ESTATE AND ASSET PROTECTION PLANNING MADE EASY

Presented and
Prepared by

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TABLE OF CONTENTS

FACTS

John and Jane are married and own a home worth approximately $800,000, a vacation home worth approximately $400,000, IRA accounts worth approximately $650,000 and miscellaneous investment accounts worth in total approximately $1,150,000. Assume that they own all of their assets jointly except for the IRA accounts which are owned in their respective names. They have three children and the three grandchildren and are both 55 years of age. Many families in this situation are generally concerned about avoiding the costs associated with the probate process, reducing and possibly eliminating estate taxes, not giving up control over their assets during their lives and ensuring the proper blood line disposition of their assets following their demise. However, the ever-changing world of federal and state estate taxes, revocable trusts, irrevocable trusts, life estates and the whole probate process can be somewhat overwhelming which may result in procrastination planning or no planning at all. The estate planning world need not be that difficult if it can simply be broken down into its component parts. The balance of this article will explore the individual aspects of estate planning and asset protection planning.

AVOIDING PROBATE

Let's begin the journey by exploring the probate process which can be best described through three basic points. First, probate can be a somewhat costly adventure for the estate as an attorney is generally hired to help the executor through the process. The legal costs may range from 2-4% of the value of the probate estate. The probate estate consists of the value of all the assets John and Jane died owning in their own name. The process begins by the attorney filing a petition to get the executor appointed, as the executor named in the will would have no authority until such appointment is complete. This process will usually require notifying all of the legatees of the appointment and hoping that none of them object. There will also be the filing of a first and ultimately a final accounting along with an inventory of all the probate assets. In addition, there may be the need to file an estate tax return, form 706, an estate income tax return, form 1041 along with any state estate tax returns that may be required. This is not a complete list of items that need to be accomplished but demonstrates that the time involved with, as well as the cost of, probate can be substantial.

The second point is that John and Jane will sacrifice any privacy with regard to what they own as well as their corresponding values, as the probate court is open to the public thus allowing anyone to look at their file. In this regard, an inventory will be filed with the court which lists all the assets that they owned in their individual names along with corresponding values. There is no privacy and the administration of your estate can be delayed for substantial periods. There is also the possibility of a challenge to your will, as the will is an estate planning document that must go through the probate process.

Finally, and perhaps the most important reason to avoid probate is that the probate process is time consuming and it exposes all of John and Jane's assets to any creditors that they or their estate may have. With regard to time, the estate must remain open for at least a period of one year following the death of the decedent to allow creditors an ample opportunity to file a claim against the estate. In addition, during this time the family may only take the assets subject to divestiture, which simply means that if a claim is filed against the estate, that such beneficiary may have to give up the inherited asset to satisfy the claim. Some common creditors are unpaid medical expenses, credit cards or possibly a particular state's department of medical assistance which has the ability to file a claim against the estate in order to recover any nursing home expenses paid on behalf of the decedent.

For these and many other reasons, John and Jane desire to avoid probate and the best way to accomplish this is for them to simply die not owning assets in their own name. John and Jane will accomplish this through the use of two revocable trusts. Assets that are owned by a revocable trust are not considered to be owned in your own name and therefore avoid the probate process. It is possible for John and Jane to avoid probate by owning their assets jointly as jointly owned assets pass by operation of law and not through the probate process. However, this is a trap for the unwary as often the surviving spouse, who will now be the sole owner of the assets, will forget to add another name to the account and die owning them in his or her own name, thus causing such assets to pass through the probate process. However, even if Jane, as the surviving spouse, added her children's names to her assets, which would solve the probate problem, it often creates many other problems such as exposing her assets to her children's creditors, loss of some control and/or divorce issues just to name a few. Therefore, this author recommends revocable trusts as a simple yet safe approach to avoiding probate.

YOUR LAST WILL & TESTAMENT

John and Jane insist that they need wills and believe that these documents are the most important part of their estate plan. However, this is simply not true. Remember, they are concerned about avoiding probate and reducing or, if possible, eliminating estate taxes. A will simply does not accomplish either of these goals as it is the only estate planning document that gets filed with the probate court. In addition, a "simple will" does not provide John or Jane with the ability to better utilize either their current $1,500,000 federal or $950,000 Massachusetts exemption amounts, thus failing to help reduce their estate tax exposure. A simple will is what most people have and it generally provides that upon the death of one spouse all assets are to be transferred to the surviving spouse. This type of will does not provide any estate tax planning benefits as the first spouse to die will waste his or her federal and Massachusetts exemption equivalent amounts. This is known as misusing the unlimited marital deduction and will be discussed in more detail below.

The will has two major functions: first, to distribute the assets to the family how and when they desire, and second, if they were young enough to have minor children it serves to appoint a guardian. With regard to the distribution of their assets, a will is not required as there are other estate planning documents that will accomplish this objective such as revocable trusts and, as mentioned above, such trusts also avoid the probate process. We will discuss revocable trusts in more detail below.

Notwithstanding the foregoing, it is still important to not only have a will, but also to distinguish between a "simple will" and a "pourover will". A pourover will, unlike the simple will defined above, is one that will catch any assets that John or Jane end up owning in their own name and make sure that they are transferred to their respective revocable trusts. This is important because after establishing their trusts, it is very possible that during their lives they may purchase other assets or open up some investment accounts in their own name. Although these assets would in fact have to go through the probate process, at least they will be put into their respective revocable trusts, which should serve to reduce their estate tax exposure.

In the event John and Jane died without preparing a will, their property would be distributed according to the laws of the state where they reside at death. Depending on the state the property may pass very differently than they might expect. For example, in Massachusetts, if you are single, your property will pass equally to your mother or father, or the survivor, unless there are children, in which case the property will be distributed equally to the children. If there are minor children, a court will appoint a guardian of the court's choice, not yours, to "watch over" the disposition of the property for your minor children.

In John and Jane's case, upon the death of one of them, since children are involved, they may be surprised to learn that only 50% of their individually owned assets will pass to the survivor while the other 50% will pass to their children. Often, the decedent may have wanted all of the assets to pass to the surviving spouse instead of some to the children currently. In any event the children may be too young or otherwise unable to handle the assets at this time. Assets which you own jointly with another person, such as bank accounts and real estate, will pass to the surviving co-owner while assets which have a beneficiary designation, such as qualified plan benefits, IRAs and life insurance, will pass to the named beneficiary. At the very least a last will and testament assures you that your property will pass according to your wishes and not the wishes of the state. However, this whole process may be avoided by simply utilizing revocable trusts.

REVOCABLE TRUSTS

As mentioned above, John and Jane will establish two revocable trusts as part of their estate plan. A revocable trust, sometimes called a living trust or loving trust, is an instrument that John and Jane will establish during their lives into which they will transfer their property prior to death. Please do not make the common mistake of not funding the trust once it is created. Funding a trust simply means that you retitle your assets to the name of the trust. Therefore, Jane will put some assets into her trust and John will put some assets into his trust. However, they each will use their respective social security numbers to establish any such bank or investment accounts inside the trusts. In the event they do not fund the trusts, then any assets they die owning in their own name will go through the probate process. At death, the assets in trust are distributed and/or held in a continuing trust according to their wishes.

It is important for John and Jane to have two trusts in order for them to more fully take advantage of both their current $1,500,000 federal and $950,000 Massachusetts exemption amounts. Each state may vary as to their own estate tax system, but Massachusetts has recently enacted its own estate tax effective for people dying after January 1, 2003. This is important because any plan that shifts all the assets to the surviving spouse will result in the loss of one federal and Massachusetts exemption, which is the common result when people have simple wills or own everything jointly. In fact, prior to planning, this is where John and Jane were headed, which is the government's trap for the unwary. Essentially, you must use your exemption while living or upon your death as the government does not allow the surviving spouse to use any unused exemption equivalent amount remaining after the death of the first spouse to die. The government allows for something called the unlimited marital deduction which means you can leave as much as you want to your spouse without paying any estate taxes on the first death. This format allows the government to collect more in taxes upon the death of the second spouse than would otherwise be the case if some advanced planning had been done. In other words, don't let the government do your estate planning.

These revocable trusts for Massachusetts residents are designed in such a way that upon the death of the first spouse to die, the trust will break down into three trusts; a general marital share, a special marital share, and a remainder or by pass share. Depending on where you reside, there may or may not be this extra share called the special marital share which would be designed to help reduce any state estate taxes that may be imposed upon the first spouse's death. The surviving spouse, as trustee, would be directed to allocate to the general marital share the exact amount of assets necessary to eliminate federal estate taxes. The trustee would also be directed to allocate the special marital share, in the case of a Massachusetts resident, the exact amount of assets needed to eliminate Massachusetts estate taxes. These amounts will depend upon the size of the decedent's estate and the exemption equivalent amount in effect for the year of death. This formula will allow you to take advantage of whatever the exemption amount is in effect on the date of your death. This is important with all the changes that have been and will continue to take place regarding the federal and state estate tax situation.

These three shares would be administered separately upon the death of the first spouse to die. The general marital share will provide that all income must be paid to the surviving spouse during life. Additionally, the surviving spouse, as trustee, would be permitted to withdraw principal upon request. The surviving spouse also will be permitted to direct the final disposition of the marital assets upon his or her death. Essentially these assets are left to the surviving spouse free and clear (although technically in trust). Any assets in the marital share will ultimately be taxes in the surviving spouse's estate but would escape taxation on the first spouse's death. If John died first and his trust had one half of the family assets (i.e. $1,500,000) then his marital share would not have any assets in it, as all the trust assets would have funded the special martial and the remainder or by pass share with amounts that would be determined based on the federal and state exemptions in effect on the date of death. The assets of the remainder share would be subject to the federal and state estate tax on John's death, but no tax would be due as John would simply utilize his exemption amounts upon his demise while the assets of the special marital share will only be taxed at the federal level as this share, coupled with the remainder share, will equal the federal exemption amount, thus resulting in no federal estate tax due. Remember, the assets of the remainder share alone will never exceed the Massachusetts exemption amount, thus resulting in no tax due at the state level on the first spouse to die.

The remainder and special marital share will also provide that all income must be paid to the surviving spouse for life. Additionally, the surviving spouse will be permitted to withdraw principal to the extent necessary to maintain his or her health and support in the standard of living to which they were accustomed as of the date of the death of the first spouse to die. This small restriction is what enables John and Jane to more fully utilize both their current federal $1,500,000 and Massachusetts $950,000 exemption amounts, thereby allowing them to transfer currently $3,000,000 of assets to their family federal estate tax free. In addition, all the assets of the special marital share and remainder share will grow federal estate tax free as such assets will not be included in the surviving spouse's estate regardless of how much they grow between the date of the death of the first spouse to die and the date of the second spouse's death. Note, the assets of the special marital share will be subject to Massachusetts estate taxes on the death of the surviving spouse.

During the lives of John and Jane, although the assets are split between their respective trusts, they will individually maintain control over the trust property as they will serve as co-trustees on each trust. Generally, the trustees may act independently during their lives. There are however, no hard and fast rules on who serves as trustee of revocable trusts and it may be determined by each individual. The revocable trusts will provide for an orderly administration of their assets and succession of trustees.

Finally, insofar as income tax consequences are concerned John and Jane will continue to pay the income taxes associated with any such trust income at their lower individual rates. These trusts are grantor trusts, and since the donor and the trustee are the same person, no separate fiduciary income tax returns, forms 1041, will be required to be filed. They will continue to receive their income tax reporting information in their own social security numbers, as mentioned above, and thus may simply report the information on their individual tax return, form 1040. Many people believe that with trusts automatically come higher tax bills, but that simply is not always true. It depends on the type of trust involved. Generally, a grantor trust, whether revocable or irrevocable, will cause the trust's income to be taxed at the individual donor's tax rate. A complete discussion on taxation of trust income is beyond the scope of this article.

REDUCING ESTATE TAXES

Let's explore how revocable trusts will actually serve to reduce the estate tax exposure for John and Jane. The first step of the estate planning process is for John and Jane to identify and value all assets which would be includible in their estate upon their demise. These assets include their cash, marketable securities, residence, vacation home, receivables, any ownership of businesses, qualified plan benefits, IRAs, face amounts of life insurance and any property over which you have a general power of appointment. These assets are valued at the fair market value on the date of their death. What they paid for these assets is irrelevant. Life insurance can be a tricky asset as many people may have been told that it is tax free. However, life insurance is only income tax free to the beneficiary, but if you die owning it in your own name it is very much estate taxable at its death benefit value.

Once the value of their assets is determined, the government allows certain deductions and exemptions. The most important deduction, as mentioned above, is the so-called marital deduction. Under existing federal and some state regulations (i.e., Massachusetts), there is an unlimited marital deduction. This means that neither the federal government nor the particular state will impose an estate tax on the death of the first spouse to die if all assets are left to the surviving spouse. Therefore, it sounds like John could die and leave everything to Jane without paying any taxes.

This sounds simple enough, but this kind of erroneous planning will cost the family plenty since estate planning is all about saving estate taxes on the second death. This is because each spouse who dies has the ability to shelter currently $1,500,000 from federal estate taxes and $950,000 from Massachusetts estate taxes, but, as mentioned above, the government does not allow the surviving spouse to utilize any exemption which was unused by the first spouse to die.

Consider John and Jane, who together own approximately $3,000,000 of various assets. Each spouse has a "simple will" which leaves all individually owned assets to the surviving spouse. Any assets which do not pass according to the terms of the will, pass to the surviving spouse because of the joint form of ownership and beneficiary designations. Upon the death of John survived by Jane, no federal estate tax, and in certain states (i.e., Massachusetts) no state estate tax, is due because of the unlimited marital deduction.

The tax computation would be as follows:

Gross Estate	$1,500,000
Marital Deduction	$1,500,000
Taxable Estate	$ 0
Federal Estate Tax	$ 0

Upon Jane's death, who owned all the estate's assets at that time, a substantial federal and Massachusetts estate tax will be due and payable. The computation will be as follows:

	Federal	Massachusetts
Gross Estate	$3,000,000	$3,000,000
Martial Deduction	$ 0	$ 0
Exemption	$1 500,000	$ 950,000*
Taxable Estate	$1,500,000	$3,000,000
Approx. Federal Tax	$ 742,200	
Approx. Mass. Tax		$ 187,280

*Note, in Massachusetts when you exceed the exemption the whole estate is taxed. This so-called second-to-die tax can be minimized, if not "eliminated," in most cases, as discussed above, with properly drafted wills and trusts.

It is imperative for the first spouse to die to fully utilize his or her current $1,500,000 federal and $950,000 Massachusetts exemptions. This can only be accomplished by passing the first $1,500,000 or $950,000 of that person's estate to a person other than the surviving spouse. Disinheriting the surviving spouse is usually inconsistent with one's desire to provide for the surviving spouse, so this amount is placed in a special trust called either a by-pass trust, credit shelter trust, remainder trust, and a special marital share as mentioned above. The trust is set up so that the surviving spouse has access to the money, if needed, but the funds will not be includible in the surviving spouse's estate.

As a result, upon the death of the surviving spouse, Jane in our example, the estate tax would be as follows:

Gross Estate	$1,500,000
Marital Deduction	$ 0
Exemption	$1,500,000
Taxable Estate	$ 0
Tax Due	$ 0

As this example shows, federal estate taxes can be eliminated easily for estates that are $3,000,000 or less with proper estate planning. This works because upon John's death his $1,500,000 of assets in his trust's remainder and special share combined subject to federal estate taxes. However, the estate did not actually pay any taxes but instead utilized John's $1,500,000 exemption equivalent amount, thereby leaving only Jane's $1,500,000 of assets, assuming no growth, to be taxed upon her death. This demonstrates that for people with $3,000,000 of assets or less federal estate taxes are effectively eliminated. Note that through the use of the special marital share, you can also eliminate Massachusetts estate tax on the first death, and possibly on both deaths depending on the size of your estate as the state exemption amounts may differ from the federal amount.

As many people know, the estate tax rates and exemption equivalent amounts are changing over the next several years which appears to create a lot of uncertainty in the estate planning arena. The exemption amounts are increasing as follows:

Year	Federal Exemption Equivalent	Massachusetts Exemption Equivalent
2001	$ 675,000	$ 675,000
2002	$1,000,000	$ 700,000
2003	$1,000,000	$ 700,000
2004	$1,500,000	$ 850,000
2005	$1,500,000	$ 950,000
2006	$2,000,000	$1,000,000
2007	$2,000,000	$1,000,000
2008	$2,000,000	$1,000,000
2009	$3,500,000	$1,000,000
2010	Repealed	$1,000,000
2011	$1,000,000	$1,000,000

However, through the use of family revocable trusts and proper estate planning, John and Jane can actually create certainty in what appears to be a very uncertain estate planning world. These revocable trusts, as described above, have tax funding formulas that allow John and Jane to take advantage of whatever the federal and/or state exemption equivalent amount is in effect on the date of their death. Although, since the estate tax appears to be back in full force in the year 2011, that would be an advisable time to review your federal estate plan, if not sooner, to see if your assets have grown to a level that has exceeded the exemption equivalent amount then in effect. It is important to review your estate plan currently from a state perspective as Massachusetts has recently enacted their own estate tax.

However, do not fall into the "trap for the unwary," which is simply to assume that you have no need for any planning since your assets are less than $1,500,000. Although it is true that you would not have a need for federal estate tax planning, you may still want to avoid probate and perhaps protect your assets from the costs associated with long term care. This type of planning is generally referred to as medicaid planning or asset protection planning and will be discussed in detail below.

LARGER ESTATES

Larger estates face an estate tax problem even with proper planning. The federal estate tax rates begin at 37% and go as high as 55% in the year 2011. There also is a special generation skipping tax of 55%. Your estate may lose as much as 80% to various taxes on the death of the second spouse if income taxes are considered. The solution to this problem usually is a combination of wealth replacement life insurance planning and an aggressive lifetime giving program using one or more techniques depending upon your overall objectives. If you consider gifting property away during your life, you may consider a Qualified Personal Residence Trust (QPRT), a Grantor Retained Annuity Trust (GRAT), a charitable remainder trust, a self-canceling installment note or even a private life annuity. You also may consider a traditional irrevocable life insurance trust, a family limited partnership, or even a Delaware series limited liability company. The series limited liability company may also serve to provide some enhanced creditor protection, especially for people who have multiple rental or commercial properties. These topics are beyond the scope of this article but can be discussed in more detail at a meeting if it is appropriate for your situation.

Once you determine the shrinkage attributable to various taxes, you should consider replacing the wealth with life insurance. The insurance industry has produced a special insurance policy designed specifically for this purpose. The so-called second-to-die life insurance policy insures both spouses rather than one and, as a result, is substantially cheaper than the cost of insuring either spouse, or both, through separate policies. This insurance also eliminates the need to try to determine which spouse will die second. Many people are surprised to learn that these policies can be obtained even when one spouse has a health problem since the insurance company bases its insurability decision on the health of both spouses and joint mortality. This technique enables you to use leveraged dollars to satisfy some or all of any estate tax liability that remains after the implementation of estate planning documents.

If this alternative is chosen, it is important that the life insurance be purchased by the trustee of an irrevocable trust. In this way, the proceeds will not be includible in the estate of the surviving spouse and will pass income and estate tax free to your children. The mechanics of establishing an irrevocable trust are as follows. A document is drafted wherein you appoint a trustee who agrees to manage the property and make distributions according to your wishes as set forth in the trust. The trustee, using money you gifted to the trust, then purchases a life insurance policy on you and your spouse. Each year, you make gifts to the trustee in an amount equal to the annual premium. You may, in fact, wish to give more to the trust each year. This gifting technique enables you to transfer assets to your children during your lives without giving up total control over them and enables such assets to grow estate tax free and creditor protected for the children.

Under existing regulations, the trustee must notify the beneficiaries (usually your children) that they have the right to withdraw a ratable portion of the contribution for a limited period of time usually not exceeding 30 days. The trustee then will use the gift to pay for the premiums on the insurance. Neither you nor your spouse can serve as trustee. However, your children may serve as trustee. In addition, you may reserve the right to remove and replace the trustee during your lives provided, however, that the replacement trustee is neither of you nor anyone related or subordinate to you.

LIFETIME GIVING THROUGH A FAMILY LIMITED PARTNERSHIP

A family limited partnership may be the most flexible and advantageous approach to a lifetime giving program under existing IRS regulations. This is because you are able to retain more control of the property gifted than gifts made to the irrevocable trust. Also, you are entitled to receive money from the partnership for services actually rendered and the value of the gift is entitled to a substantial discount attributable to the lack of marketability and lack of control attributable to the limited partnership shares.

The concept is quite simple. A husband and wife can cause a limited partnership to be formed by signing an agreement and having a certificate filed with the Secretary of State. A husband and wife each would own a 1% general partnership interest and a 49% limited partnership interest. The general partners control the enterprise both with respect to investments as well as to the amount and timing of distributions. The assets, which could be stocks, rental or commercial real estate, provided however, that stocks and real estate should not be in the same partnership, would be transferred to the family partnership and the limited partnership shares would then be transferred to one or more of your children. You will have made a gift equal to the fair market value of the limited partnership shares. The value, however, will be substantially less than the actual value of the underlying assets since the limited partners do not have the right to cause a dissolution and cannot freely transfer their shares. In other words, you will retain the voting or controlling shares while you gift away the non controlling interests. These discounts discussed above are what enable you to transfer more than the $11,000 present exclusion amount that may be gifted under a standard lifetime giving plan.

LIVING WILL, HEALTH CARE PROXY AND DURABLE POWER OF ATTORNEY

Don't forget your health care proxy, living will and durable power of attorney! You have a right to die and not be kept alive by artificial means. You must, however, make this known prior to any such disability. If you do not make this known, it will be up to a judge to decide what your intention would have been had you been able to make the decision but for your disability. Invariably, friends and family members will have a difference of opinion as to what your intentions might have been. As a result, legal proceedings relative to the termination of life support can be long and expensive. Avoid these problems by setting forth your intentions in a "living will". A living will is essentially your statement to the world that when all hope is lost, medically speaking, you do not want any heroics and would like to be allowed to pass away in peace.

However, the health care proxy is slightly different. Unlike the living will, the healthcare proxy allows you to appoint someone else to make medical decisions for you when you cannot. In addition, these decisions are not just limited to dealing with a situation when all hope medically is lost, but instead may include giving consent for a surgical procedure, permission for prescriptions drugs, consent to admit someone to a long term care facility and many other important medical decisions. Finally, make sure you have a Health Insurance Privacy and Accountability Act (HIPAA) form prepared which will enable you to appoint family members to obtain your medical records even if you are not incapacitated.

Finally, be sure to keep the probate court away from your business affairs by designating a friend or relative as your attorney-in-fact to act on your behalf should you become disabled. This is known as a durable power of attorney. Essentially, this document allows another person to make financial decisions on your behalf, including but not limited to, accessing your bank or investment accounts, IRA accounts, safety deposit boxes, signing your name to pay bills or transfer and convey real estate. Without one of these documents you would have to get a guardianship in place for your family member and then basically ask the court for permission to do things for that person. This process can be time consuming and costly. The real problem is the time it takes to be permitted to take a simple action like transferring the family home to a child in order to protect it from the costs of long term care. This is especially problematic if the family member is already in the nursing home.

MEDICAID AND ASSET PROTECTION PLANNING

Unlike John and Jane, there are many people who have assets of around $1,250,000 or less and may be interested in either assets protection planning or estate planning or both. Although the rules for asset protection planning differ from pure estate tax planning, it is possible to provide both estate and asset protection planning for people who have assets that are a little over the current federal and/or state estate tax exemption amounts. For people who have assets less than the federal and state estate tax exemption amounts their focus will be primarily on probate avoidance and asset or creditor protection planning. However, as mentioned above, the message is for most people some kind of planning is still needed regardless of how much you may be worth. The balance of this chapter will provide a road map through the asset protection planning world and some medicaid eligibility issues.

The primary tool for asset protection planning is an irrevocable trust. Most people associate the word irrevocable trust with the relinquishment of control, inflexibility and rigidity. However, this article will explore the use of an irrevocable income only trust and show how such a trust will enable an individual to retain a significant degree of control over their assets during their life, while at the same time provide creditor protection as well as estate and income tax planning opportunities. In addition, these trusts will serve to reduce the risks associated with transferring assets outright to children. Finally, this irrevocable income only trust will help to dispel the common asset protection planning myth that one must gift their assets away and give up complete control over them in order to protect them from both the costs associated with long term care and general creditors.

In this regard, as individuals age, they begin to become concerned about the potential costs associated with long term care. Their focus may shift to discovering strategies that will protect their assets from both general creditors and the costs associated with long term care. These assets often consist of their home, vacation home, rental property and/or liquid investments. However, many individuals are generally reluctant to transfer such assets directly to their children or other family members for fear of relinquishing total control over them. Often, this fear results in procrastination or inaction, thereby leaving the individual's assets at risk. Instead, an individual may consider transferring such assets to the irrevocable income only trust mentioned above.

Let's take a typical example. Assume Jeff and Julie, a married couple, living in Massachusetts, who are generally healthy, age 75, have two children, own their own home worth approximately $300,000, other liquid investments worth approximately $300,000 and are concerned about avoiding the costs associated with the probate process as well as protecting their assets from both the costs associated with long term care and general creditors. The solution may be to transfer all or a portion of these assets to an irrevocable income only trust. The trust will provide that both Jeff and Julie will be the donors as well as the trustees of the trust during their lives. In addition, Jeff and Julie, as trustees, will retain the ability to make discretionary distributions of the income from the trust to themselves during their lives. Furthermore, as trustees, they would retain a significant degree of control over the assets transferred to the trust including, but not limited to, the ability to determine how such liquid investments should be invested, the ability to sell any such trust assets, specifically including the home, remove and replace the trustee as well as change the dispositive provisions of the trust via a limited power of appointment. These powers alone generally provide the individual with a much greater sense of independence and control during their life than would otherwise be the case with outright transfers to the children.

With regard to the primary residence, Jeff and Julie, like many couples, considered using a simple life estate as means of protecting the home instead of implementing the irrevocable trust mentioned above. This is accomplished by preparing a deed which transfers the remainder interest in the property to the children with the husband and wife retaining a joint and survivor legal life estate. In other words, this means that Jeff and Julie would retain the legal right to live in the property for the rest of their lives. Although this approach may ultimately provide protection from the costs associated with long term care, depending on the state in which you reside, it tends to create more unnecessary problems than its worth specifically regarding creditors of their children.

More specifically, life estate arrangements in Massachusetts are currently protected from the costs associated with long term care, but between July of 2003 and July of 2004 life estates were at risk due to pending legislative change. However, the 2005 budget, which passed in May 0f 2004, repealed the expanded estate recovery law (i.e. which means life estates remain a viable asset protection planning tool in Massachusetts), and it is expected to pass the senate but will be subject to line item veto by the Governor.

In any event, assuming the life estate arrangement is implemented and any of the children in our example were to get divorced or have financial difficulty during the lives of Jeff and Julie, the creditor would be able to put a lien on the property. Although the life estate will prevent the creditor from moving against the property while Jeff or Julie are living, it will nonetheless provide complications for the living children following the death of Jeff and Julie. In addition, in the event Jeff or Julie desire to sell their home during their lives, they would be required to obtain the permission from all of their children. Even if the children agreed to sell the property, assuming none of the children use this property as their primary residence, there may be a capital gains tax to be paid by the children. The sale would result in a portion of the proceeds equal to the value of the parent's life interest being allocated to them with the balance of the proceeds, which represents the remainder interest, being allocated to the children. The children would also be allocated a respective portion of the parent's cost basis in the property to be used in determining the children's capital gain.

In our case, assuming the parents paid $50,000 for their home and sold it for $300,000, the children, based on current Medicaid tables, would be allocated approximately 50% of the cost basis, and approximately 50% of the sale proceeds. The result would be that each child would receive $75,000 of the proceeds and $12,500 of the cost basis, which would result in a capital gain for each child of approximately $62,500 with a corresponding federal income tax liability of $12,500 each, not to mention the fact that the children now have an early inheritance. In addition, in order for the kids to give the proceeds back to the Jeff and Julie, assuming they will cooperate, they would be limited to giving only $11,000 per year per parent as this is the maximum allowed without incurring a gift tax liability.

With regard to Jeff and Julie, provided they have owned and used such property as their primary residence for two of the last five years and were married on the date of sale, they would have a capital gains tax exclusion of $500,000. In other words, they would only be responsible for capital gains tax to the extent their portion of the gain exceeded $500,000.

Upon further consideration, Jeff and Julie decided to transfer their home to a nominee realty trust with the schedule of beneficiaries being the irrevocable income only trust, mentioned above. The deed, as mentioned above, will reflect the reservation of a joint and legal life estate, but instead of granting the remainder interest to the children, the remainder interest will be in the irrevocable income only trust. Unlike the simple life estate, if Jeff or Julie wanted to sell their home they would not need the children's permission and would avoid the capital gains tax problems discussed above. In this regard, since the trust is a grantor trust, which means the Jeff and Julie are considered the owners for income tax purposes, they would retain the ability to avail themselves of certain capital gains tax exclusions associated with the sale of their primary residence. Therefore, in the event they chose to sell their home during their life, provided they have owned and used such property as their primary residence for two of the last five years, were married on the date of sale, and the resulting gain did not exceed $500,000, there would be no capital gains tax due. Furthermore, since assets of this trust are not accessible to the creditors of their children during their lives, it eliminates the concern of transferring assets outright to a child who may encounter financial difficulties, be a gambler, drug addict, alcoholic, or spendthrift. Finally, this type of trust will also provide Jeff and Julie some general creditor protection during their lives.

Insofar as annual income tax consequences are concerned, in the event the trust has earned income (i.e., interest, dividends, or rent), a fiduciary income tax return, Form 1041, may be required to be filed. However, since Jeff and Julie are the grantors and retain the ability to appoint the remainder or principal of the trust to a class consisting of their children of all generations in equal or unequal shares, it makes the trust a grantor trust for income tax purposes. This retained power is generally referred to as a limited or special power of appointment. Since it is a grantor trust, it does not pay any income taxes, but instead flows the income through to the grantors (i.e., Jeff and Julie) to be taxed at their lower individual rates, rather than at the higher, more compressed, trust tax rates. In other words, they will continue to pay the income taxes at their lower individual rates just like they use to prior to establishing this trust. This limited power of appointment also prevents the transfers to this irrevocable trust from being treated as gifts, thereby eliminating the concern of any gift tax due upon the funding of this trust.

Upon the demise of the survivor between Jeff and Julie, the assets of the trust will be includible in his or her gross estate and not their probate estate. This distinction is important with regard to the state's ability to recover any medical expenses spent on their nursing home care. Some states define the recoverable estate to include only probate assets, while other states define the recoverable estate to include the broader definition known as the gross estate. Massachusetts currently defines the recoverable estate to include only those assets in the individual's probate estate. However, as mentioned above, unless legislation is passed prior to July 2004 Massachusetts will expand it's definition of recoverable assets beyond the probate estate, thereby putting assets like life estates at risk. The probate estate would include any assets owned by an individual in their own name at the time of their death. Assets owned in this irrevocable income only trust are not considered assets owned in one's own name, thus are not includible in the probate estate and would not be subject to Medicaid's estate recovery provisions in those states that define the recoverable estate to only include the probate assets. Therefore, these trust assets will ultimately be protected for the children.

The estate inclusion also provides a significant income tax benefit known as a step-up in basis for capital gains tax purposes, which is not available for those who gifted appreciated assets outright to their children. For example, if an individual were to gift their highly appreciated home or stock outright to their children in an effort to protect it from the cost of long term care, the children would receive the parents' cost basis in such property, which is known as a carry over basis. In other words, whatever the parents paid for the particular asset will carry over to the children, which means any capital gain that is built into this property will remain there waiting to be recognized whenever the property is sold. In our example, if Jeff and Julie transferred their home worth approximately $300,000 outright to their children, and had paid only $50,000 for it, the children would receive their $50,000 cost basis in the property. In the event the children decide to sell the house for $300,000 shortly after the parents died, they would realize and recognize a $250,000 long term capital gain, with a corresponding federal tax liability of approximately $50,000.

However, if Jeff and Julie instead transferred these highly appreciated assets to this irrevocable income only trust, such assets would be includible in their gross estate and would receive a step-up in basis. The step-up in basis is equal to the fair market value of the property on the date of death. In our example, if Jeff and Julie had put their home in this irrevocable income only trust, and the fair market value upon their demise was $300,000, the children would receive the home with a basis equal to this $300,000 value. Therefore, if the children were to sell the home shortly after their demise, there would be little or no capital gains tax to be paid.

With regard to couples who have assets that exceed the federal and state exemption equivalents and are thus concerned about both estate and asset protection planning, these irrevocable income only trusts will still offer a viable solution. In this case the technique would require the implementation of two irrevocable trusts instead of just one. The assets would then be split between the two irrevocable trusts much like the revocable trusts mentioned above. This splitting of the assets between the trusts is what enables the couple to more fully utilize each of their current estate tax exemption equivalent amounts, as the assets in the trust of the first spouse to die will be taxed in the decedent's estate but will not be taxed in the surviving spouse's estate.

For example, if a couple has $2,000,000 of total assets and died in 2005 without any planning, the surviving spouse's estate tax would be significant. The calculation is as follows:

Gross estate	$2,000,000
Marital deduction	$ 0
Exemption	$1,500,000
Taxable Estate	$ 500,000
Tax due	$ 225,000

(This does not include any state estate tax)

However, if the couple had two irrevocable trusts established and funded with each one owing approximately one half of the assets, the estate tax would be currently eliminated as some of the assets would be taxed on the first death and some of the assets would be taxed on the second spouse's death. However, in either case the amount of assets subject to tax would have been less than the exemption equivalent amounts in effect thus no actual tax would be paid and the trusts would have still offered all of the creditor protection benefits, mentioned above, during the lives of the couple.

The calculation of tax due on the second death would be as follows:

Gross estate	$1,000,000
Marital deduction	$ 0
Exemption	$1,500,000
Taxable estate	$ 0
Tax due	$ 0

(This does not include any state estate taxes)

Finally, this technique may allow for the use of estate valuation discounts upon the death of a spouse. In this regard, any real estate the couple had would have been divided between the two trusts which creates a fractional ownership interest and would be subject to lack of control and lack of marketability discounts. In other words, a one-half piece of real estate is not worth one-half the value to a third party as that person does not have complete control over the property and thus should not be worth one-half for estate valuation purposes either. These discounts may be in the 25-40% range. However, different facts and circumstances may result in discounts that are significantly different.

In conclusion, this irrevocable income only trust allowed Jeff and Julie to transfer assets to a vehicle that will provide protection from their creditors, their children's creditors, and the cost of long term care, while at the same time allowing them to retain a significant degree of control over such assets during their lives. In addition, this trust provides some estate and income tax planning benefits. This irrevocable trust is about as close as you can get to having your cake and eating it too.

ABOUT THE FIRM

Cushing & Dolan, P.C. was founded in 1984 by Leo J. Cushing, an attorney and Certified Public Accountant. Mr. Cushing is a Boston native. He was educated at Boston Latin School, University of Notre Dame, New England School of Law, cum laude, and obtained a Masters Degree in Taxation from Boston University School of Law.

Mr. Cushing began his legal career serving the public as an Assistant Attorney General for the Commonwealth of Massachusetts investigating and prosecuting complex criminal and civil cases. Subsequently, he joined the private sector as a tax attorney with the international accounting firm of Ernst & Whinney (now Ernst & Young).

Mr. Cushing's mission in establishing the firm was to provide high quality legal services at affordable cost. It is his belief that these objectives can only be achieved through a true commitment to continuing education. Leo has written and lectured extensively in the area of sophisticated estate planning techniques. Among his recent presentations are:

- Trust income tax planning after OBRA - International Association for Financial Planning: Annual National Convention.
- Effective wealth transfer planning with family limited partnerships - South Shore Estate Planning Council.
- Wealth transfer planning with self canceling notes and other installment obligations - Boston Estate Planning Council.
- Advanced estate planning techniques - Foundation for Continuing Education
- Income taxation of decedents, estates and trusts - Foundation for Continuing Education.
- Estate planning with family limited partnerships - Massachusetts Society of Certified Public Accountants, Round Table Presentation.

- Medicaid planning after OBRA - Foundation for Continuing Education.
- Protecting disability benefits from personal injury settlements - Massachusetts Continuing Legal Education (MCLE).
- Preparing estate tax returns for the legal assistant - Massachusetts Continuing Legal Education (MCLE).
- Preparation of fiduciary returns - Massachusetts Continuing Legal Education (MCLE).
- How to prepare federal and Massachusetts estate tax returns - Massachusetts Continuing Legal Education (MCLE) (Managing Editor, Publication Date: November, 1994.)

If you would like any additional information or a free consultation concerning any one or more of these issues, please contact us at (617) 523-1555. We look forward to working with you.

WEALTH TRANSFER PLANNING
WITH FAMILY LIMITED PARTNERSHIPS

Why consider a family limited partnership? Let's compare with an irrevocable trust.

		Irrevocable Trust	Limited Partnership
1.	Retain Control	No	Yes (1% control)
2.	Retained interest	No	Yes
3.	Crummey notices	Yes	No
4.	Valuation	No discount	40%-50% discounts
5.	Income tax rates	Punitive	Individual rates with individual deductions
6.	May be amended	No	Yes
7.	Disputes settled by arbitration	No	Yes
8.	Legal fees paid by losing party	No	Yes
9.	Own life insurance on the general partner	Yes	Yes