# CUSHING & DOLAN, P.C.
## Spring Seminar Series

# Maybe I Should Have Been a Brain Surgeon II

by


Leo J. Cushing, Esq., CPA, LLM
Cushing & Dolan, P.C.
Attorneys at Law
Totten Pond Road Office Park
375 Totten Pond Road, Suite 200
Waltham, MA 02451
(617) 523-1555
lcushing@cushingdolan.com
www.cushingdolan.com


May 21, 2010

## I. ESTATE PLANNING IN 2010 - MAYBE I SHOULD HAVE BEEN A BRAIN SURGEON II - IT'S TIME TO ACT NOW!

ECONOMIC GROWTH AND TAX RELIEF RECONCILIATION ACT OF 2001
PUB. L. 107-16 6/7/01 – "2001 ACT"

1. 2001 Act – Estate and Gift Taxes Rates Reduced and Exemption Amounts Increased

A. Act § 511, Act § 521

The estate and gift tax rates were reduced each year until the estate tax was completely repealed in 2010. At the same time the rates were being reduced, the amount that was exempt from estate and gift taxes was increased. The gift tax remains in effect after repeal of the estate tax.

The following table shows the rate reductions and the exemption increases for the estate and gift taxes between 2002 and 2010:

| Year | Estate Transfer Exempt Amount (Applicable Exclusion Amount) and GST Exemption | Lifetime Gift Exempt Amount | Highest and Gift Tax Rates |
|---|---|---|---|
| 2002 | $1 million | $1 million | 50%* |
| 2003 | $1 million | $1 million | 49% |
| 2004 | $1.5 million | $1 million | 48% |
| 2005 | $1.5 million | $1 million | 47% |
| 2006 | $2 million | $1 million | 46% |
| 2007 | $2 million | $1 million | 45% |
| 2008 | $2 million | $1 million | 45% |
| 2009 | $3.5 million | $1 million | 45% |
| 2010 | Tax repealed | $1 million | 35% (gift tax) |
| 2011 | $1 million | $1 million | 55% |

*Reflecting repeal of the 5% surtax. Effective for estates of decedents dying and lifetime gifts made after 2001.

**Planning Note:**
The lifetime gift tax exemption will stay at $1,000,000. The reason for this was concern over the likely significant income tax loss by virtue of the shifting of assets to lower income tax-bracket taxpayers. As a result, current gift giving techniques, particularly those which incorporate discounts and leverage (such as family limited partnerships, limited liability companies, grantor retained annuity trust, qualified personal residence trusts, and the like) will remain important techniques. Also, note that even after the estate tax is repealed in 2010, the gift tax will remain with a maximum gift tax rate of 35%, which is related to the maximum income tax rate in effect for the year 2010.

**Planning Note:**
Byrd Amendment -- Sunset Provisions
Unless Congress votes to extend the estate tax repeal and/or any portion of its relief, the entire legislation will sunset on January 1, 2011. 2001 Act § 901. This means that the entire 2001 Act will be automatically repealed and the estate tax system will revert to current law, which provides that in the year 2011, the maximum exemption equivalent amount will be $1,000,000 with the return of the 55% maximum estate and gift tax rate.

B. Basis of Property Received from a Decedent – ACT §§ 541, 542

(1) Present Law

Gain or loss, if any, on the disposition of property is measured by the taxpayer's amount realized (gross proceeds realized) on the disposition, less the taxpayer's basis in such property. Basis generally represents a taxpayer's investment in property with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

Property received from a donor of a lifetime gift takes a carryover basis. "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. The basis of lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If the basis of the property is greater than the fair market value of the property on the date of gift, then, for purposes of determining loss, the basis is the property's fair market value on the date of gift thereby providing the donee with a "stepped down" basis.

Property passing from a decedent's estate generally takes a stepped up basis. "Stepped up basis" for estate tax purposes means that the basis of the property passing from a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is selected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). This step up (or step down) in basis eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death and has the effect of eliminating the tax benefit from any realized loss.

In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse (under the community property laws of any state, U.S. possession or foreign country), generally is treated as having passed from the decedent, and thus is eligible for stepped up basis. The rule applies if at least one-half of the whole of the community interest is includible in the decedent's gross estate.

(2) 2001 Act –Modified Carryover Basis

Once the estate tax is repealed in 2010, a modified carryover basis structure will be established. Under this structure, recipients of property transferred at death generally will acquire a basis in the property equal to the lesser of the:

- Decedent's basis in the property immediately before death, or
- Date-of-death value of the property.

The so-called modified carry-over basis rules, which allow a basis increase, applies to "property acquired from a decedent" by bequest, devise, or inheritance, or by the decedent's estate from the decedent and any property passing from the decedent to the extent such property passed without consideration. New Code 1022 (e)

Property acquired from a decedent is treated as if the property had been acquired by gift. Thus, in general, the character of gain on the sale of property received from a decedent's estate is carried over to the heir. For example, real estate that had been depreciated and would be subject to recapture if sold by the decedent, will be subject to recapture if sold by the heir.

(3) Types of Property to which the modified carryover basis rules apply

The modified carryover basis rules apply to property "acquired from the decedent." Property acquired from the decedent is:

(a) property acquired by bequest, devise, or inheritance, New Code § 1022(e)(1)

(b) property acquired by the decedent's estate from the decedent, New Code § 1022(e)(1)

(c) property transferred by the decedent during his or her lifetime to a qualified revocable trust as defined in IRC § 645(b)(1), New Code § 1022(e)(2)(A)

(d) property transferred by the decedent during his lifetime in trust with the right reserved to the decedent at all times before his death to make any change to the enjoyment thereof through the exercise of a power to alter, amend or terminate the trust. New Code § 1022(e)(2)(B),

(e) any other property acquired from a decedent by reason of the decedent's death to the extent such property passed without consideration (e.g., property held as joint tenants with right of survivorship or as tenants by the entireties), and New Code § 1022(e)(3)

(f) the surviving spouse's one-half share of certain community property owned by the decedent and the surviving spouse as community property.

**Planning Note:**
The decedent will not be treated as owning any property by reason of holding a general power of appointment. New Code § 1022 (d)

(4) Aggregate Increase in Basis

Under the 2001 ACT, the basis of such property shall be increased by a so-called "basis increase". In the case of any estate, the aggregate basis increase is $1,300,000. New Code § 1022 (b) (2) (B). Additionally, basis may be further increased by any unused capital losses, net operating losses, and certain built-in losses of the decedent.

An additional $3 million of basis increase is available for property transferred to a surviving spouse for a total of $4,300,000.

The executor chooses the property that will receive these basis increases. However, in no event can the basis of property be adjusted above its date-of-death value.

Non-residents who are not U.S. citizens will be allowed to increase the basis of property by up to $60,000. The $60,000, $1,300,000 and $3,000,000 amounts are to be adjusted for inflation occurring after 2010, but not less that $5,000 in the case of $60,000, not less than $100,000 in the case of $1,300,000, and not less than $250,000 in the case of $3,000,000.

(5) Property acquired by Surviving Spouse

The special $1,300,000 spousal property basis increase applies to so-called "qualified spousal property." The term "qualified spousal property" means (A) an outright transfer of property, and (B) qualified terminable interest property. New Code § 1022(c)(1)(2) and New Code § 1022(c)(1)(3).

Quality Terminable Interest Property – New Code § 1022(c)(1)(3)

(1) All income must be payable for life to the spouse at least annually; and
(2) No person has any power to appoint property to any person other than the surviving spouse.

**Planning Note:** Federal and Massachusetts QTIP election can differ.
Same as IRC 2056(b)(7)

**Planning Note:**
Great care will be needed in drafting and funding marital and by-pass trusts to maximize the benefit of the new basis rules.

(6) Special Rule Relating to Grantor Trusts

Any transfer of property in trust will be treated as a taxable gift under IRC § 2503 unless the trust is treated as wholly owned by the donor or the donor's spouse. New Code § 2511(c)

**Planning Note:**
Irrevocable Medicaid Planning Trusts must be grantor trusts and not just old fashioned "incomplete gifts" under Regs. 25.2511-2 (c).

(7) Rules Allocable to Basis Increase

The basis increase will be allocated by the executor on an asset-by-asset basis (for example, basis increase can be allocated to a share of stock or a block of stock), however, in no case can the basis of an asset be adjusted above its fair market value.

If the amount of basis increase is less than the fair market value of the asset who's basis are eligible to be increased under these rules, the executor will determine which assets and to what extent each asset receives a basis increase. 2001 Act § 1022(d)(3)(A) and (B).

(8) Reporting Requirements: New Code § 6018

(a) Transfers at Death

For transfers at death of non-cash assets in excess of $1,300,000 (so-called " large transfers"), and for transfers of certain gifts received by a decedent within three years of death, the executor of the estate (or the trustee of a revocable trust) will report to the IRS;

- the name and taxpayer identification number of the recipient of the property;
- an accurate description of the property;
- the adjusted basis of the property in the hands of the decedent and its fair market value at the time of death;
- the decedent's holding period for the property;
- sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income;
- the amount of basis increase allocated to the property; and
- any other information as the Treasury Secretary may prescribe.

The return must be filed with the decedent's final income tax return and labeled IRC § 6018 Return.

Additionally, the person required to make this return must furnish to each person who receives property a written statement showing (1) the name, address, and telephone number of the person making the return and (2) the information included in the return with respect to the property acquired from, or passing from, the decedent to the person receiving the property. The statement must be filed within thirty (30) days after the return is filed.

(b) <u>Property acquired by the decedent within three (3) years of death.</u> New Code § 1022(d)(1)(C)

In general, there will be <u>no</u> step-up in the basis for property acquired by the decedent by gift or by intervivos transfer for less than adequate and full consideration money or money's worth during the 3 year period ending or the decedent's death. This exclusion does not apply to property acquired by the decedent from the decedent's spouse unless the spouse had acquired the property by gift within such 3 year period.

(c) <u>Penalties: New Code § 6716</u>

Any person required to report to the IRS transfers at death of non-cash assets in excess of $1,300,000 in value who fails to do so, is liable for a penalty of $10,000 for the failure to report such information. Any person required to report to the IRS the receipt by a decedent of appreciated property within three years of death who fails to do so is liable for a penalty of $500 for the failure to report such information to the IRS. There also is a penalty of $50 for each failure to report such information to the beneficiary. No penalty will be imposed with respect to any failure that is due to reasonable cause. If any failure to report to the IRS or beneficiary is due to intentional disregard of the rules, then the penalty is 5% of the fair market value of the property for which reporting was required, determined at the date of the decedent's death (for property passing at death), or determined at the time of gift (for a lifetime gift).

(9) <u>Lifetime Gifts – New Code § 6019 (b)</u>

If a gift tax return is required to be filed under IRC § 6019, the donees must be provided with a written statement containing the name, address and telephone number of the person making the return within thirty (30) days after the date the return is filed and such person must receive the information contained in the return relative to the property received by such person. New Code § 6019 (b). Was this effective in 2002?

(10) Special Ownership Rules for Purposes of the Basis Increase

- The decedent will be treated as having owned the surviving spouse's one-half share of community property (which will be eligible for a basis increase), if at least one-half of the property was owned by and acquired from, the decedent. Thus, similar to the present law rules set in IRC § 1014(b)(6), both the decedent's and surviving spouse's share of community property will be eligible for basis increase.

- In the case of property held as joint tenants or tenants by the entirety with the surviving spouse, one-half of the property is treated as having been owned by the decedent and is thus eligible for the basis increase. New Code § 1022(d)(1)(B)(i)

• In the case of property held jointly with a person other than the surviving spouse, the portion of the property attributable to the decedent's consideration furnished is treated as having been owned by the decedent and will be eligible for a basis increase.

• The decedent will be treated as the owner of property (which will be eligible for a basis increase) if the property was transferred by the decedent during his lifetime to a revocable trust. New Code § 1022(d)(1)(B)(ii)

• The decedent shall not, however, be treated as owning any property solely by reason of holding a power of appointment with respect to such property. New Code § 1022(d)(1)(B)(iii)

• Certain property will not be eligible for a basis increase, including:

(a) property that was acquired by the decedent by gift (other than from his or her spouse) during the three year period ending on the date of the decedent's death; IRC § 1022(d)(1)(C)

(b) property that constitutes a right to receive income in respect of a decedent (IRD);

(c) stock or securities of a foreign personal holding company;

(d) stock of a domestic international sales corporation;

(e) stock of a foreign investment company; and

(f) stock of a passive foreign investment company (except for which a decedent shareholder had made a qualified electing fund election).

## II. THE RODRIGUES HOMESTEAD EXEMPTION

2 years ago -- homestead exemptions
(Still need to find)

## III. DRAFTING IRREVOCABLE MEDICAID TRUSTS AFTER THE DOHERTY DECISION

| Trust Provisions | Superior Court Analysis | Appeals Court Analysis |
|---|---|---|
| **Article II of Family Trust:** The purpose of this Trust is to supplement, but not to supplant, what benefits and services the Settlor may from time to time be | **Article II of Family Trust:** Article II establishes that the Family Trust was established for Doherty's benefit and urges the Trustee to accumulate principal to | **Article II of Family Trust:** We remain unconvinced that the niece and nephew are unable, in any reasonably foreseeable circumstance, to invade trust |

| Trust Provisions | Superior Court Analysis | Appeals Court Analysis |
|---|---|---|
| eligible to receive by reason of her age, disability or other factors from federal, state, and local government, insurance and charitable sources. This Trust is established with the recognition that the nature and extent of the complex and multiple needs of the Settlor are such that her own resources and those of her family, would quickly become exhausted if relied upon as a primary resource of her care. It is recognized further that governmental and charitable programs, in themselves, contain many gaps which, if not addressed, would greatly reduce the possibility of the Settlor maintaining herself as independently as possible and having the capacity to meet her future needs adequately for medical, residential, personal, and other services. With these considerations guiding its decision-making, the Trustee agrees to take control and management of the Trust estate, and invest and reinvest the principal, receive the income therefrom, and, after paying the reasonable and proper expenses of the Trust, manage and distribute the principal and net income of the Trust in accordance with the requirements of this instrument.<br><br>Without limiting or enlarging the authority of the trustee in accordance with the trust purposes, it is stipulated that the Trust shall be used in ways that will best enable the Settlor to lead as normal, comfortable, and fulfilling life as possible; in fact, regardless of the future health status, she be cared for at home or in any event in the most normal and home-like environment as possible and consistent with her needs for treatment and care; that she may have as many opportunities as possible for normal social interaction with members of her family and other | better meet her future needs. | assets for Muriel's benefit. When considered as a whole, what strikes us most strongly is that Muriel's trust constitutes a remarkably fluid vehicle intelligently structured to provide both Muriel and the trustees maximum flexibility to respond to Muriel's changing life needs. Indeed, embedded in the trust governing recitation is not only an explicit assessment that public or other charitable benefits will likely be insufficient to provide Muriel the quality of life she might desire, but the corollary implicit direction for the trustees, in such case, to invade assets to make up that difference. |

| Trust Provisions | Superior Court Analysis | Appeals Court Analysis |
| --- | --- | --- |
| persons in the community in a manner consistent with her age and interests; and that she have every reasonable opportunity to be responsible for her own welfare, independent of this Trust, to the extent of her capacities.<br><br>The Trustee shall accumulate the trust principal to the extent feasible due to the unforseeability of the Settlor's future needs, however, accumulation or use of Trust is to be determined without regard to the interests of the remaindermen. | | |
| **<u>Article V. A. 1.: Net Income</u>**<br>The Trustee shall pay the entire net income from the family trust to or for the benefit of the Settlor in quarterly or more frequent installments during her lifetime. | **<u>Article V. A. 1.</u>**<br>No problem – Income is available | **<u>Article V. A. 1.</u>**<br>No Problem – Income is available |
| **Article V. A. 2.:**<br>**<u>Distributions of Principal</u>**<br>During the lifetime of the Settlor, the Trustee shall make no distributions of principal from the family trust to or on behalf of the Settlor. | **Article V. A. 2.:**<br>**<u>Distributions of Principal</u>**<br>Article V. A. 2. purports to prohibit the trustee from distributing trust principal to Doherty stating, "During the lifetime of the Settlor, the Trustee shall make no distributions of principal from the family trust to or on behalf of the Settlor." The Superior Court quotes, "This provision, however, is in direct conflict with many of the provisions of the trust, citing Article II, which establishes that the Trust was created for the benefit of Doherty to accumulate principal, Article V. C., which requires the Trustee to obtain Doherty's permission before selling the Chestnut Street property, Article IV. giving Doherty the right to assign principal through an instrument during her lifetime or by Will to family members of a choice, <u>and finally, Article XXII, giving the Trustee the unfettered discretion to close the family trust and distribute all the assets to the beneficiaries.</u> | **Article V. A. 2.:**<br>**<u>Distributions of Principal</u>**<br>The Appeals Court did not address the lifetime power to appoint nor did it address the testamentary power to appoint. The Appeals Court wrote, "We observe that, pursuant to Article XXII, the Trustee may, in its sole discretion and notwithstanding anything contained in this Trust to the contrary, pay over and distribute the entire principal of the trust fund to the beneficiaries thereof, free of all trusts, so long as the trustees in their sole judgment determine that the fund created shall at any time be of a size which… shall make it inadvisable or unnecessary to continue such trust fund."<br><br>The Appeals Court also focused on Article XIV. H., which gives the trustee to determine all questions as between income and principal and to credit or charge to income or principal or to a portion between them, any receipt or gain. Notwithstanding any statute or rule of law for distinguishing |

| Trust Provisions | Superior Court Analysis | Appeals Court Analysis |
|---|---|---|
| | | income from principal or any determination of the courts. |
| **Article IV: Lifetime <u>Power of Appointment</u>:**<br>Article IV. granted Doherty the right to assign principal, through an instrument during her lifetime, to members of her choice. | **<u>Article IV</u>:**<br>Problematic when combined with all other "bad" provisions. | **Article IV:**<br>**<u>Power of Appointment</u>:**<br>Did not discuss. |
| **Article V: Testamentary <u>Power of Appointment</u>:**<br>Article V. granted Doherty the right to assign principal through an instrument, by Will, to family members of her choice. | Problematic when combined with all other "bad" provisions. | Did not discuss. |
| **<u>Article XXII</u>:**<br>Article XXII gives the trustee the unfettered discretion to close the family trust and distribute all assets to the beneficiaries. | **<u>Article XXII</u>:**<br>Article XXII gives the trustee a sole discretion to determine that it is no longer advisable or necessary to continue the family trust. The trustee has the power to make the decision to pay over and distribute the entire principal of the family trust to the beneficiaries.<br><br>Doherty argues that Article XXII is put in place to provide for those instances where trust assets are so limited, that is economically and practical to maintain the trust, however, no such limiting restriction is found in the language of the family trust. If this was the intention of the drafters, such language should have been included in the instrument.<br><br>According to the plain language of the family trust, the trustee's discretion is extremely broad. As was stated by the Hearing Officer, "The trustee, in its sole discretion, could just as readily determine that the trust assets had grown too large to administer or, in the alternative, that Doherty's unforeseeable needs are such that it required the termination of the | **<u>Article XXII</u>:**<br>At first blush, MassHealth's conclusion seems a bit odd insofar as trust Art. V.A.2 explicitly provides, as noted, that the trustee may "make no distributions of principle from the Trust, to or on behalf of Muriel. But as MassHealth strongly presses upon us, this clause may not be read in isolation; rather, it must be construed and qualified in light of the trust instrument as a whole. See Harrison v. Marcus, 396 Mass. 424, 429 (1985). Taking this maxim to heart, we observe that trust Art. XXII generally provides that the trustee may, "in its sole discretion" and notwithstanding "anything contained in this Trust Agreement" to the contrary, "pay over and distribute the entire principle of [the] Trust found to the beneficiaries thereof, free of all trusts" so long as the trustees, "in [their] sole judgment," determine that the "fund created…shall at any time be of a size which…shall make it inadvisable or unnecessary to continue such Trust fund." Similarly, trust Art. XIV.H gives to the trustee the power to |

| Trust Provisions | Superior Court Analysis | Appeals Court Analysis |
|---|---|---|
| | trust."<br><br>Doherty is a lifetime beneficiary as is established by Article II and, per Article XXII, the Trustee has discretion, at any time and for any reason, to pay over the principal to Doherty during her life.<br><br>The Court noted that these provisions appear to be in direct conflict with Article V.A.'s prohibition against distributing principal to Doherty. Under the traditional trust law, it is true that the court would look to the settlor's intent to reconcile these provisions but, in this case, the family trust must be analyzed in light of the prevailing public policies in federal and state Medicaid laws. | "determine all questions as between income and principal and to credit or charge to income or principal or to apportion between them any receipt or gain…notwithstanding any statute or rule of law for distinguishing income from principal or any determination of the Courts." [FN5] |