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To: Clients and Friends
From: The Attorneys at the Law Firm of Bove & Langa, P.C.
Re: Important Recent Developments and Planning Opportunities: October 2005

FIRM UP-DATE

Each year the American Bar Association's publication for general practitioners – GP Solo – showcases the best legal articles published in the ABA's numerous publications. Earlier this year, Alexander's "The Purpose of Purpose Trusts" was selected as the best Estate and Financial Planning article for 2004. Melissa was selected to be vice-chair of the Generation Skipping Tax Committee of the American Bar Association's Real Property and Probate Section. Her first official act was to participate in a roundtable discussion of new developments at the ABA's September meeting in San Francisco. Closer to home, Lynn and Bob each presented a lecture on homesteads and other creditor protection techniques for the family home at the Massachusetts Continuing Legal Education's August seminars on "Preserving and Protecting the Principal Residence."

NEW DEVELOPMENTS

Estate Tax Update: As many of you know, the federal estate tax is scheduled to be phased out over time and eventually repealed in 2010. Although the law currently imposes no estate tax on decedents dying in 2010, the estate tax returns with a vengeance in 2011, wiping out all the benefits we experienced with the phase-out and bringing us back to the rules of 2001. This uncertainty in the federal estate tax law is continually being addressed by Congress with various proposals to make the repeal permanent or to compromise with some other federal estate tax regime. So far, we have nothing to report on the legislature's progress, so we continue to live with the uncertainty. Currently, all assets in excess of $1,500,000 will be subject to a federal estate tax for a decedent dying in 2005, at a maximum rate of 47%! The exemption increases to $2,000,000 for a decedent dying in 2006, 2007, or 2008.

And we continue to remind our married clients who have not come in to have their estate plan reviewed in light of the 2003 changes to the *Massachusetts* estate tax law, they should do so as soon as possible. As noted in our December, 2000, "Massachusetts Estate Tax Advisory" (available on our website or upon request), Massachusetts has decoupled its estate tax law from the federal law and now separately imposes an estate tax on estate assets in excess of $950,000 for decedents dying in 2005 and $1,000,000 for decedents dying in 2006 and thereafter. Comparing the Massachusetts exemption to the federal exemption of $2,000,000 for decedents dying in 2006 results in a difference of $1,000,000. Under a plan commonly used for married persons prior to the Massachusetts change, this difference of $1,000,000 would now be taxed by Massachusetts on the

first death, resulting in over $99,600 in Massachusetts estate taxes that could otherwise be deferred and possibly eliminated!

<u>New Rules For Bankrupt Debtors</u>: The federal Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 was enacted last April, and planners are still debating its impact on asset protection planning. In a victory for those who find themselves behind the eight ball, the Act has significantly increased protection for retirement accounts. Now, a debtor's 401(k), rollover IRA SEP IRA, and SIMPLE IRA are completely protected in bankruptcy. Note, however, that a debtor's traditional IRA and Roth IRA are only protected up to $1 million in the aggregate. Regarding annuities and life insurance, the protections are unchanged although the Act imposes new domicile requirements which must be met before a state's protection can be claimed.

Perhaps most striking is the attack Congress has made on residential homesteads and asset protection trusts. To qualify for a state homestead exemption greater than $125,000 (Massachusetts has a $500,000 homestead) a debtor must have acquired the home 1,215 days prior to the filing of bankruptcy. (We'll do the math for you -- three years and four months.) Even if the 1,215 day acquisition threshold is met, a creditor may still prevail against the homestead if it can be shown that the debtor engaged in certain prohibited acts within a ten year period, such as securities fraud. Also captured by a ten year look back are self-settled asset protection trusts, both domestic (AK, DE, MO, NV, OK, RI, SD, and UT) and offshore. If the trustee in bankruptcy can prove actual intent to defraud a creditor, property transferred to an asset protection trust (or "similar device") within the ten year period prior to filing bankruptcy will be within the bankruptcy estate.

So, what does this mean? Again, it is too soon to tell. In a recent bankruptcy case, a judge disregarded the 1,215 day acquisition threshold based upon a literal reading of the Act thus illustrating a latent defect that will probably result in Congressional action. The definition of a "similar device" will be left to the courts to decide. What we do know is what we have been saying for years: if you are in a high risk profession the sooner you undertake the implementation of an asset protection plan the greater your chances of withstanding a creditor attack.

<u>Annuities And The Elderly – Let The Buyer Beware</u>: An annuity contract, typically sold by a bank or insurance company, is an investment which offers the buyer (the "annuitant") guaranteed periodic income (often monthly) until the annuitant's death. Such contracts can also provide continuing payments for a spouse or for other beneficiaries. A "variable" annuity contract is one where the cash in the contract is invested in stocks and mutual funds, so the value of the contract, and thus the annuity payments, can fluctuate with the value of the annuity portfolio. While annuities definitely have a place in some portfolios, it is generally agreed they are a bad investment for older (say, age 70 or older) individuals. Recently, the indiscriminate sale of annuities to the elderly by some banks in the area was the target of an investigation by the Massachusetts Secretary of the Commonwealth's office, and as a result of that investigation, two major banks admitted wrongdoing and agreed to take steps to rectify the problem. One was Bank of America, which agreed to offer their annuity customers the opportunity to liquidate their annuities with no penalty. The other was Citizens Bank, which was fined $3 million for "unethical and dishonest conduct in pushing the sale of variable annuities to elderly bank customers." Citizens Bank also agreed to allow elderly customers to liquidate their annuities without penalty.

Annuities offer tax-deferred growth on the investment until it is withdrawn. Elderly individuals at or near retirement and planning for a fixed income generally do not need tax-deferred growth, so one big advantage of the annuity is not likely to be realized. Further, payments are based on a person's normal life expectancy, and unless certain contract options are taken, payments stop on the annuitant's death. Thus, an elderly annuitant who meets an early death will be "cheated" out of his or her investments.

One aspect of annuities that adds confusion to this whole issue is that elderly individuals with moderate savings who are facing nursing home costs could actually benefit from the purchase of an annuity. This is because current Medicaid law treats annuity payments as income, whereas the funds used to purchase the annuity are treated as a resource, and in most states, to qualify for Medicaid, a person can have excess income but not excess resources.

The best way to determine whether an annuity purchase makes sense for you is to get a professional opinion from an advisor other than the person or bank selling you the annuity.

Will You Owe An Additional Tax Or Receive A Refund For Capital Gains in 2002?: In 2002, the Massachusetts Legislature increased the tax rate for capital gains to 5.3% for transactions that occurred on or after May 1, 2002. Subsequently, the Massachusetts Supreme Judicial Court ruled that this May date violated the Massachusetts Constitution and ruled that an effective date of January 1, 2002 must be used. Therefore, taxpayers who reported capital gains that occurred before May 2002 could now owe an additional tax. Note that if a taxpayer has died in the interim, the taxpayer's estate will be responsible for any tax due (or would be entitled to any refund owed as discussed below).

There is pro-taxpayer legislation pending that could make the effective date January 1, 2003 and if this were to happen, then taxpayers who reported capital gains that occurred between May and December 31, 2002 may be entitled to a refund. However, if the effective date is kept as January 2002, there is also pro-taxpayer legislation pending that would waive penalties and interest on any additional tax. There may also be a total forgiveness of tax liabilities that are $100 or less.
The Department of Revenue can still issue Notices of Assessment to collect tax deficiencies for 2002, however, it has stated that it will temporarily defer issuing such notices to allow time for the Legislature to take final action on the pending proposals.

Circular 230: What is this and why are you seeing it everywhere? Advisors love disclaimers (a "don't blame me" statement) and want to put them anywhere they can! So, you can just imagine how excited we are that the IRS is now telling us to add another disclaimer to our correspondence. Circular 230 is the title of an IRS regulation that, in certain circumstances, requires attorneys and other tax advisors to inform clients that they cannot rely on their tax advisor's opinions to avoid *penalties* if the tax plan is challenged by the IRS. Please note that Circular 230 is primarily focused on aggressive and generally untested techniques not clearly supported in the tax code. Also remember that if you are ever given advice to forge a new path in the tax area, you should be given a full analysis of all the risks. There are ongoing discussions between the IRS and tax practitioners regarding Circular 230 to address concerns that these mandatory notices send a bad message to our

clients – that you cannot rely on our advice. Until these issues are cleared up, you may see this notice on letters, e-mails, and other communications that contain tax advice. During this interim, you may see an overuse of the notice because there is still uncertainty as to where the notice is or is not required. Hopefully, this will be resolved soon.

Medicaid Up-Date: As the cost of nursing home care increases, there has been a greater focus on the role that Medicaid plays in paying for such care. As you may have learned from the media, Congress will consider proposals to tighten or eliminate the rules that allow asset transfers in order to qualify for Medicaid. These potential changes include recommendations to extend the current three year look-back period for non-trust transfers to a five year look-back period for all transfers. In addition, rather than having the penalty period for transfers start in the month of the transfer, the penalty period for transfers made within the look-back period would begin on the later of (i) the date the applicant applies for Medicaid coverage or (ii) meets all Medicaid eligibility requirements. Although we cannot predict when, or if, such changes may be made, it is reasonable to believe that Medicaid planning involving transfers of property may be grandfathered and subject to the current rules if the transfers are made prior to any legislative change. Typically, these transfers would focus on protecting the principal residence and any family vacation property. With all the uncertainty in this area of the law, the importance of prior planning is key, including the purchase of long term care insurance where possible.

PLANNING OPPORTUNITIES

Discouraging A Will Contest: Money can be a great rationalizer, particularly where estates are concerned. People who would not dream of suing their brothers, sisters, parents, or cousins suddenly feel quite justified in vigorously seeking their "rightful" share of an estate by contesting a will that left them out or did not leave them "enough." It is no secret that will contests are public, painful, and expensive, no matter who wins or loses, but is there a way to prevent or at least discourage a contest?

While it is impossible to take away a person's right to his day in court, it is quite possible to discourage him from exercising that right by giving him something to lose if he makes that choice. One effective way is to include "no-contest" provisions in your will and trusts. A no-contest provision generally revokes a bequest if the intended recipient challenges the estate. Of course, there must be a bequest to be revoked, otherwise the potential challenger still has nothing to lose. So, if you fear a challenge to your estate by someone, make a bequest to that special someone of an amount that would be difficult to pass up. For example, if you have chosen to leave nothing to one particular troublesome child, but know this is going to cause more problems for the others, instead you can include a bequest to the wayward child of, say, $25,000 along with a no-contest provision stating that if he challenges the estate, he gets nothing. Although you may not want to leave a bequest to this person at all, the no-contest provision is useless unless there is something to lose, so it is usually well-worth it to protect against a fight over your estate.

To make the clause work, the amount at risk must be a meaningful amount to the beneficiary, an amount that will make him think twice before he rushes to his lawyer's office and starts running up legal fees. The one-dollar bequests are certainly out, as are those in the hundreds of dollars.

Typically, unless the estate is very large, conditional bequests of $10,000 to $25,000 would be a good starting point.

Selling Investment Property And Expecting A Large Capital Gains Tax?: It is possible in some cases to defer (and possibly avoid) a capital gain on the sale of investment property by engaging in a so-called "like-kind exchange". A like-kind exchange occurs when you sell property held for investment and reinvest the sale proceeds in similar investment or "like-kind" property. For example, if you sell rental property and use the sale proceeds to buy other rental property, you have "exchanged" one property for another. Of course, it is not quite that simple, and there are time frames and other rules to adhere to, but if the rules are met, then the capital gain on the sale of the exchanged property is deferred until the sale of the newly acquired property. If there is a very large capital gain tax to be dealt with, it may, under certain circumstances, behoove the taxpayer to hold onto the acquired property until death to take advantage of the step-up in basis rules for assets held at death (washing away all the built-in capital gains). Note that a like-kind exchange is generally not available for your residence unless you can somehow meet the requirement that the property is held for investment.

Employers Take Note – Time Is Short For New Benefit Plan: Starting in 2006, employers can now offer a Roth 401(k), in addition to a regular 401(k). The key difference is that like a Roth IRA, the contribution to a Roth 401(k) will be included in taxable income. The distributions will be tax-free, however, provided the assets have been in the plan for at least five years, and the distribuitons take place after age 59½. Like a standard 401(k), there is no income limit for contributions, and a participant can contribute up to $15,000 in 2006. Compare this to a Roth IRA to which you can contribute just $4,000 in 2006 assuming you don't exceed the income limit. Unlike a Roth IRA, a Roth 401(k) requires that minimum distributions begin at age 70½. An employer can offer both regular 401(k) and a Roth 401(k), but an employee's combined salary contribution is limited to $15,000. The provision for a Roth 401(k) was established in the 2001 Tax Act and will expire in 2011 unless Congress extends the law. Any contributions made to a Roth 401(k) will retain their tax-free character upon distribution. Keep in mind, the decision to offer a Roth 401(k) is up to an employer.

Charitable Opportunities: If the Hurricanes Katrina and Rita have not depleted your charitable resources, and you wish to donate additional funds this year to benefit programs serving Greater Boston but are unsure where to turn, consider an organization such as The Boston Foundation which offers a "Funding Opportunities List" which is available October 15th by calling Dulcea Morgan at the Boston Foundation at 617-338-2686. The organizations on the list have been investigated by The Boston Foundation so you can easily benefit from their due diligence in selecting worthy organizations. Perhaps you will find a new area of interest or a special program need that will enrich your family by broadening the family's philanthropic goals.

LLCs And Charging Orders: If you have a membership (i.e. ownership) interest in a limited liability company (LLC), you may be aware that the LLC affords you what is known as protection from "outside liability", which is the protection of the LLC assets from a member's personal creditors, such as an ex-spouse or a judgment creditor in a personal injury suit. Generally, the most a personal creditor can obtain against an LLC member is a "charging order" against the member's

LLC interest, which is basically the right to receive any distributions the LLC chooses to make to the debtor-member. If the LLC's manager chooses not to make distributions, then the creditor must wait until the manager decides to do so, or pursue a settlement on his claim. Obviously there are limits to how far this can be taken, but there are a number of legitimate business reasons to withhold distributions or to make only limited distributions to members. In addition, a creditor with a charging order has absolutely no management or voting rights, meaning that the creditor cannot participate in the decision to make distributions, nor can it participate in the decision to continue or to dissolve the entity.

It is important to note that if no distributions are made pursuant to a charging order, at some point a court might order a "foreclosure" on the membership interest and permit the creditor to acquire the debtor's membership interest. Under a foreclosure, the debtor could not vote the interest or participate in the operation of the LLC, but would be entitled to its percentage share of ongoing distributions and its share of the value of the LLC upon liquidation. Only a limited number of states forbid foreclosure, with Delaware recently amending its LLC law to provide the strongest creditor protection in this regard. So, if you want more protection, a Delaware LLC is recommended. Even so, you would still need to register the LLC in Massachusetts as a "foreign LLC" if the LLC does business in Massachusetts or holds Massachusetts realty. Thus, annual fees would be paid to two jurisdictions.

SUMMARY

We hope you have found this newsletter informative. If you wish to discuss amendments of your estate plan documents to save Massachusetts estate taxes, the relocation of an existing LLC to Delaware, the addition of a no contest clause to your documents, the possibility of undertaking a like-kind exchange, a review of your asset protection structure, or any other idea mentioned above, please do not hesitate to contact any of us.

Charitable Donation Advisory

With Hurricanes Katrina and Rita has come a vast outpouring of support for the victims. Please remember to make sure that the charity you choose to contribute to is reputable by checking it out at www.charitynavigator.org.

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