to her children. Assuming those assets grow at 10%, Rachel's children will have \$1,930,690 in ten years. If instead Rachel waits to transfer those assets at her death and there is only a \$1 Million exemption, the \$1,930,690 will be subject to federal estate tax of at least \$418,810, resulting in a net to the children of only \$1,511,879.

For clients whose estates are going to be taxable under any foreseeable circumstance, taking advantage of the 2010 gift tax rate of 35% may offer great overall tax savings.

### Grantor Trusts

A "grantor trust" is something defined twice by the Internal Revenue Code - one way for income taxes and another way for estate and gift taxes. In other words, the rules don't match. Therefore, with careful design, an irrevocable trust can be made to be a grantor trust for income tax purposes - yet not be a grantor trust for gift and estate tax purposes.

By using this long-standing wrinkle in the Internal Revenue Code, the strategies for transfers of assets by gifts and sales to irrevocable trusts can be virtually "supercharged." Making the recipient trust a grantor trust for income tax purposes but not for estate tax purposes produces tax-free compounding of income in the trust and estate depletion for the donor through the attribution of that income to the donor. And, paying those taxes is not an additional gift to the trust.

In our previous example, if the transfer was to an income tax grantor trust, Rachel's paying the tax on the trust income would make the trust grow to \$2,593,742, or \$663,052 more than if the gift were directly to the children and they paid the tax.

**Planning Tip:** Clients sometimes tire of paying taxes on income not received or clients' economic situations change and they can no longer afford to pay the extra

taxes. To deal with such contingencies, good planning includes having a “spigot” provision in these grantor trusts so that the income tax grantor trust status can be turned off.

### Historically Low Interest Rates

The last piece of the puzzle is today’s historically low interest rates. The following chart shows recent Applicable Federal Rates (AFRs) - the “safe harbor” interest rates provided by the government for, among other things, intra-family loans.

Loan Term	November 2009	December 2009	January 2010	February 2010	March 2010
3 Years or Less (Short Term)	0.71%	0.69%	0.57%	0.72%	0.64%
3-9 Years (Mid Term)	2.59%	2.64%	2.45%	2.82%	2.69%
More than 9 years (Long Term)	4.01%	4.17%	4.11%	4.44%	4.35%

The “7520 Rate,” which is used in calculating remainder interest values and charitable benefits in Grantor Retained Annuity Trusts (“GRATs”), Charitable Lead Annuity Trusts (“CLATs”), and Charitable Remainder Annuity Trusts (“CRATs”), is 120% of the mid-term rate.

These low interest rates make the strategies discussed below even more attractive, particularly when applied to interests in an FLP or FLLC the fair market value of which is lower than the value of its assets because of lack of control and reduced marketability. As noted above, these adjustments are hated by the IRS and there is talk of eliminating them in any estate tax legislation.

### Installment Sales to Grantor Trusts

A prior version of THE PLANNER we compared and contrasted installment sales to grantor trusts and GRATs. Suffice it to say that both of these strategies are aided by low interest rates, particularly historically low interest rates like we are experiencing now.

**Planning Tip:** Consider gifting rapidly-appreciating volatile assets to a GRAT and selling rapidly-appreciating assets to a grantor trust through either an installment note or self-canceling installment note (SCIN).

### Charitable Lead Trusts

The Charitable Lead Trust (CLT) is a type of charitable trust that can be used to reduce or virtually eliminate any estate or gift tax on wealth transfers. In a CLT, the client creates a trust that grants to a charity or charities, for a set number of years, the first or “lead” right to receive a stream of equal payments from the trust. At the end of the term of years, whatever is left in the trust goes to the remainder beneficiaries, typically the client’s children or grandchildren. If the CLT runs out of assets, the remainder beneficiaries get nothing.

CLTs (like GRATs) benefit from low interest rates. That is so because, in determining the current value of the CLT’s remainder interest, the IRS assumes that the assets in the CLT will grow at the Section 7520 rate in effect when the CLT is established. Therefore, CLTs created now (whether during lifetime or at death) benefit from the current historically low interest rates.

In a typical CLT, the calculated remainder interest value is set very near, but just slightly above, zero. That way, the remainder passes to the beneficiaries without using any significant amount of the client’s gift tax exemption. The statute of limitations runs on all aspects of the transaction, including asset valuation, upon the filing of the associated gift tax return.

**Planning Tip:** For charitably minded clients with estates anticipated to be taxable, the Charitable Lead Annuity Trust, in today’s low-interest environment, offers an excellent opportunity to make charitable gifts and, as an added benefit, transfer wealth to the client’s beneficiaries without using up lifetime gift tax exemption.

**Planning Tip:** Charitable Lead Annuity Trusts are particularly suited for hard-to-value assets (such as real estate or family limited liability company interests) and assets which are expected to grow rapidly in value.

### Conclusion

Despite lingering economic difficulty and estate tax uncertainty, there are numerous reasons why clients should plan now rather than wait until we have more economic and estate tax certainty - and many of these reasons exist regardless of clients’ net worth. Furthermore,

for clients who may be subject to federal or state estate tax, the benefits of planning sooner rather than later, combined with today's historically low interest rates, creates a great opportunity for the planning team to help them meet their wealth transfer and other planning goals and objectives.

## **2010 Tax Code Changes: The Effect on Medicaid Planning and your Elderly Clients**

The New Law. There is currently no federal estate tax or generation-skipping tax for decedents dying in 2010 unless Congress passes new estate tax legislation this year. The federal estate tax will return in 2011 with a \$1 million exemption (\$2 million for married couples with basic planning) and the generation-skipping tax exemption will return at \$1 million, indexed for inflation. This means that a person with assets of \$10 million, \$20 million or even \$100 million who dies in 2010 will not pay a dime of estate tax. However, assets a decedent owns and passes on to a beneficiary at death will receive little, if any, step-up in basis, thus creating a large capital gains tax problem for the beneficiary who acquires the property.

As of January 1, 2010, IRC Section 1022 became effective and substantially changed the rules for obtaining a step-up in basis for real property or appreciated assets passed to a beneficiary at the death of the property owner. Section 1022 replaced the prior rule, IRC Section 1014, which expired on December 31, 2009, along with the estate tax.

### **What does it mean?**

Section 1022(d)(1)(A) allows a step-up in basis up to \$1.3 million for an individual and \$3 million for a surviving spouse (as long as it is received outright or as qualified terminal interest property) in property owned by, and transferred from, the decedent at the time of the decedent's death.

### **An Illustration:**

Harry, a single person, owns a home worth \$2 million at his death. He bought his home 20 years ago for \$200,000. Harry's Will leaves everything outright to his daughter, Kathy, at his death. If Harry dies in 2010 while Section 1022 is in effect, Kathy will receive Harry's property with a basis of \$1.5 million, not \$2 million. Once Kathy sells

the property, she will pay capital gains on the difference between the selling price and \$1.5 million.

**Planning Note:** In 2010, property passing at death may receive little or no step-up in basis at death, resulting in larger capital gains when the property is sold.

### **The Effect on Irrevocable Trust Property Muddy Waters.**

There is no clear answer as to the effect of Section 1022 on property held in an irrevocable grantor trust (often referred to as a Medicaid Asset Protection Trust), which is commonly used as an asset protection tool in Medicaid planning. Some experts believe that property held in an irrevocable grantor trust will not get any step-up in basis at the grantor's death, and others believe the opposite. What is clear is that the lack of step-up for property held in an irrevocable trust is only applicable to property transferred by grantors who die in 2010 or while Section 1022 is in effect. The value of irrevocable grantor trusts in Medicaid planning has not changed - these trusts are still a valuable tool for asset protection.

**Planning Note:** The usefulness of irrevocable trusts in Medicaid planning has not changed even though property held in an irrevocable trust may not receive a step-up in basis if the grantor dies this year.

### **The Effect on Life Estate Property No Step-Up In Basis.**

There is no support in Section 1022 for a life estate holder to be considered an owner for purposes of a step-up in basis. Therefore, it appears that property held subject to a life estate interest will not receive a step-up in basis at the death of the life estate holder during 2010 or while Section 1022 is in effect.

### **The Effect on the 121 Exemption Remains Intact.**

IRC Section 121 provides for a \$250,000 exemption from capital gains for a single person who sells his/her home, and a \$500,000 exemption for a married couple who sell their home. It appears that the Section 121 exemption will still be available for assets held individually, or in an irrevocable Medicaid Asset Protection Trust, assuming the appropriate rights

to the home were retained in the trust. There were no changes to the grantor trust rules that would prevent the Section 121 exemption from applying to property held in a Medicaid Asset Protection Trust.

**Planning Note:** Life estate property will not get a step-up in basis in 2010, but the 121 exemption on homestead property remains.

### What Happens Next?

Congress could enact federal estate tax legislation this year --retroactive to January 1, 2010, or effective on some later date - and Section 1022 would then likely be repealed. Whether the new legislation would be retroactive is unknown. It is also possible that Section 1022 could be repealed even if new estate tax legislation is not passed this year. Absent further action from Congress Section 1022 will expire on December 31, 2010. Remember -- these rules are only applicable to those persons who die while these provisions are in effect, not to trusts or life estate deeds that are drafted while these laws are in effect.

### Staying the Course.

Although Section 1022 makes it difficult to obtain a step-up in basis for death occurring in 2010, this provision will not be around past 2010. Absent further changes in the law, the latest date that the step-up in basis provisions will return is January 1, 2011, when the estate tax is reinstated. And, these provisions only affect property with a low cost basis. Cash assets like checking accounts, CDs and savings accounts are unaffected by this legislation.

**Planning Note:** The 2010 legislation only affects property with low cost basis, not cash assets like CDs, checking accounts and savings accounts.

### Conclusion.

The changes to the tax code can seem very confusing. Luckily, these changes are only in effect for a short time (up to a year maximum) and only affect those persons who die this year or while these provisions are in effect. And while it is necessary to stay abreast of these new rules, it is also important to remind seniors and their loved ones of the importance of planning early to protect

assets from the rising costs of long-term care.

### Below are links to the full text of each Internal Revenue Code Section referred to above:

IRC 121: [http://www.law.cornell.edu/uscode/uscode26/usc\\_sec\\_26\\_00000121----000-.html](http://www.law.cornell.edu/uscode/uscode26/usc_sec_26_00000121----000-.html)

IRC 1014: [http://www.law.cornell.edu/uscode/uscode26/usc\\_sec\\_26\\_00001014----000-.html](http://www.law.cornell.edu/uscode/uscode26/usc_sec_26_00001014----000-.html)

IRC 1022: [http://www.law.cornell.edu/uscode/uscode26/usc\\_sec\\_26\\_00001022----000-.html](http://www.law.cornell.edu/uscode/uscode26/usc_sec_26_00001022----000-.html)

IRC 2511: [http://www.taxalmanac.org/index.php/Internal\\_Revenue\\_Code:Sec.\\_2511.\\_Transfers\\_in\\_general](http://www.taxalmanac.org/index.php/Internal_Revenue_Code:Sec._2511._Transfers_in_general)

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