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## **Introduction**

The estate planning process continues to become more complex. As the work of the estate planner becomes more technical, terms such as “Marital Deduction Trust” are augmented by others such as “Qualified Terminable Interest Property Trust,” “QDOT,” and “sponge tax” and the work product of the estate planner tends to be taken on faith, rather than as a result of understanding on the part of the client.

The planning of your estate is one of the most important projects that you may undertake. This booklet will explain, at least in general terms, the estate planning process.

Some of the mechanics are sophisticated, and not made any clearer by the language that is used in estate planning documents. We try to write in plain language, but sometimes this is not possible because much of what is involved in estate planning is very technical, incorporating concepts from many areas - property law, contract law, and tax law, among others.

While the mechanics of estate planning may be exquisite, you should be generally familiar with the tools that we use, and the techniques used in applying those tools. This booklet begins with a discussion of the probate process, goes on to discuss wills, trusts, and taxes, presents an illustration of the use of the Marital Deduction Trust, and then discusses several other topics important in estate and wealth planning.

Estate planning is the process by which your assets may be arranged so that they pass to your intended beneficiaries as efficiently as possible. Estate planning involves inventorying assets, determining objectives, assessing the problems (including taxes) which must be dealt with in achieving those objectives, rearranging ownership of property as necessary, and designing legal documents which will achieve the intended result.

Estate planning is sometimes thought of as a concern only of the very wealthy, who wish to avoid paying more taxes than necessary. Nothing could be farther from the truth; estate planning is an issue for every person who has assets and who wants to make sure that those assets will do as much as possible for his beneficiaries.

Many considerations in estate planning have to do with other than taxes. There may be a child who, because of disability or lack of experience, cannot handle money; there may be an elderly parent who needs to be provided for but should not receive money outright; there may be children with shaky marriages, needing special support provisions or arrangements to see that family funds which they might inherit do not wind up being divided with the other spouse in a divorce; and there may be a need to protect assets against nursing home expenses.

Estate planning may have to deal with issues of business ownership. If there is a family-owned business, should it be continued? If it is to be sold, how should it be sold? If one of the family members is to continue the business, how should ownership be transferred to that person so that the other family members will not feel that they have been unfairly treated? Dealing with the business situation as part of the estate planning process may prevent a costly and painful distress sale of the business later.

Any person with assets should plan who is to receive those assets and how they are to be distributed. Estate planning is not less important in the smaller estate - it is more important. The needs of the beneficiaries of the smaller estate may be as great or greater than the needs of the beneficiaries of the larger estate, so planning is essential to make sure that the available assets are distributed as effectively as possible.

This booklet is not a do-it-yourself manual, for several reasons. The work involved in estate planning is often very complicated, and beyond the scope of this booklet. Also, the law changes often - while this booklet is up-to-date as of its printing, the law may have changed when you read it.

## **The Probate Process**

A person wishing to pass assets to his beneficiaries on his death may do so in several ways. He (we will use the term “he” throughout for convenience) may do so by will. He may do so by form of ownership - having assets in joint names with the person or persons to whom the assets are intended to pass. He may do so by contract, where a third party is obligated by contract to pass assets to a someone, as in the case of a life insurance policy under which the insurance company agrees to pay the policy proceeds, upon the death of the insured, to the beneficiary or beneficiaries designated by the policy owner, or in a trust where the trustee agrees to pay certain amounts as provided by the trust agreement.

The probate process is involved in the case in which the person transfers assets by will, or dies owning assets in his own name but has no will. The probate process is not involved in the case of assets which are jointly owned or in the case in which amounts are paid to a beneficiary in accordance with terms of a contract; in these two instances, we refer to the assets as passing outside of probate.

Probate is the mechanism which has been established by the state to facilitate the transfer of assets by a person to his desired beneficiaries at his death in accordance with his desires which are incorporated in a document called his will, or, if he has no will, to distribute his assets in accordance with state law. The probate process must:

1. If there is a will, determine that the document which appears to be the decedent’s latest will is, in fact, his will and not a forgery, and, if it is his will, that it is his most recent will.
2. If there is a will, determine that the person who has been selected by the decedent to carry out or “execute” his will (the “executor”) does so in strict accordance with the terms of the will.

3. Require that the probate assets be listed in an inventory and valued.
4. Make sure that the decedent's debts are paid before any amounts are distributed to beneficiaries.
5. Make sure that the state and federal taxes attributable to the decedent's estate are paid.
6. Make sure that benefits are distributed to the persons who are entitled to receive them, and in the correct amounts.

It is possible to “avoid probate” by having assets owned jointly or by having assets pass as the result of a contract with a third party. The advantages of avoiding probate may be illusory, however, in that particular assets may not lend themselves to joint ownership or being passed on by contract; taxes and other expenses must be paid in any event, and the will may offer the simplest and most flexible means of transferring title.

## **Wills**

People have been making wills since Roman times or earlier. In early English law, wills were made orally, by declaring one's intentions to a group of witnesses, and one could dispose of all property, except real estate, by will. Real estate was required to pass to the eldest son (the custom of primogeniture) so that the King could easily trace who owned the property and who, therefore, was liable for taxes, supplies, and military services.

In England in 1540 the law was changed to permit all property to be left by will. About three hundred years ago, English law was further changed to require that wills be in writing.

In Massachusetts, every person eighteen years of age or older and of sound mind may make a will. A will must be in writing, signed by the testator at his direction, and witnessed by two persons.

Witnesses to the will should not be beneficiaries under the will, or married to beneficiaries under the will. If a witness is a beneficiary, or the spouse of a beneficiary, the gift to the beneficiary is stricken from the will, unless there are two other witnesses to the will, so that that particular witness may be disregarded.

A testator may leave property to whomever he wishes, except that if a married person makes a will and does not provide for his spouse, the spouse may, by a proceeding in Probate Court, “waive” the will and claim a share of the probate estate. The reason for this rule is the public policy consideration that testators not leave their spouses as public charges.

A spouse may agree not to exercise a right to waive a will even if no provision has been made for the spouse. This is often done in the case of persons who have been married before, have separate families, and agree that each spouse shall be free to leave all assets to his or her children, and shall not be obligated to make any provision for the other spouse. Such agreements, if properly drawn, are legally binding.

If a testator does not provide for his child, and the will does not indicate that the omission was deliberate, the child may claim that he was forgotten, and if there is no strong evidence that he was not forgotten, he may claim his intestate share. A testator is not required to provide for his child in his will - if he does not provide for his child, he should state in the will that the omission was not caused through accident or mistake. It is not necessary to leave a child one dollar as is often done. The purpose of the gift of one dollar is to show that the child has not been left out through oversight, and this can as well be shown by a statement to that effect.

The rule with respect to spouses and that with respect to children does not extend to other relatives. There is no duty to provide for any other relative, such as a mother, father, or cousin, and they may not claim an intestate share because they were not provided for in the will.

A will must be executed with certain formalities, and it must be amended with the same formalities. Notes on the face of the will do not serve as amendments. A codicil (an amendment executed with the same formality as a will) or a new will should be executed.

A will may be revoked by the testator or someone who, at his direction and in his presence, burns, tears, cancels, or obliterates the will. Marginal notes on the face of the will which do not amount to an “obliteration” will serve to revoke the will.

A will is revoked automatically, by operation of law, if the testator is married after executing the will and the will does not indicate that it was executed in contemplation of marriage. This is like the omitted child rule, in that it recognizes that sometimes testators fail to bring their wills up to date.

A will may be amended by a codicil, but the codicil must be undertaken with the same formality as the execution of the original will. Usually it is better to execute a new will if changes are desired, since the execution of multiple codicils can create confusion and mistakes.

If a person dies “intestate” (without leaving a valid will), his assets pass, by the laws of intestate distribution, to his wife and children, and if he dies without a spouse or children, to other relatives, and if he dies without any relatives at all, his assets “escheat” to the Commonwealth of Massachusetts. The provisions of the statute governing intestate distributions are, except in rare instances, not what the decedent would have wanted had he considered where his assets should go.

## Trusts

The trust is one of the principal devices we use in estate planning. A trust can save substantial amounts in Federal Estate Taxes and Massachusetts Estate Taxes, and provides flexibility and security in administering family assets.

A trust is an arrangement under which one party (the trustee), holds assets (the trust res or corpus) for the benefit of the trust beneficiaries. The person who establishes the trust is called the grantor or donor or trustor. The trustee holds legal title to the trust assets. The beneficial title to the trust assets rests in the trust beneficiaries.

The trustee may be a family member, a friend, a bank or trust company, or a member of a law firm. Members of this firm often serve as trustees.

Since beneficial title rests in the trust beneficiaries, and the trustee holds only legal title, the assets do not “belong” to the trustee. For example, if the trustee should become insolvent, the trustee’s creditors may not seize the trust assets, since they are not the trustee’s assets, but are the beneficiary’s assets.

A trust may be established by an agreement which is entered into during life, or by an arrangement which is set up in a will. In the first instance, the trust is referred to as an “inter vivos” or “living” trust. In the second case, the trust is referred to as a “testamentary” trust.

Generally, we prefer to use the “inter vivos” trust, because the agreement which is entered into during life between the grantor and the trustee is entirely private and confidential, and the financial affairs of the grantor and his family are not subject to public scrutiny, as are testamentary trusts. If the trust is set up in the grantor’s will, the ongoing management of the trust is reflected in accounts which are filed with the probate court and which can be viewed by anyone who wishes to go to the probate court and ask for the files.

In addition to the difference between the “inter vivos” and the “testamentary” trust, we have distinctions between “funded” and “unfunded” trusts, and “revocable” or “irrevocable” trusts. The trust which we commonly use for estate planning purposes is unfunded - that is, there are no funds placed in the trust at the time of its execution, other than, perhaps, a nominal amount such as ten dollars. The trust may hold insurance policies on the life of the grantor payable to the trustee, hence the common name “insurance trust”.

In the case of the unfunded trust, assets may later be added to the trust during life (as, for example, where the grantor sells a business and wants the trustee to administer the assets), or assets may not be added to the trust until the death of the grantor, when, under the terms of his will, assets “pour over” into the trust. The funded trust is most often used in the case of the grantor with liquid assets who wants to have the convenience of having his assets managed for him.

If a trust is to be funded with the purpose of avoiding probate, it is essential to see that no substantial amount of assets remains in the name of the grantor of the trust. If substantial assets remain outside of the trust, probate may be necessary in any event.

A trust may be either “revocable” or “irrevocable”. If it is revocable, the grantor may change any of its terms or may terminate it and require the trustee to return any assets which the trustee is holding. If the trust is irrevocable, the grantor does not retain the right to terminate the trust and receive back the assets, and usually does not retain the right to change the terms of the trust, although he may retain the right to make certain changes (such as choosing among beneficiaries) when those changes do not add up to the power to terminate the trust.

Most trusts which are used in estate planning are revocable. Irrevocable trusts are used in situations in which the grantor wants to remove the assets from his estate for tax purposes, and is willing to give up control of those assets permanently as the price for saving estate taxes. Life insurance is often placed in irrevocable trusts,

since substantial amounts can be removed from the taxable estate with little or no gift tax cost.

The most common type of trust which we use in estate planning is the revocable inter vivos trust. It is that type of trust which we will be discussing in this booklet.

In addition to saving taxes, the trust also saves probate expenses. In Massachusetts, because of the relative simplicity of the probate process, that savings is usually minimal. In some other states, such as California, probate expenses may be significant.

The principal purpose of the probate process is to transfer title to assets from the decedent to his designated beneficiaries. Assets which are held by a trustee are governed by the terms of the trust, and the probate process is not necessary to transfer title to those assets.

Massachusetts has adopted the Uniform Probate Code, which will be effective with respect to wills on January 1, 2012. Under the Uniform Probate Code it will be possible in many cases to administer estates in an informal manner, with minimal cost.

The emphasis in this discussion will be upon the benefits of trusts in saving taxes, but saving taxes is only one of the benefits in using a trust, and in some cases may be the least important reason for establishing a trust. Trusts serve many other purposes, such as providing for children during minority if parents are deceased, providing for disabled beneficiaries during their lifetimes, making income and principal available to beneficiaries while protecting both from the claims of the beneficiary's creditors (the "spendthrift" trust), and providing a vehicle for the management of money.

## **The Federal Estate Tax**

We have had a federal estate tax for many years. Whether it is a good thing to tax estates has been hotly debated for a long time. Caesar Augustus, the first of the Roman emperors, established an inheritance tax of five percent, which applied to transfers other than to a wife or child. Thus, the tax controversy probably goes back to 27 BCE. The answer is not any clearer now than it has ever been.

The proponents of the Federal Estate Tax argue that it prevents the establishment of an aristocracy, as contrasted with a meritocracy. They suggest that, without the intervention of a Federal Estate Tax, it would be possible for the owners of large estates to establish “dynasty trusts” and eventually to exert improper control over the economy. They also point to the revenue generated by the Federal Estate Tax.

The opponents of the Federal Estate Tax assert that it has a negative effect upon family-owned businesses, that it is a drag on entrepreneurship, and that it taxes wealth that has already been taxed once on an income tax return. The opponents of the Federal Estate Tax often use the pejorative term “death tax” in discussing the Federal Estate Tax.

Both of these arguments have merit. There has been increased interest in abolishing the federal estate tax in recent years. That interest resulted in the passage of EGTRRA.

In 2001 Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”). EGTRRA provided that the Federal Estate Tax would be gradually scaled down so that, in 2009, the first \$3,500,000 of each estate would be free of tax and the excess would be taxed at 45%. In 2010 the tax would be repealed, and, unless Congress acted earlier, in 2011 it would be revived as it was in 2001, with \$1,000,000 free and the excess taxed at 55%.

We expected that Congress would act in late 2009 or early 2010 to continue the Federal Estate Tax as it was in 2009. Months

wore on, and this did not happen, leaving us with no certainty as to the Federal Estate Tax.

Congress was not able to agree until, in the dying moments of the Congressional year, Congress passed the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, otherwise known as the 2010 Tax Relief Act. This law extends the provisions of EGTRRA for two years, and will sunset on December 31, 2012, which means that the Federal Estate Tax will once again be a political football two years from now.

A detailed discussion of the provisions of the 2010 Tax Relief Act is beyond the scope of this booklet. What follows is a brief outline of the law.

The 2010 Tax Relief Act revives the Federal Estate Tax with an exclusion of \$5,000,000 per estate and “portability” of the exclusion between spouses. If a married person does not use all of the \$5,000,000 in his estate, the excess may be carried over and used by his spouse.

Property included in the taxable estate of a decedent for Federal Estate Tax purposes will receive a “stepped-up” basis equal to the fair market value of the property as of the date of death or an alternate valuation date six months later.

The Generation Skipping Transfer Tax exemption is raised to \$5,000,000.

The Federal Gift Tax is unified with the Federal Estate Tax and has an exclusion amount of \$5,000,000 and a tax on the excess at 35%.

We had expected that Congress would grant the Internal Revenue Service several of its wishes with respect to tax saving devices. The IRS has been concerned about the practice of taxpayers, in making substantial inter-family gifts of entities such as family limited partnerships and limited liability companies, of claiming

valuation deductions of as much as 40% for lack of marketability and lack of control on these gifts.

The IRS has also been concerned about the use of short-term (Grantor Retained Annuity Trusts), some as short as two years, to reduce the transfer tax cost of making gifts. Congress, however, did not act with respect to these tax practices, so they will continue to the benefit of taxpayers.

At one time there was a credit against the Federal Estate Tax for state death taxes paid by the estate of the decedent. This credit ranged from nothing, in the case of taxable estates of less than \$660,000, to 16% on that part of taxable estates that exceeded \$10,100,000.

This was not a deduction, but a credit - it reduced the Federal Estate Tax dollar-for-dollar. States such as Florida, and, in 1997, Massachusetts, established their estate tax regimes (the “sponge tax”) based on this credit. The sponge tax absorbed the amount of the Federal Estate tax credit for state death taxes paid, so in effect it did not cost the estate anything - if the money were not paid to the state it would be paid to the Internal Revenue Service. The credit was wiped out by EGTRRA, and has not been restored in the Tax Relief Act.

In computing the Federal Estate Tax, debts and expenses may be deducted from the gross estate. Where assets pass to a surviving spouse, the Federal Estate Tax Marital Deduction, which is unlimited, will apply.

To the extent that taxable gifts are made during life, the \$5,000,000 exclusion is reduced. For example, if a taxpayer makes \$2,000,000 in taxable gifts during his lifetime, and then dies with \$4,000,000 in assets, his estate will pay a tax based on \$1,000,000 - the \$2,000,000 in taxable gifts reduces the \$5,000,000 exclusion amount to \$3,000,000 in the estate, so that the tax is imposed on the remaining \$1,000,000.

## **The Marital Deduction**

The Marital Deduction provision in the Federal Estate Tax law was the answer of Congress to the inequity arising because of the community property system which exists in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Puerto Rico. Under the community property system, all property acquired by either spouse during marriage is treated as being owned equally by both spouses.

When one spouse dies in California, for example, with assets of \$1,000,000, only one half, or \$500,000, is subject to tax, since the other spouse already is treated as owning half of the assets under the community property system. If the same person died as a resident of Massachusetts, which is not a community property state, the entire amount of property he owned, even if left to the surviving spouse, would be subject to tax except for the Marital Deduction provision.

In order to remedy the inequity, one state adopted the community property system. This proved unworkable because of the legal issues involved in trying to relate the community property system, which grew out of Spanish law, to the conventional system, which was a product of English law.

Congress solved the problem by adopting the Federal Estate Tax Marital Deduction. As originally adopted, this provided that if a resident of a state, other than a community property state, left assets to the surviving spouse under circumstances such that they would be taxable in the estate of the surviving spouse, the value of those assets, up to one-half of the decedent's adjusted gross estate, was deductible for Federal Estate Tax purposes. This provision placed a resident of a state like Massachusetts, which did not follow the community property system, in the same position as the resident of a state like California, which used the community property system.

Congress, in the Tax Reform Act of 1976, changed the Federal Estate Tax Marital Deduction to provide that, regardless of the size of the estate, a maximum Federal Estate Tax Marital Deduction in the amount of \$250,000 would be allowed.

The Economic Recovery Tax Act (ERTA) expanded the Federal Estate Tax Marital Deduction to allow an unlimited Marital Deduction, instead of one-half of the adjusted gross estate, and to permit “Qualified Terminable Interest Property” to qualify for the Federal Estate Tax Marital Deduction. Before ERTA, property would not qualify for the Federal Estate Tax Marital Deduction unless the surviving spouse had certain rights in it so that it would be includible in the estate of the surviving spouse for Federal Estate tax purposes when the surviving spouse died.

If the surviving spouse had only a “life estate” (the right to receive income for life), this would not qualify for the Marital Deduction because upon the death of that spouse the life estate would be extinguished and would not be includible in the estate of the surviving spouse. For a trust to qualify for the Federal Estate Tax Marital Deduction, before ERTA, it was necessary for the surviving spouse to have either a power to withdraw assets during life or a general power to appoint the trust assets at death.

A “power of appointment” is a power to direct where certain assets are to go, even if one does not own them (as, for example, the power to direct the disposition of assets held by a trustee). A general power of appointment is a power that may be exercised in favor of anyone, including the decedent’s estate.

ERTA permits a “Qualified Terminable Interest Property Trust” to be deductible for Marital Deduction purposes. The “QTIP” trust must provide that income will be payable to the surviving spouse at least annually, for life, but the surviving spouse need not have any power to withdraw assets or appoint the trust proceeds at death.

If the decedent's executor so elects, the property in the QTIP trust will qualify for the Federal Estate Tax Marital Deduction, and the value of the QTIP trust will be includible in the estate of the surviving spouse for Federal Estate Tax purposes, notwithstanding that the surviving spouse may not have had the power to direct the disposition of the assets in the trust at death, and such assets may pass to a designated beneficiary under the trust terms. The estate of the surviving spouse is entitled to receive from the QTIP trust reimbursement for the Federal Estate Tax paid by the estate of the surviving spouse as a result of the inclusion in his or her estate of the QTIP property.

In administering the Massachusetts Estate Tax, Massachusetts has adopted the Federal Estate Tax rules in effect as of January 1, 1975. In 1985 the Massachusetts law was changed to reflect some of the federal changes made since January 1, 1975.

Effective July 1, 1994 the Massachusetts Estate Tax Marital Deduction became unlimited - earlier it was limited to one-half of the adjusted gross estate. The QTIP trust now qualifies for the Massachusetts Estate Tax Marital Deduction, upon an affirmative election by the decedent's executor.

The term "Marital Deduction Trust" has two meanings. It may refer to the system of trusts, incorporated in one instrument, which includes the "Family Trust", also called the "Credit Shelter Trust" or the "Bypass Trust," the "Marital Deduction Trust" and the "QTIP" trust. It may also mean the trust within the system of trusts that is intended to qualify for the Federal Estate Tax Marital Deduction and the Massachusetts Estate Tax Marital Deduction. If one says that he has a "Marital Deduction Trust", he generally means that he has an estate plan consisting of a will together with a trust instrument that involves two or three trusts including the Marital Deduction Trust.

In calculating the value of the gross estate for Federal Estate Tax purposes, assets which are jointly owned by the decedent and the decedent's surviving spouse are included in the estate of the decedent

only to the extent of one-half of their value. This rule applies regardless of which spouse contributed to the purchase of the assets.

The unified Federal Estate Tax and Federal Gift Tax rates provide for no tax on the first \$5,000,000 of taxable assets and 35% on the excess taxable assets.

Property which is jointly owned by persons who are not husband and wife is treated as being entirely taxable in the estate of the first joint owner to die, except to the extent that the surviving joint owner can show that he contributed to the jointly owned property.

In computing the Federal Estate Tax, debts and probate expenses may be deducted from the gross estate. Where assets pass to a surviving spouse the Federal Estate Tax Marital Deduction, which is unlimited, will apply.

### **The Massachusetts Gift Tax**

There is no Massachusetts Gift Tax; however, gifts made within three years of the date of the donor's death are includible in the decedent's estate for Massachusetts Estate Tax purposes. Gifts not exceeding \$10,000 per donee per year are excludable.

### **The Massachusetts Estate Tax**

The Federal Estate Tax is no longer a consideration in many cases, because the first \$5,000,000 in each estate is exempt from taxation. However, the Massachusetts Estate Tax is still in effect, and the impact can be significant.

Before January 1, 1976, Massachusetts had an inheritance tax. (An inheritance tax is based upon the amount each donee inherits, and upon the closeness of his relationship to the decedent, whereas an estate tax is based upon the size of the total estate.)

On January 1, 1976, this inheritance tax was changed to an estate tax, and in 1985 was changed again to reflect changes made in the Federal Estate Tax since January 1, 1975, to which the Massachusetts Estate Tax was keyed.

In 1992 the Massachusetts Legislature voted to abolish the Massachusetts Estate Tax and replace it with a “sponge tax,” so called because it “sponged up” the Federal credit. Before it was revised by EGTRRA, the Federal Estate Tax system provided for a credit against the Federal Estate Tax for State Death Taxes paid. If this amount was paid to a state, it could be credited, dollar for dollar, against the Federal Estate Tax that was due. The sponge tax was used in Florida and some other states, and it really cost estates nothing, since if the amount was not paid to the state it would be paid to the federal government.

The Massachusetts legislature wiped out the Massachusetts Estate Tax and replaced it with a “sponge tax” because studies, and the practical experience of estate planners, showed that many taxpayers changed their domiciles from Massachusetts to Florida or other states, so as to avoid the Massachusetts Estate Tax. When the taxpayers changed their domiciles, they took with them their bank accounts, brokerage accounts, and other economic activity, and ceased paying Massachusetts income taxes. The cost of losing the income tax receipts and the economic impact of losing the other business was believed to exceed the amount of the Massachusetts Estate Tax which was collected.

When EGGTRA was enacted, with the intention of wiping out the Federal Estate Tax, the federal credit for state death taxes paid was wiped out along with it. Thus, the sponge tax no longer worked, and Massachusetts had to establish another format for the Massachusetts Estate Tax. Florida also lost its estate tax, but was unable to replace it because of limitations in the Florida Constitution.

Massachusetts changed the Massachusetts Estate Tax to what the Federal Credit would have been under the Internal Revenue Code in effect on December 31, 2000. The Massachusetts Estate Tax is now

calculated by preparing a Federal Estate Tax return as it was revised in July 1999. The Massachusetts Estate Tax is the Federal Estate Tax Credit for state death taxes as shown on that return.

Since the Federal Estate Tax law at that time had an exclusion amount of \$1,000,000, there is no Massachusetts Estate Tax liability for taxable estates of \$1,000,000 or less.

Gifts made within three years of the decedent's death are entirely includible in the estate for Massachusetts Estate Tax purposes. Gifts not exceeding \$10,000 per donee in each year are excludable from the gross estate for tax purposes, even if made as "deathbed gifts" less than three years before death.

The Federal Credit for State Death Taxes ranges from \$205 on taxable estates of \$1,000,500 to \$1,082,000 on taxable estates of \$9,960,000

The Massachusetts Estate Tax on a taxable estate of \$1,000,500 would be \$205, for a taxable estate of \$1,100,000 would be \$38,800, for a taxable estate of \$1,200,000 would be \$45,200, for \$1,300,000 would be \$51,600, for \$1,400,000 would be \$58,000, for \$1,500,000 would be \$64,400, for \$1,600,000 would be \$70,800, for \$1,700,000 would be \$78,000, for \$1,800,000 would be \$85,200, for \$1,900,000 would be \$92,400, for \$2,000,000 would be \$99,600, and it increases from there at a rate which rises to 16% on the excess over \$9,960,000.

Here is the official Massachusetts Estate Tax Schedule:

<b>From</b>	<b>To</b>	<b>Credit</b>	<b>+ %</b>	<b>Excess of over</b>
1,100,000	1,600,000	38,800	6.4	1,100,000
1,600,000	2,100,000	70,800	7.2	1,540,000
2,100,000	2,600,000	106,800	8.0	2,100,000
2,600,000	3,100,000	146,800	8.8	2,600,000
3,100,000	3,600,000	190,800	9.6	3,100,000
3,600,000	4,100,000	238,800	10.4	3,600,000
4,100,000	5,100,000	290,800	11.2	4,100,000
5,100,000	6,100,000	402,800	12.0	5,100,000
6,100,000	7,100,000	522,800	12.8	6,100,000
7,100,000	8,100,000	650,800	13.6	7,100,000
8,100,000	9,100,000	786,800	14.4	8,100,000
9,100,000	10,100,000	930,800	15.2	9,100,000
10,100,000	----	1,082,800	16.0	10,100,000

Effective July 1, 1994, the Massachusetts Estate Tax Marital Deduction became unlimited - earlier it was limited to one-half of the adjusted gross estate. The QTIP Trust now qualifies for the Massachusetts Estate Tax Marital Deduction, upon an affirmative election by the decedent's executor.

We use the Marital Deduction Trust to reduce the Massachusetts Estate Tax liability in an estate in the case of a married person. This technique, which saves Federal Estate Taxes as well as Massachusetts Estate Taxes, is a mechanism to "park" some assets in the case of the first spouse to die, so that those assets will be available for the surviving spouse, but will not be taxed in the estate of the surviving spouse.

In the case of married persons, each spouse establishes a trust which divides into three parts - the "Family Trust, also called the "Bypass Trust" or the "Credit Shelter Trust", the Marital Deduction Trust, and the QTIP trust. The Family Trust is our "parking" trust.

Assume that spouses have total assets of \$2,400,000, and that it is all in the name of the first spouse to die. This amount is less than the Federal Estate Tax threshold of \$5,000,000 so we do not worry about the Federal Estate Tax in any event, but we are concerned about the Massachusetts Estate Tax.

If the first spouse to die leaves all of his or her assets to the survivor, there will be no Massachusetts Estate Tax in his or her estate, because of the unlimited Massachusetts Estate Tax Marital Deduction. The tax problem comes in the second estate, which will have a taxable estate of \$2,400,000 which will attract a Massachusetts Estate Tax of \$130,800.

Of the \$2,400,000 in the first estate we allocate \$1,000,000 to the Family Trust. It will be available to the surviving spouse, but will not be taxable in his or her estate. The balance, \$1,400,000, will be allocated to the Marital Trust. We do not need to use the QTIP Trust in this instance since we have no Federal Estate Tax liability in the second estate.

The result of using the trust arrangement is that the estate of the second spouse to die will not be valued at \$2,400,000 but will be valued at only \$1,400,000, since the \$1,000,000 in the Family Trust will not be includible in the estate.

The result is that the tax liability in the second estate will be \$58,000 instead of \$130,800, a saving of \$72,800.

If the estate were large enough to attract a Federal Estate Tax we would take one further step, using the QTIP Trust.

## The Generation Skipping Transfer Tax

After the Federal Estate Tax was established, it soon appeared that very wealthy families could avoid taxes over generations by leaving their children, and perhaps their grandchildren and great-grandchildren, income interests in property only, and not any rights over principal. If the children and grandchildren had only the right to income from property, such property would not be includible in their estates for Federal Estate Tax purposes. Subject to certain state law requirements (“the rule against perpetuities”) it was possible for estates to be held in trust for decades and provide for successive generations, without the imposition of an estate tax.

To correct this situation, Congress adopted the Generation Skipping Transfer Tax (“GSTT”), which is one of the most complex and difficult areas of the tax law. The GSTT, which imposes tax at the top estate tax bracket of 35%, applies whenever assets pass to a “skip person.”

For instance, assume that you leave assets in trust for your child for life, with the remainder to pass to your grandchildren. Your child has the right to receive income and, at the discretion of the Trustee, principal. The assets would not be includible in your child’s estate at his death because he did not have any right to demand principal during life and did not have a general power of appointment over the trust assets at death. When your child dies, the assets pass to your grandchildren, who are “skip persons” and the GSTT applies.

Every person has a \$5,000,000 exemption for generation skipping assets, which may be allocated among trusts by his executor. Assets held within a trust which is covered by the GSTT exemption remain exempt, notwithstanding that the trust may increase in value well beyond \$5,000,000.

Trusts which skip generations offer substantial tax planning opportunities. At the same time, the GS’I’ can be very costly if an

estate plan is not carefully arranged, if the GSTT exemption is not thoughtfully allocated, and care is not taken to recognize transfers to skip persons.

## **The Federal Gift Tax**

Federal tax law has long provided for a tax on gifts. To avoid taxing smaller amounts, Congress initially excluded the first three thousand dollars per donee per year - this amount was later raised to \$10,000 per donee per year, and is now \$13,000 per donee per year.

Gifts to provide for medical expenses are not subject to tax, and gifts to pay school tuition (but not room and board, books, etc) are also exempt. You must make payments of medical expenses directly to the provider of the services, and you must make school tuition payments directly to the school - if you give the amounts to the patient or the student and then they pay the medical provider or the school, the gifts will not be exempt from gift taxes.

Spouses may elect to have gifts made by either of them treated as having been made one-half by each. Thus, a married person may make gifts in any year in the amount of twenty-six thousand dollars per donee without gift tax liability, if the spouse assents.

For Federal Gift Tax purposes, there is an unlimited deduction for gifts made by one spouse to the other. This Gift Tax Marital Deduction is the counterpart of the Federal Estate Tax Marital Deduction.

If you make gifts in any year in excess of the exemption, you must file a Federal Gift Tax return, and the amount of the tentative gift tax is reduced by any available amount of the unified credit (discussed under the Federal Estate Tax material).

Gifts made within three years of death, in the case of life insurance policies, transfers with retained life estates, transfers taking effect at death, revocable transfers, and powers of appointment are included in the donor's estate for tax purposes.

## **Illustration of The Marital Deduction Trust in Operation**

We earlier looked at the situation of the spouses who owned \$2,400,000 in assets. Because the total was less than the Federal Estate Tax floor, we did not have to consider the Federal Estate Tax. Thus, we funded the Family Trust with \$1,000,000 to shield that amount from Massachusetts Estate Tax in the estate of the survivor.

Now let us assume that we have a family with \$8,000,000 in assets, all in the name of one spouse, who is the first to die. Since this exceeds the \$5,000,000 Federal Estate Tax floor, we are concerned about the Federal Estate Tax, because we want to keep the estate of the surviving spouse below \$5,000,000 so as not to generate Federal Estate Tax.

We will first allocate \$1,000,000 of assets to the Family Trust (sometimes referred to as the “Credit Shelter Trust”), which we earlier referred to as our “parking” trust. The amount in the Family Trust is protected from taxation in the estate of the surviving spouse for Federal Estate Tax and Massachusetts Estate Tax purposes, because the surviving spouse has no power to direct payment of those assets to himself or herself.

There is a total of \$5,000,000 which is not subject to Federal Estate Tax in the estate of the first spouse to die. We have used \$1,000,000 of that to fund the Family Trust, so we have \$4,000,000 remaining of the amount that is free from Federal Estate Tax. We allocate that \$4,000,000 to the Special Marital (QTIP) Trust.

The decedent’s executor elects QTIP status for Massachusetts Estate Tax purposes so the \$4,000,000 is treated as includible in the estate of the surviving spouse for Massachusetts Estate Tax purposes and thus is deductible for Massachusetts Estate Tax purposes. If the executor did not make the QTIP election, the amount of \$4,000,000 would not be deductible for Massachusetts Estate Tax purposes and a tax would be paid on that amount currently. It is almost always

desirable to defer the payment of taxes as long as possible - here it is deferred until the death of the surviving spouse.

The decedent's executor does not elect QTIP status for the \$4,000,000 for Federal Estate Tax purposes, because that \$4,000,000 is already protected from taxation in the first estate as part of the \$5,000,000 which goes free, and does not have to be treated as includible in the estate of the surviving spouse for Federal Estate Tax purposes in order to be protected from taxation in the first estate.

The QTIP Trust, with the power in the decedent's executor to elect in or out of the QTIP treatment, thus permits us to deal effectively with the two different estate taxes, one with a \$1,000,000 exempt amount and the other with a \$5,000,000 exempt amount.

We have now dealt with \$5,000,000 of assets. \$1,000,000 has been protected from Massachusetts Estate Tax in the estate of the surviving spouse and \$5,000,000 has been protected from Federal Estate Tax in the estate of the surviving spouse.

The remaining \$3,000,000 is allocated to the Marital Deduction Trust. The surviving spouse may have various powers over the Marital Deduction Trust, including perhaps the power to withdraw any part or all of it. The Marital Deduction Trust will be includible in her estate for Federal Estate Tax and Massachusetts Estate Tax purposes (to the extent that she has not spent it) and will be deductible in the estate of the first spouse to die.

The tax savings might be greater than indicated, in that the surviving spouse might choose to spend assets in the Marital Deduction Trust, accumulating assets in the Family Trust. If that were done, the Family Trust would grow and the Marital Deduction Trust would shrink, so a considerable amount of wealth might be moved from the Marital Deduction Trust, where it would be taxable in the estate of the surviving spouse, to the Family Trust, where it would not be subject to tax, either for federal or Massachusetts purposes.

Another way to save taxes might be to place life insurance policies in an irrevocable trust, so that the death proceeds would be available to the surviving spouse, but not taxable in his or her estate.

Making gifts, to use up the annual exclusion, is an effective way to reduce the estate of the surviving spouse. The grantor retained interest trust (“GRIT”) is another effective device, making it possible to transfer a significant amount of value because the surviving spouse retains the right to use the property or receive the income from the property for a period of time, and the value of the gift for tax purposes is discounted to reflect the fact that the full gift is deferred for some time.

Charitable gift techniques, such as the charitable gift annuity, the charitable remainder trust, and the charitable lead trust, may enable a donor to increase one’s current income, receive an income tax deduction, and save taxes, all at the same time.

## **Jointly Held Property**

Property held in joint names has many advantages when properly used. Jointly held property avoids probate, and qualifies for the Federal Estate Tax Marital Deduction and the Massachusetts Estate Tax Marital Deduction.

If the combined estates of a husband and wife are of such size that it is unnecessary or inappropriate to use a trust arrangement - for example, \$900,000 - it can be good planning to have all of the family assets in the joint names of the spouses. In the estate of the first spouse to die, there will be no need of probate, and there are no tax considerations to be dealt with.

On the other hand, if the combined estates of a husband and wife are large enough so that a trust arrangement is needed (using the Family Trust, the Marital Deduction Trust, and the QTIP Trust), or any one or more of them, or if the surviving spouse is unable to handle funds, it is important to look at any joint ownership of

assets in the context of the estate plan which is being established. Once the estate plan is established, assets should not be moved into joint ownership without considering the effect on the estate plan.

Married persons tend to place assets in joint names. Many estate planners have worked with clients and established excellent estate plans, only to visit with the client later and discover that the estate plan is unworkable because of an increase in jointly owned property.

At one time it was considered absolutely essential to divide family assets equally between spouses so that the trust of whichever spouse died first could be properly funded. Joint property was frowned upon.

We do not regard this with such concern now, because of the possibility of using disclaimers. For example, if both spouses have established trusts, and when one dies it is found that all of the family assets are held in joint ownership between the spouses the surviving spouse may, within nine months, disclaim one-half of the jointly held property. That property would then pass into the other spouse's probate estate and be "poured over" by will into his or her trust.

## **Disclaimers**

If one receives property and then transfers it to someone else, that transfer is a taxable gift. For example, let's assume that Father, in his will, leaves \$1,000,000 to "my son, if he survives me, otherwise in equal shares to my grandchildren." Son survives Father, and accepts the bequest.

Son has very large assets of his own, and since he does not need the money left to him by Father, he gives the money he has received to Grandchildren. The gift by Son to Grandchildren is (subject to the exclusion of \$13,000 per donee) a taxable gift, and uses up \$1,000,000 of Son's lifetime exemption equivalent.

There is another way Son could have arranged for the \$1,000,000 to pass to Grandchildren. That is the “qualified disclaimer.”

Under Section 2518 of the Internal Revenue Code if, within nine months of the date on which one becomes entitled to receive assets, he files a written refusal to accept the property, that constitutes a qualified disclaimer, and the legal effect will be the same as if he had predeceased the donor. In the case at hand, if Son, within nine months of Father’s death, disclaimed the \$1,000,000, that amount would pass to Grandchildren without any tax effect on Son, and would not constitute a taxable gift and would not use up any of Son’s lifetime exemption equivalent. The result is a potential savings of \$350,000 or more in taxes in Son’s estate.

Another situation might be the case of the wife whose husband died, leaving his entire estate to her, if living, otherwise to their children. If she already had substantial funds of her own, she might want to disclaim a part of the funds left to her, so that they would pass to her children without any tax consequences, and never be taxed in her estate. (Since \$5,000,000 is the exemption equivalent in the husband’s estate, there would be no tax liability in the husband’s estate as a result of the wife’s disclaimer if she disclaimed up to \$5,000,000.)

A further example might be the case in which the husband set up an estate plan using a Marital Deduction Trust arrangement. Because of an oversight, all of the assets owned by husband and wife were joint, so that no assets were available to pass into the Marital Deduction Trust. The concern in this case would be to reduce Massachusetts estate taxes.

If the wife were to disclaim \$1,000,000 of assets, those assets would not pass to her, but would pass into her husband’s probate estate and then be “poured over” into the Marital Deduction Trust, thus making the estate plan work, and saving the Massachusetts Estate Tax on \$1,000,000 in the wife’s estate.

The use of the disclaimer in this context is an illustration of “post-mortem estate planning” in which the estate planner may be able to continue the planning process and take steps to adjust the estate plan even after the death of the client.

In addition to disclaiming specific amounts of money, one may disclaim certain powers, such as powers with respect to trust property, in order to correct estate planning errors or to adapt the estate plan to changed circumstances.

## **Trust Protectors**

Lawyers who have done work in asset protection, using trust arrangements in the Channel Islands (Jersey, Guernsey, Alderney, Sark and Herm) as well as the Isle of Man and other offshore jurisdictions have used trust protectors for many years. The trust protector is a person or an institution having the power to provide certain directions to the trustee or trustees of a trust or to modify the trust.

In offshore asset protection planning, we use trust protectors to exercise certain powers which, for various reasons, we cannot allow the grantor of the trust to have. The trust protector is now being used in domestic estate planning.

The laws with respect to trusts are changing. There have been more changes in the last thirty years than there were in the prior three hundred years.

The tax laws are also changing. It has been said that two things are inevitable - death and taxes - but death does not get worse every time Congress meets. The most recent legislation sets the pattern for the Federal Estate Tax for the next two years, but we cannot be sure that format will not be changed at any time, and it is likely that it will be changed two years from now when the temporary changes wrought by the present law expire.

If a trust is used in the estate plan we will often provide for a trust protector. The trust protector can amend the trust if it is necessary to do so because of tax law or other law changes or changes in circumstances, and the grantor is unable to make those changes. When the grantor dies, the trust he has established becomes irrevocable, and he is not there to amend it, but the trust protector may do so.

The Probate & Family Court has jurisdiction over trusts. In some cases a judge will amend a trust to correct an estate planning error or to conform the trust to what is needed currently. Such a proceeding may be costly and time consuming, and there may be no assurance in a given case that a judge will have the power to change the trust. Thus, it is often desirable to designate a trust protector.

## **Durable Powers of Attorney**

The durable power of attorney is one of the most valuable tools we can use in estate planning. You should execute a durable power of attorney.

A power of attorney may be oral, but generally is a written instrument by which one person (the principal) designates someone as his or her agent (formerly called “attorney in fact”) to perform certain acts. At common law (that is, the law which developed over centuries through custom and court decisions, as contrasted with law established by statute), the power of attorney was of no effect if the principal became incompetent.

In legal theory, the agent has only the power the principal has, and if the principal is, for example, in a coma and unable to sign documents, the person holding the power is similarly unable to sign documents on behalf of the principal. This common law rule created problems because when the power of attorney was most needed it was not available.

Massachusetts law now provides that if the instrument states: “This power of attorney shall not be affected by subsequent disabil-

ity or incapacity of the principal” or contains language to that effect, the authority conferred upon the agent will continue notwithstanding the disability of the principal.

A durable power of attorney may be written as broadly or narrowly as is desired. For instance, a power may authorize an attorney only to sign a particular document - such as, “to sign, on my behalf, a deed for my residence from me to my children”, or it may be limited to signing checks on a particular bank account.

The power could be very broad, and authorize the attorney to do anything with respect to the principal’s business which the principal could do. Such an authority might involve a number of pages. The power of attorney may be tailored to the circumstances of the particular case; in business transactions, powers of attorney may be very narrow; in cases involving powers granted to spouses, the power of attorney may be very broad.

It is possible to draft a power of attorney to be effective only in certain circumstances, such as if the principal has been declared by a physician to be incompetent. This is referred to as a “springing power” since it springs into effect when certain things have happened.

Using a springing power is unwise, because a power of attorney is only as good as its acceptance by the person to whom it is presented. The bank teller or stockbroker may not be able to determine whether or not the springing power has sprung, and this may present real problems.

If you want to place limitations on the exercise of the power of attorney, deposit the document with us, with instructions to release it to the agent, if we are satisfied that you are incompetent or if some other condition is met.

You should grant the power of attorney only to someone trusted to exercise it according to your wishes. Such a person might be a spouse, a child, a member of our firm or some other person in whom you have confidence.

If you become legally incompetent, and have not executed a durable power of attorney, in order for anyone to act on your behalf, they must be appointed by the Probate Court to be the conservator or guardian of you or your property. This process is time-consuming, involves expense (for court filing fees and for a surety bond), and may expose your financial affairs to the eyes of anyone who wants to go to the Probate Court and examine the files.

A power of attorney may provide by its terms that it will terminate upon the happening of a certain event or on a certain date, and you may revoke it at any time (assuming, of course, that you are competent). If you are incompetent and a guardian or conservator is appointed for you (which is generally not necessary if a power of attorney has been executed) the guardian or conservator may amend or terminate the power of attorney. The power of attorney will terminate when you die.

The agent is a fiduciary. He or she must act in your best interests. If he or she is to handle funds, those funds must be properly accounted for. If the agent takes action which is not authorized by the written power of attorney, or takes action which is known to be contrary to your best interests, the agent may be held legally liable to you.

The durable power of attorney is intended to provide a solution to an immediate problem. In some cases, the durable power of attorney may enable an agent to act on behalf of the grantor for the balance of the grantor's life, and, so long as the agent is well and able to act, this may work out satisfactorily.

A living trust enables a trustee to take possession of, and manage, the assets of the grantor, and is designed to continue through the grantor's life, and as much longer as is necessary to accomplish the trust purposes. The trustee of the living trust may be more competent to manage the grantor's affairs than the agent. For this reason, often an agent is authorized to take possession of a grantor's assets and fund a living trust; if the disability of the grantor were of a short duration,

the agent could continue to manage the assets, but if the disability appeared to be long-term, the agent could fund the trust, and the grantor would be assured of having competent management of his assets.

## **Basis**

“Basis” is a term we use often in estate planning. “Basis” is “cost” for tax purposes; that is to say, the amount you can offset against the sale price in determining gain.

When an asset is included in an estate for Federal Estate Tax purposes, its basis “steps up” to the value at the date of death, except for certain assets (“income in respect of a decedent”); such as annuity contracts and retirement benefits which would have constituted taxable income when received.

Assets which do not acquire a “stepped up” basis at death are said to have a “carryover basis.” The income which is received by the beneficiaries is referred to as “income in respect of a decedent,” and any estate tax attributable to those assets may be claimed as a deduction against the income generated by those assets.

If you are going to give away assets to reduce the size of your estate for tax purposes, look first to high-basis assets. Usually you should keep low-basis assets so they will be included in your estate for tax purposes, and the basis in those assets will be stepped up at death. Basis in assets does not step-up when the assets are given away.

For example, assume that you own stock in XYZ Corporation, which you bought thirty years ago for \$1,000. It is now worth \$100,000. If you give this stock away during your life, the person to whom you give it (the “donee”) will have your basis, or \$1,000, and will eventually have to pay a large capital gains tax when the stock is sold. If, on the other hand, the stock is includible in your estate for tax purposes, its basis will step up to \$100,000, and the beneficiary will pay capital gains tax only to the extent that the amount he receives on the sale of the stock exceeds \$100,000.

## The Health Care Proxy

Massachusetts adopted the health care proxy in 1990. The health care proxy is similar in many ways to the durable power of attorney. The durable power of attorney is often referred to as a “financial power” and the health care proxy as a “health care power.”

A competent adult (the “principal”) may appoint someone (the “agent”), and perhaps an alternate, to act for him in the event of disability. If a physician determines that the principal is unable to make or communicate health care decisions, and enters such determination in the principal’s medical record, the agent’s authority to make decisions begins. When the physician enters the determination in the medical record, we say that he has “invoked” the healthcare proxy.

The health care agent will have the right to receive all medical information about the principal, and to make all medical decisions the principal could make if competent. If the principal regains competence, the authority of the health care agent ends.

The authority of the agent is limited only by any restrictions which are placed in the health care proxy. In order to make the health care proxy fully effective, we recommend that no restrictions be placed on the authority of the health care agent.

The health care proxy is superior to the “living will” for several reasons. First, the living will is not recognized by statute in Massachusetts, whereas decisions made by the health care agent must be obeyed by health care providers.

Second, the living will tries to state what ought to be done in the event of serious illness of the principal, but it is impossible to imagine every possible situation which could occur and every response which medical personnel might make to that situation. The health care agent has the authority to make judgments as to medical treatment, whatever the medical problem may be.

You should sign a health care proxy. Furnish a copy to your physician, and to your agent. Spend the time to talk with your health care agent, and make sure that he or she understands what you want to happen if you are disabled.

## **Review of Your Estate Plan**

You should review your estate plan at least once a year. Circumstances change, and any number of special circumstances may arise. Your assets may change, you may have specific assets you want to leave to particular beneficiaries, you may wish to change your executor, or you may need to make a special provision for one of your beneficiaries for Medicaid or other reasons.

You also may acquire assets, such as annuity contracts or investment vehicles, which provide for beneficiary designations upon death, or you may acquire rights under pension plans that require beneficiary designations, and the beneficiary designations which worked well in the past may not work well with your existing estate plan.

Many investment vehicles today provide for “POD” or “payable on death” designations, and this could interfere with your estate plan. For example, if you have provisions in your estate plan for specific gifts to beneficiaries, and then you dispose of those items through POD provisions, this will result in confusion and frustration. It may also result in a situation where the beneficiaries receive certain assets under your estate plan and equivalent assets under POD provisions -- this can result in “double dipping” and may not be what you intend.

If an estate plan is to do its job, it is essential that the estate plan be reviewed whenever there is a change in the law, a change in assets, or a change in circumstances.

## **IRAs And Other Retirement Plan Benefits**

Benefits from retirement plans are includible in your estate for Federal Estate Tax and Massachusetts Estate Tax purposes. You must be very careful if you want to achieve the best estate planning results from retirement plan benefits.

Benefits from retirement plans, including IRAs, are usually entirely includible in income when received. They are referred to as “income in respect of a decedent” since if you had received them during your lifetime, they would have been ordinary income to you. Unlike most other property, you have no basis in IRAs and other retirement plans.

An IRA is essentially a tax-free loan from the IRS. You contribute to the IRA with before-tax money, the IRA grows tax-free, and the tax liability is imposed when the proceeds are drawn down. The IRS is essentially loaning you the money you would otherwise pay in taxes along the way.

You should have expert advice in dealing with IRAs. If planning is done properly, you may be able to extend IRA payout over many years (the so-called “stretch IRA”) and over the lives of several beneficiaries, with considerable tax benefit, in that the IRA will continue to grow, tax-free, and the benefits will be subject to tax at a modest rate. On the other hand, if the planning is not done properly, the income tax impact of the IRA may be accelerated, and the tax effect may be punitive.

## **Reducing Transfer Taxes**

We use the term “Transfer Taxes” which embraces the Federal Gift Tax, the Federal Generation Skipping Transfer Tax, the Federal Estate Tax, and the Massachusetts Estate Tax, because that is a much broader concept than simply “Estate Taxes.”

There are a number of ways to reduce transfer taxes. In considering this subject however, it is essential to remember that taxes should not be the first order of importance. Plan for tax reduction, but do not let the tax tail wag the estate planning dog.

In the case of a married couple, look first at the Marital Deduction Trust. Unless the total family assets exceed \$10,000,000, the Marital Deduction Trust will probably wipe out any Federal Estate Taxes.

If there is no Federal Estate Tax issue, and the Massachusetts Estate Tax liability is large, you may wish to consider changing your domicile to another state that does not have a state estate tax. Florida does not have an estate tax.

At the present time, the only states beside Massachusetts with estate taxes are Connecticut, Delaware, the District of Columbia, Hawaii, Illinois, Indiana, Iowa, Kentucky, Maine, Maryland, Minnesota, Nebraska, New Jersey, New York, North Carolina, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont, and Washington.

If you are going to move from Massachusetts in order to save estate taxes, you must understand the concept of domicile. You may have any number of residences, but only one domicile. Domicile is where you go with the intention of remaining for the indefinite future - the place you consider to be your home.

Since intention is a subjective matter, it is measured by things you do. In dealing with domicile issues, we look at what you have

done. You might say that domicile is that place where you have sufficient connections so that the jurisdiction may subject you to tax.

If you plan to change your domicile to a state without an estate tax, here are some of the things you should do. Notify your Town Clerk that you are changing your domicile. Register to vote in your new state. Establish homestead on your new property, if, as in Florida, it is provided by local law. Join clubs in your new domicile, and establish relationships with providers of services, such as physicians and dentists. Change your estate plan to reflect the new jurisdiction. (If it is Florida, we can help you.) Change the address on your passport. Register your automobile in the new domicile, and obtain a driving license in your new community.

In the case of persons domiciled in other states, Massachusetts has the power to impose its estate tax on real estate and tangible personal property that is located here. Real estate is land and anything attached to it, and tangible personal property is anything except land or things attached to it, which has value in itself. For example, a stock certificate is intangible personal property, since it has no intrinsic value. A bag of gold coins, an airplane, a boat, an automobile - these would be tangible personal property, since they have value in themselves.

You may wish to change the character of real estate remaining in Massachusetts. For example, if you change your domicile to Florida, and you still have a house and land in Massachusetts, you may be able, under certain circumstances, to change the legal character of that house and land from real property to intangible personal property, as, for example, by placing the house and land in a limited liability company or a partnership. A share in a limited liability company or an interest in a partnership is not real estate - it is intangible personal property.

If you move from Massachusetts and still retain property here, domicile is the issue on which the Massachusetts Department of Revenue may try to build a claim that you are actually still a Mas-

sachusetts domiciliary. If you plan to change your domicile from Massachusetts to another state, let us advise you how to do this effectively.

You can reduce the value of your estate by giving away assets. Annual exclusion gifts (\$13,000 per donee per year if you are concerned about Federal Tax liability - \$10,000 per year if your concern has to do with Massachusetts Tax liability) - are an effective way to reduce your taxable estate.

If you are going to make gifts, consider your own comfort and security first. If the tradeoff for your feeling safe and secure is that you retain more assets, your estate pays some estate tax, and your beneficiaries receive a little less on your death, that is reasonable. If giving away assets is going to cause you concern for your own security, don't do it.

If you are going to give away assets, do so in the most tax-efficient way. For instance, if you give your children \$1,000,000 in cash, that reduces what will pass tax-free at your death by \$1,000,000. If you establish a limited liability company (LLC) or other vehicle, and give your children interests in the LLC, for transfer tax purposes you may be treated as giving away only \$600,000, instead of \$1,000,000.

Similarly, if you are going to give your house to your children, you can reduce the transfer tax cost by establishing a Qualified Personal Residence Trust (QPRT). This involves making a present gift of an interest which will not become final for some time. The present transfer tax value of a deferred gift is discounted from the fair market value of the gift.

There are many other vehicles that provide reductions in the transfer tax value. Grantor Retained Annuity Trusts (GRATs) are also useful devices for transferring assets at less than present value for transfer tax purposes.

If you are interested in charity, there are many opportunities to reduce the value of your estate and pass assets to your family at the same time. The Charitable Remainder Annuity Trust (CRAT) or the Charitable Remainder Unitrust (CRUT) may serve your purposes of making charitable gifts and at the same time transferring assets to your family at a reduced transfer tax cost.

If you propose to use any of these devices to save taxes, you must have competent professional advice. We will be glad to work with you to examine the methods which may work best for you in reducing transfer tax costs.

## **Medicaid Planning**

As advances in medical care make it possible for persons to live longer, the possibilities of serious illness, and a stay in a nursing home, increase. Medicare and various types of private medical insurance pay for physicians and medicines, but Medicare does not cover nursing home expenses, which may wipe out even a substantial estate. Medicaid pays long-term nursing home expenses.

Medicaid is a Federal program which, called MassHealth, is administered in Massachusetts by the Division of Medical Assistance (“DMA”) of the Executive Office Of Health And Human Services. The Medicaid program has changed over the years, in response to the tension between our society, which wants to provide for the elderly who are unable to care for themselves, and the taxpayers who feel that they are stretched to the limit.

The costs of Medicaid are an increasing burden to the Commonwealth of Massachusetts. In late December 2010 the Massachusetts legislature approved a supplemental budget of \$330,000,000, of which more than \$270,000,000 was needed to cover increasing Medicaid costs.

The Medicaid law is extremely complex, and the rules change often. The program should be administered in the same way in

every state, but we have found that the application of the program varies from one state to another, and there is even variation in treatment in MassHealth offices. What follows is a brief discussion of the Medicaid program in Massachusetts today - we expect the law to change at any time.

To be eligible for Medicaid, in addition to other requirements, one must be 65 or older, blind, or disabled for Social Security purposes (that is, qualify for Supplemental Security Income (“SSI”) and, if single, have not more than \$2,000 of “countable assets”.

“Countable assets” are all assets to which the applicant has access, but do not include the principal residence if the applicant’s spouse resides there, life insurance with a face value of less than \$1,500, and funds up to \$1,500 (with earnings thereon) set aside for burial expenses.

Bank accounts, certificates of deposit, money market accounts, and credit union accounts which are held jointly are presumed to belong to the joint owner who applies for Medicaid; if the joint owner is other than the spouse, the presumption may be overcome by showing contribution by the other joint owner. If the joint owner is the spouse, it makes no difference because both spouses are treated as one unit. Other assets held jointly are deemed to be owned equally by all joint owners.

Married persons are treated as one economic unit. All assets owned by either the spouse in the nursing home (the “institutionalized spouse”) or the well spouse (the “community spouse”) are treated as owned by that economic unit. The former practice of transferring assets to the community spouse in order that the ill spouse might qualify for Medicaid will no longer work.

In the case of a married couple, the “community spouse” may keep one-half of the family assets up to \$111,560 (the “Community Spouse Resource Allowance”), not including the house, and all the income that he or she personally has.

The community spouse may keep a minimum of \$1,821.25 (the Minimum Monthly Needs Allowance or “MMNA “). The maximum is \$2,739 per month. If the community spouse does not have that amount of income, he or she may petition the DMA for permission to transfer some income from the institutionalized spouse or to retain additional assets to produce the needed additional income.

The institutionalized spouse may keep \$72.80 per month as a Personal Needs Allowance (the “PNA”).

If the DMA refuses relief, the Probate Court, after a hearing, may override the DMA and order a higher Community Spouse Income Allowance. This may be provided in part by a transfer of income-producing assets from the institutionalized spouse to the community spouse.

If one gives away assets within sixty months (the “look-back” period) of applying for Medicaid, the applicant will be disqualified from Medicaid for a period of time, starting with the date of transfer, determined by dividing the value of the assets transferred by the rate assumed by the Commonwealth of Massachusetts for nursing home expenses (presently \$274 per day, or \$8,334 per month).

That period of time is not limited. If a transfer of assets is made before the look-back period, no disqualification results.

Two examples will illustrate the rule just referred to. Assume that someone makes a gift of \$333,360 to a child, and, five years and one day later, applies for Medicaid. Since the look-back period has run, the transfer is not considered, and the person will qualify for Medicaid if the other requirements are met.

Assume that the same person makes a gift of \$333,360, and then applies for Medicaid four years and eleven months later. He will be disqualified from receiving Medicaid for \$333,360 divided by the monthly rate of \$8,334, or 40 months.

Under the earlier law, the disqualification period would begin on the first day of the month in which the transfer was made, so that the person in our illustration would have run out the disqualification period and would be entitled to Medicaid coverage.

However, under the Deficit Reduction Act of 2005 (DRA), the disqualification period does not begin until four requirements are met. The transfer must have been made, the person must be receiving a long-term care level of services, the applicant must be otherwise financially entitled to MassHealth coverage (having spent his assets down to \$2,000 and, if he is married, having spent the community spouse's assets down to the Community Spouse's resource allowance), and the applicant must need the MassHealth benefits, at least in part (that is, the nursing home must not be paid from another source).

However, a transfer of a residence to a spouse or to children under certain circumstances will be exempted from this rule. Real estate owned by a person in a nursing home will be subject to claims by DMA for Medicaid payments made.

If you or an acquaintance anticipate having to enter a nursing home, time is very critical. The earlier the planning process is started, the better the results which may be achieved.

We have a number of planning devices available to us. Among these devices are prepaying burial costs and paying off loans.

We may be able to change the character of assets by purchasing income-producing assets, or converting property into an income-producing asset (as in the case of a vacation home). It also is possible for the community spouse to purchase an annuity which meets Medicaid specifications, and which will convert an asset (which must be divested) to an income stream (which the community spouse may retain).

Real estate should be transferred to the community spouse. Transfers of any type of assets between spouses do not count for Medicaid purposes.

If a child has served as a caretaker of the Medicaid applicant, providing care so that the applicant was able to stay out of the nursing home, it may be possible to transfer the principal residence to that child, without penalty, under the “caretaker child” exception to the disqualifying transfer rules. If you want to use this exception, it is essential to keep adequate records.

The caretaker child must have resided in the home for at least two years. There have been many cases in which the MassHealth authorities argued that the child had resided elsewhere part of the two years.

The condition of the Medicaid applicant must have been such that, but for the services of the child, the applicant would have been a patient in a nursing home. For instance, if the applicant needed the child only to do errands and prepare meals, that would not be sufficient, because the applicant would not then have needed a nursing home level of care.

It is possible for the community spouse to refuse to respond to questions from the Medicaid authorities about assets he or she has. This is the so-called “spousal refusal.”

Under the law, the Medicaid authorities may then grant benefits to the institutionalized spouse and take over his or her common-law right to receive necessary support from the community spouse. In some states, such as Florida, it is not currently the practice to pursue the community spouse for support -- the Massachusetts practice is not clear at this time.

Nursing homes are much less expensive in other parts of the country. In some other states, Medicaid regulations are administered more favorably. It may be possible for the institutionalized spouse to move to Florida or some other state where the rules are more liberal and the drain on family assets will therefore be less.

The Medicaid law changes from time to time and the administration of the Medicaid program changes frequently. The comments in

this booklet are current as of January 2011, and are general in their application. The Medicaid regulations change frequently and you must seek professional assistance when a Medicaid question arises because of the generality of these comments and the uncertain state of the law. Medicaid plans must be reviewed often.

## **Future Developments**

The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 extends the provisions of EGTRRA for two years. After that time the fate of the Federal Estate Tax law, and the Federal Gift Tax and the Generation-Skipping Transfer Tax, will once again be on the table for debate.

Some of the proposed changes are wiping out the Federal Estate Tax and wiping out the step-up in basis which now occurs when someone dies and property is included in their taxable estate, as well as striking the federal transfer tax system entirely and substituting some other tax scheme, such as a value-added tax (“VAT”). There is no agreement as to what would be the best system, and we must wait for two years to see what happens.

Congress has the difficult task of trying to raise as much revenue as possible and at the same time not displease taxpayers any more than necessary. As Edmund Burke said: “To tax and to please, no more than to love and be wise, is not given to men.”

Changes in the Federal Estate Tax laws are more unsettling to taxpayers than changes in the Federal Income Tax law, because they may require taxpayers to replan their estates, at considerable effort and cost. On the other hand, changes in the Federal Income Tax law from time to time are expected, and taxpayers are used to dealing with them.

Congress might choose to limit the number of Federal Gift Tax exemptions one can claim in a given year. It is not uncommon for a very wealthy taxpayer with a number of children and grand-

children to give away, without tax consequences, several hundred thousand dollars a year. Reducing the number of tax-free gifts one could make would generate some tax revenue with limited political impact.

We think it unlikely that Congress would reduce the \$5,000,000 credit shelter amount because many taxpayers have built their estate plans around the \$5,000,000 value. Changing this would arouse considerable opposition.

Wiping out stepped-up basis for inherited assets would also generate a substantial outcry from taxpayers, for several reasons. First, many estate plans have been built around basis considerations, and second, stepped-up-basis is widely regarded as something which is bought with the estate taxes which one pays. Taking away the stepped up basis would create a feeling on the part of many taxpayers that they were paying estate taxes and getting nothing in return. In addition, determining tax cost of something acquired many years earlier is difficult or impossible.

It might be worthwhile for Congress to consider wiping out the estate tax, including the stepped-up basis. This would enable taxpayers to manage their affairs free from concern about estate tax liability; it would ease pressure on family businesses, which are often impacted by estate taxes, and it would increase income taxes.

The increased revenue from income taxes (because of the lower basis resulting from no step-up on death) might go far to make up the loss in estate taxes, when one has in mind the cost of planning for the taxes (on the taxpayers' part) and collecting the taxes (on the part of the government).

One argument against repeal of the Federal Estate Tax is loss of revenue. Another argument against repealing the tax is that it prevents large concentrations of wealth, and therefore serves a valuable social purpose.

The latter argument is the subject of strong feelings, and illustrates one problem with the enactment of tax laws, in that many issues, other than revenue questions, become involved. As Otto von Bismarck said: “If you like laws and sausages, you should never watch either one being made.”

## **Conclusion**

Estate planning involves many areas of the law, including wills, trusts, estate taxation, income taxation, pension plans, profit sharing plans, IRAs, Social Security, Medicaid, real estate law, corporation law, partnership law, and property law. It is impossible to cover estate planning in depth, but I have tried, in these few pages, to give you an introduction to some of the elements involved in planning your estate.

I hope that this booklet will be of value in illustrating some of the common principles which underlie estate planning, and that it will help you participate with us in the development of your own estate plan. You will also find information on our firm’s website: [Haddletonlaw.com](http://Haddletonlaw.com).

I will appreciate your comments and suggestions for future issues of this booklet.

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