The Guttenberg Press

PRESERVING YOUR ASSETS ... PLANNING YOUR FUTURE

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Dear Friend,

There have been 2 significant pieces of legislation involving estate taxes and elder law that may have major effects on planning.

First, Maryland legislation signed by Governor Ehrlich on May 2, 2006 provides a method of deferring the Maryland estate tax on the death of the first spouse while preserving the federal estate tax exemption. The legislation creates a "state-QTIP" election that we are already incorporating into the plans for our Maryland clients who require estate tax planning. We will address this and other changes in greater detail in our summer issue, but we wanted to give all a "heads up." Please call us in the interim to discuss.

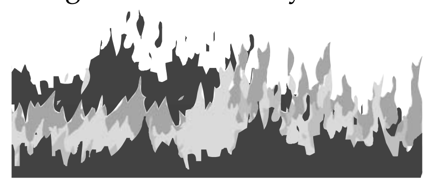
Second, the new changes in Medicaid eligibility (discussed on Page 3) are drastic and impact seniors who are concerned about long term care funding and in fact could impact clients and their gift giving plans.

Finally, for those with a thirst for intergenerational education funding, we unveil a tax-favored trust – called a "HEET" which could be used to fund the education of descendants for generations.

Let's stay in touch!

A Trust That's Too Hot Not To Touch: The HEET

It's hard to imagine that there's an estate planning vehicle that could provide for the educational expenses of children, grandchildren, and even great-grandchildren while avoiding estate and gift tax for generations! It's a trust that has been labeled the "HEET" (Health and Education Exclusion Trust), and we have been utilizing the HEET as a key estate tax planning tool for affluent families. Recently, the Section 529 plan has loomed as a popular strategy for funding a grandchild's tuition, but the HEET sets up a structure that could provide for such funding for many generations.



"HEET"ing up Your Estate Plan

Here's how it works: A HEET enables individuals to avoid gift and generation skipping transfer (GST) tax on certain "gifts" for generations. A HEET capitalizes on exemptions from the gift and GST taxes which are generally imposed on transfers between individuals. Let's take a quick look at these transfer taxes.

Transfer Taxes on Gifts for Education Funding

Transfers from one individual to another may be subject to (1) gift tax on transfers to another individual and (2) an additional GST tax on transfers to individuals who are, or are deemed to be, more than one generation younger that the donor. There are exceptions. For example, transfers that qualify for the annual exclusion (currently $12,000) are excluded from the gift tax as are all transfers between spouses. There is an additional exclusion for "certain transfers for educational expenses or medical expenses." Therefore, tuition payments made directly to an educational organization or payments made directly to the health care provider are not considered taxable gifts. These gifts, for which there is no monetary cap, avoid both gift and GST tax. Here's where the planning comes into play.

Beyond the 529 Plan

Unlike a 529 plan, a donor cannot pre-fund tuition or medical expenses for descendants and future descendants under the unlimited gift or GST exclusion for tuition or medical expenses. However, a donor can fund that special trust called a HEET with an unlimited dollar amount. As long as a few rules are met, all distributions out of the trust will be free

IN THIS ISSUE:

IS A HEET TOO HOT? OTHER GIFTING OPTIONS

As we have explored in other articles, there are other opportunities for funding educational expenses. Not as exotic or spectacular as the HEET, but still attractive:

- **Annual Exclusion Gifts**. Every individual may gift $12,000 to any other person each calendar year. A couple may combine their exclusions to gift $24,000. Gifts may be made outright or to a Uniform Transfers to Minor's Act (UTMA) account. As long as the donor is not the custodian of the UTMA, the gifted amounts plus future income and appreciation will be removed from the donor's estate. The gifted amounts can be used for the grandchild's benefit until he or she reaches 21 years of age.

- **Annual Exclusion Gifts to a Trust**. Annual exclusion gifts may be made to a properly drafted trust and still qualify for the annual exclusion. These trusts can be structured as "Crummey" or "2503(c)" Trusts.

- **Section 529 Plans**. These plans are established to pay the educational expenses of another individual. A person is allowed to "pre-fund/ frontload" the plan with up to 5 years of annual exclusion gifts ($60,000 for a single donor, $120,000 for a married couple). Unlike the distributions from a HEET that are to pay tuition at any educational level, 529 accounts permit distributions for only post-secondary accredited institutions (college or equivalent) but may be used for books, supplies, equipment, and room and board along with tuition.

- **Tuition or Medical Expenses**. As the underlying basis for a HEET, an individual may make unlimited gifts for tuition or medical care of another if made directly to the school or healthcare provider. As noted in the main article, the HEET takes this a step further by pre-funding future educational costs through a trust vehicle. In a recently issued ruling (Rev. Rul. 200602002), the IRS allowed a donor an unlimited gift tax exclusion for tuition for prepayment of future tuition to cover through grade 12 for each of his grandchildren! A key aspect of the ruling was that the tuition payments were nonrefundable. This ruling is an important one for those grandparents who wish to assure themselves of a gift and estate reduction opportunity (for tuition payments) prior to their deaths.

HEET EXAMPLE

Facts: Sarah, who has a net worth of $5 million, has 4 grandchildren. She has always paid her grandchildren's tuition. In her Will, Sarah leaves a bequest of $1 million to a HEET to pay tuition expenses for her grandchildren and great-grandchildren. The trust terminates when her youngest grandchild attains the age of 60. At termination, any remaining funds are distributed to her Alma Mater.

Result: When Sarah dies, she has not used up any of her GST exemption. Thus, at her death she could leave up to another $2 million (GST exemption for 2006) to her children in generation-skipping trusts. Out of her $5 million estate, at least $3 million would be GST exempt– which means that amount plus any appreciation would save significant taxes for her descendants!

of gift and GST tax and the trust can pay the tuition and medical expenses of the donor's descendants for generations. In addition, the HEET may be used to fund tuition at *any* educational level (while the 529 is limited to college or beyond).

HEET Requirements

To qualify as a HEET, the trust must meet a few very basic tests. First, all payments from the trust must be for tuition and/or medical services and paid directly to the school or provider. Second, the beneficiaries of the trust must be identified either by name or by class description (e.g., "my grandchildren"). Finally, the trust must have a "significant" charitable beneficiary. This is to prevent a GST tax when the trust terminates and the corpus is distributed.

Charity Must Take Some of the HEET!

As noted above, one requirement of a HEET is that there be a charitable beneficiary. There are choices here. The remainder of the trust upon termination can be paid to a charity. Or, the trust may be structured so that the charity is included as an ongoing beneficiary of the trust. The charity can be a public charity or even one's private family foundation. Therefore, if your estate already includes a plan to leave money to charity, that gift to charity could be combined with a trust established to fund tuition and/or medical expenses.

Funding the HEET (Forever)

A HEET can be funded either during life ("intervivos") or at death through a Will ("testamentary"). If the HEET is an intervivos trust, the contributions to the trust may be subject to the annual exclusion (but distributions could be paid for tuition and medical expenses without incurring a GST tax). If the HEET is testamentary, the assets used to fund the trust would be subject to the estate tax, but not gift or GST tax (because of the tuition/medical exemption). **As such, a testamentary HEET could be funded with an unlimited amount of assets that could fund tuition for generations of descendants.** Further, if the trust is set up in a state like Maryland which allows perpetual/dynasty trusts, the HEET can last as long as a descendant is living. In such case, it may be prudent to consider naming a perpetual trustee such as a bank or trust company.

Determining the Funding Amount

How much should the donor set aside to fund this trust? This depends on the projected number of descendants and how many generations of tuition a donor is interested in funding. We have found that it is prudent to enlist the involvement of a financial advisor in making this determination. Indeed, it is our practice to ensure that accountants and financial/investment advisors be involved in any planning for sophisticated estate planning strategies like the HEET!

Is a HEET for you?

There are various planning opportunities for funding tuition. [See left column.] However, the HEET provides the most spectacular opportunity for affluent families who intend to provide for the tuition or medical expenses of descendants while saving estate taxes for generations to come. [See HEET example in left column.] The trust can be set up during lifetime or at death and can be implemented by both married couples and single individuals. The trust is particularly attractive in Maryland which allows perpetual trusts.

Our estate planning team has developed and implemented the HEET for clients. Please contact us to discuss how a HEET can be integrated into your estate planning.

NEW MEDICAID ELIGIBILITY RULES REQUIRE REVISED PLANNING FOR LONG TERM CARE

On February 8, 2006, President George W. Bush signed into law the Deficit Reduction Act (DRA) of 2005. The DRA made major changes affecting qualification for government Medicaid programs and are the most significant changes in this area since the passage of OBRA '93. These changes alter the planning strategies for those seeking to qualify for Medicaid to fund the rising cost of nursing homes.

MAJOR CHANGES

#1: Lengthening the "Look-Back Period"

◗ The Jump From 3 Years to 5 Years: When a person applies for long term care benefits under Medicaid, the Medicaid program "looks back" in time from the month of application for a specified number of years to determine if the individual and/or his or her spouse made any gifts during that look-back period. Under the DRA that look-back period for gifts has been increased to 5 years. This applies to transfers both to an individual or a trust. This is a significant change from the prior look-back period of 3 years for transfers to individuals and 5 years for transfers to certain trusts.

◗ Effect: Upon applying for Medicaid to fund long-term care, the applicant must now report all gifts made during the prior 5 years -- resulting in a denial of eligibility. Thus, it is critical that seniors who may possibly need Medicaid to fund long-term care carefully monitor gifts to family members, even when they are healthy. The person who waits until he or she has run out of funds to qualify for Medicaid eligibility could be denied eligibility for many months (or years) if the applicant made gifts (even well-intentioned gifts) within the 5 years prior to the application.

#2: Postponement of Penalty Period Start Date

◗ A New Start Date for Measuring Gifts: The DRA made important changes to the "start date." Under the prior Medicaid rules, the period for ineligibility for gift transfers began to run the month in which the transfer occurred. Under the DRA, the penalty period would now begin to run only after the applicant has spent down his or her countable assets to the state's applicable resource limit (currently $2,500 in Maryland), is in a nursing home or CCRC, and has otherwise been approved for Medicaid.

◗ Effect: No longer can one "wait out" a transfer penalty period at home or while private paying at a nursing home or CCRC. The new law thus precludes the applicant from retaining countable assets (and spending it down on medical care) while a transfer penalty period for gifts is running.

#3: Home Equity Above $500,000

◗ Under the DRA, home equity over $500,000 counts as an available resource. (The state has an option to increase this amount to $750,000.) This restriction does not apply if the applicant's spouse (or child under the age of 21 or disabled) continues to reside in the home.

OTHER CHANGES

◗ **Life Estate Transfers**

The transfer of a life estate without the power to sell, assign, transfer or mortgage is now considered a transfer that is subject to a transfer penalty unless the transferee resides in the home for at least one year after the transfer.

◗ **Annuities**

In order for annuities not to be deemed a countable resource, they must be irrevocable and nonassignable; actuarially sound, and have equal payments (deferral and balloon payments are no longer allowed). This asset although not countable would now be subject to estate recovery upon the death of the Medicaid recipient. Under the DRA, the state must be named as the remainder beneficiary or the contingent beneficiary after the recipient's spouse (or child under 21 or disabled).

◗ **Continuing Care Retirement Community (CCRC) Deposits**

Many CCRC's require a hefty deposit or entrance fee. Under the DRA, this deposit or entrance fee is now an available resource to the applicant residing in the CCRC even though the CCRC may retain control of the deposit. This rule can be a major trap for those entering CCRCs whose assets run out.

Summary and Action

The DRA's revamping of the Medicaid eligibility rules can cause hardship for many seniors who will need to rely on nursing home care. What are we advising our clients? Obviously, major legislation always engenders uncertainty in interpreting the rules. Long term care insurance is one option we may recommend. Even without such insurance, there are still methods of protecting funds and gifting assets without major adverse results. It will be that much more difficult, but proactive, strategic planning with the look-back and eligibility rules in the context of a client's specific financial circumstances and overall estate planning is even more important.

Please contact us to discuss DRA and to assist you in developing and implementing a plan.

Things We've Been Up to Lately

- Elizabeth and Amanda have both been admitted as members of the Baltimore Estate Planning Council.

- Liz has become a member of the Maryland Bar Association's new paralegal section.

- Aryeh has become a member of the Trusts and Estates Law Section of the New York Bar. In addition to a busy Maryland practice, our office handles estate planning and administration for New York clients.

- Congratulations to our dear friend, Howard Tzvi Friedman, who was inducted as President of the American Israel Political Action Committee (AIPAC) at its annual conference at the DC Convention Center from March 5-7, 2006. On March 7, Aryeh and other Baltimore leaders participated in meetings on Capitol Hill with Senators Sarbanes and Mikulski and Congressman Cardin addressing pending legislative bills affecting the Middle East.

- We created a testamentary "HEET Trust" for a client who wished to ensure that the education of her descendants would continue to be funded after her death. The trust was drafted as a HEET (see lead article) so as to preserve the clients's generation-skipping exemption and thereby save potentially large federal estate taxes for the family.

- We designed a "special needs" trust for a client to preserve governmental benefits being provided to the client's child with special needs. (The assets for the other child were allocated for a generation-skipping trust that would save estate taxes for that child.) We drafted the special needs trust pursuant to the "Maryland Discretionary Trust Act," which contains safe harbor provisions for this purpose.

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