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To: Clients and Friends
From: The Attorneys at Bove & Langa
Re: Important Developments and Planning Opportunities: March 2007

FIRM UPDATE

A Change And A Thank You. Our usual approach in opening our firm's newsletter is to update you on developments of the firm and its members, highlighting lectures and accomplishments. In this newsletter we would instead like to open by expressing our most sincere appreciation and humble thanks to the many of you, our clients and professional friends, who have thought enough of us and our service to refer friends, relatives, and business acquaintances to us as new clients. This is the highest of compliments, and we cannot express enough appreciation. Rest assured that every one of us, from staff to senior members, will do our utmost to warrant and maintain such trust and confidence. Again, we thank you.

NEW DEVELOPMENTS

New Rules For Charitable Deductions: As we mentioned in our October Newsletter, the Pension Protection Act of 2006 (the "PPA") was signed into law on August 17, 2006. The PPA changes some of the rules for charitable deductions of clothing and household items and added new requirements for the substantiation of donations. So, if you were thinking of cleaning out your attic or basement and donating some goods, you should be aware of these new rules which took effect on January 1, 2007. Here is a quick synopsis:

Clothing And Household Items: The PPA states that no deduction is allowed for charitable contributions of clothing or household items unless the item is in "good used condition" or better. "Household items" include furniture, furnishings, electronics, appliances, and linens, but food, paintings, antiques, objects of art, jewelry, and gems are among those excluded from the definition. Deductions may be denied for any contribution of clothing or household items with "minimal monetary value," such as used socks or undergarments. While no definition of "good used condition" is given, the intent is to ensure that donated clothing and household items are of meaningful use to charities. Note, however, that a contribution of an item of clothing or a household item that is worth more than \$500 may be deductible even if not in good used condition or better, if a qualified appraisal for the item is included with the taxpayer's return.

New Substantiation Rules: A donor who claims a deduction for charitable contributions must maintain reliable written records of the contributions. For contributions of property such as clothing or household items, a donor must keep a receipt or written communication from the charity whenever practicable, showing the name of the charity, the date and location of the contribution, and a detailed description (although not the value) of the donated property. For monetary contributions, a donor must maintain a bank record (such as a cancelled check or bank statement) or written communication or receipt from the charity showing the name of the charity, and the date and amount of the contribution – this is true regardless of the amount of the donation. Before passage of the PPA, the IRS did not require receipts for monetary gifts of \$250 or less.

Tax Relief And Health Care Act Of 2006. On December 20, 2006 the Tax Relief and Health Care Act of 2006 (the “Act”) was enacted, which retroactively reinstates some tax cuts that expired on December 31, 2005 and loosens restrictions on pre-tax contributions to Health Savings Accounts for taxpayers who participate in high deductible health plans. Some general highlights include:

Deductions For Qualified Tuition And Related Expenses: Deductions for qualified tuition and related educational expenses have now been extended through 2007, although the deductible amounts remain the same.

Additional Extensions: The Act also has extended the election to deduct state and local general sales tax, deductions of expenses paid or incurred by elementary and secondary school teachers in purchasing supplies for their classrooms up to \$250, the “cut off date” for taxpayer eligibility in an Archer Medical Savings Account, and certain credits for residential energy efficient property through December 31, 2007.

Excise Tax On Unrelated Business Taxable Income Of Charitable Remainder Trusts: In a favorable change to the treatment of charitable remainder trusts (“CRTs”) with taxable business income, the Act now imposes a 100% excise tax on the unrelated business income of a CRT, but allows the CRT to retain its nonprofit status. Prior to the Act, even one dollar of unrelated business income would destroy the CRT’s nonprofit status for that year, thus subjecting all of its income to taxation.

High Deductible Health Plans And Health Savings Accounts: Some of the most notable changes under the Act affect taxpayers who participate in high deductible health plans (“HDHPs”), which, very generally, are health plans with a deductible of at least \$1,100 for individual coverage, and \$2,200 for family coverage. Participants in HDHPs may continue to make tax-free contributions to Health Savings Accounts (“HSAs”) to be used for qualified medical expenses for themselves and their families. However, the Act makes broad changes to HSA restrictions and requirements by (1) no longer limiting HSA contributions to the health plan’s annual deductible; (2) allowing individuals who become eligible to contribute to HSAs in any month during a tax year to contribute to their HSA as though they were eligible as of the first of

the year; and (3) by allowing individuals to make a one-time irrevocable contribution from their IRA to their HSA.

Next time you revisit your employee benefits package you may want to check with your human resources department to determine if establishing an HSA is an option for you. If this is not an option through an employer, IRS Publication 969 (available at www.irs.gov) provides the “nuts and bolts” of the HSA qualification requirements to help you determine whether you should consider establishing an HSA for yourself.

Let’s Drink To Uncle Bill, And Deduct It! A traditional part of a funeral or memorial service for many families is to gather after the service to celebrate the deceased’s life. This could include a luncheon, party, or gathering at a family member’s home. But, is the luncheon or party an estate tax deductible funeral expense? It might be according to a recent Tax Court decision. The Court disallowed costs for a funeral luncheon in this case, because it did not find that it was a necessary expense incurred *in connection with* the decedent’s actual funeral. The luncheon was held after the funeral, in a separate location, for *purposes of thanking* those who came to pay their respects to the decedent and *who had helped her during her lifetime*, so the Court determined that this shifted from the “traditional focus of a funeral in eulogizing and laying to rest the decedent.” The Court did not unqualifiedly disallow estate tax deductions for such luncheons or parties.

So, you may ask, “How *can* we deduct that drink in memory of Uncle Bill?” We recommend making it clear that such luncheon or party is being held in further memory of the deceased, by, for example, making specific mention on the announcement that the “funeral luncheon” is to directly follow the services for purposes of continued memorial to the decedent. As well, hold the luncheon or party at the same location as the funeral or memorial service; or, if this is not possible, at a location near the site of the services. We also recommend keeping an itemized record of the expenses. The celebration of the decedent’s life must be connected to the funeral or memorial service itself, and the traditional focus of laying a loved one to rest. If you keep these guidelines in mind when planning, that drink to Uncle Bill may be deductible!

Rental Property And Local Law — Beyond The Lease And The LLC:

Residential rental property introduces many issues to a well-structured estate plan. For example, a family might use a limited liability company to segregate liability exposure. Or, a triple net lease might be used to permit a family member tenant to deduct real estate taxes. Often overlooked are the rules imposed by particular towns. For example, the Town of Barnstable has an ordinance which requires a landlord to register with the Board of Health any dwelling unit offered for rent. Failure to file can trigger penalties which can reach \$300 per day of violation. Once registered, the unit will undergo a health code inspection. Since last summer, Barnstable also restricts the number of tenants and motor vehicles at a rental unit, even if the unit is within your own home. So, the LLC and the proper lease may only be the starting point, with the next stop Town Hall.

Is Your Home(stead) At Risk? Have you or a loved one been involved in an accident or some other incident causing injury? Are you afraid your house may be at risk of loss? If so, do you believe it is too late to protect your primary residence? Think again. You may still be able to protect your principal residence by recording a homestead exemption, which can provide a Massachusetts homeowner protection from creditors to the extent of \$500,000 of equity in a principal residence. However, a homestead exemption will not protect against debts acquired prior to the recording of the exemption. Although a bald claim for personal injury does not constitute a debt (“I’ve been hit!”), a recent Land Court case held that a prejudgment attachment of real estate connected with a personal injury claim constituted a preexisting lien that could not be defeated by a subsequently recorded homestead. Therefore, if you are involved in an incident that may result in a personal injury claim against you, make sure you have a valid homestead recorded on your principal residence – prior to the injured party filing a prejudgment attachment.

Medicaid Annuities Have Another Life: A favored option in qualifying for Medicaid is the conversion of countable investment assets into a non-countable stream of income by the purchase of an annuity. MassHealth (the agency that oversees Medicaid in Massachusetts) has recently issued a bulletin in which it states that pursuant to the new regulations under the Deficit Reduction Act of 2005, an annuity purchased on or after February 8, 2006, must list MassHealth as the first remainder beneficiary up to the total amount of medical assistance paid on behalf of the annuitant. This should still allow an at-home spouse to purchase an annuity as part of a plan to qualify the nursing home spouse for Medicaid. Although the at-home spouse must name MassHealth as a remainder beneficiary, if the at-home spouse is never a recipient of Medicaid benefits, then the balance will pass to the secondary remainder beneficiaries (family) named after MassHealth. If the rules are not met, then the amount paid to purchase the annuity will be treated as a disqualifying transfer of assets.

A Loophole, Going, Going.... Thanks to our pals at the IRS, almost gone but not quite yet is a useful technique that estate planners have been using for years. It’s called a private annuity. The effect is to provide income to a person for life, but on her death, the asset exchanged for the income-stream would not be taxed in her estate. In a typical case, a parent who had appreciated assets, such as stocks or income-producing real estate, would transfer the asset to a child in return for the child’s promise to pay the parent (beginning immediately or at some later date – even years later) an income for life. If the parent (the annuitant) died before receiving the full value, or even before receiving any amount, the balance would be free of estate taxes in the parent’s estate. Meanwhile, the parent would only pay capital gains tax on actual receipt of payments, in proportion to each payment. Note that this would be the result only when the transferee is *not* an insurance company or other such organization. A transfer of assets to such an organization in return for an annuity would trigger an immediate tax.

Now, the IRS wants to effectively eliminate this loophole and has proposed regulations that would cause the annuitant (the parent in our example) to be taxed immediately upon transfer of the asset, *whether or not any payments are received*. An effective death knell for private annuities.

In a half-hearted attempt to allow taxpayers to adjust to this harsh and poorly thought-out regulation, the IRS has provided a transition period, within which some private annuities may still be employed. Between October 18, 2006 and April 18, 2007, a person may enter into a private annuity contract with another *person* (not an entity), and provided the agreement is not secured (it wouldn't be even under previous law), and the transferee does not sell or exchange the asset within two years of the transfer, the "old" rules will still apply – i.e., no tax until receipt of payments and no estate tax on the transferred asset.

While this does not give you much time to plan, the private annuity may still offer some effective tax savings. Note that this regulation does not apply to private annuities created before October 18, 2006.

PLANNING OPPORTUNITIES

While One Loophole Dies, Another One Lives. In many instances, a favorable alternative to the private annuity is a self-canceling installment note ("SCIN"). In some respects, a SCIN is simplicity personified. It is a promissory note that is automatically cancelled if the holder of the note dies before it is paid in full. For instance, Dad, age 75, sells his Cape Cod home to his two children for fair value, and the children sign a 12-year note for that amount with interest. The children agree to pay the interest quarterly and the principal will be due at the end of the 12 years. One trade-off for this loophole is that a premium must be charged either on the rate of interest or the principal of the note to reflect the risk taken by Dad that if he dies, he will not receive the full sales price.

If Dad dies anytime before the 12-year due date, the children owe nothing more (the note is cancelled), and the value of the home is excluded from Dad's estate for estate tax purposes. If there is a gain on the sale, however, Dad's estate will recognize the gain. Meanwhile, even though the children may have paid nothing on the principal of the note, they enjoy a basis (tax cost) in the property equal to the value of the note, so that a sale at that price would result in no gain to the children.

You May Be A Massachusetts Resident! The Massachusetts Department of Revenue has been cracking down on residency for income tax purposes. Until recently, Massachusetts has used the "183-day test" – i.e., if you lived in Massachusetts for 183 days or more during a calendar year, then you would be considered a Massachusetts resident for income tax purposes. (Please note that the 183-day test has not been used for estate tax purposes.) But with increasing numbers of people wintering in Florida or spending summers in Maine, for example, some people were spending fewer than 183 days in Massachusetts and thus thought they were not residents of Massachusetts for income tax purposes. But it's not that simple. Recently, Massachusetts has been using more of a facts-and-circumstances test to make its residence determinations. In addition to considering where a taxpayer spends his or her time, other factors

include where the taxpayer owns or leases property, where the taxpayer's permanent employment is, the location of the banks where the taxpayer holds accounts, where the taxpayer is registered to vote, was issued a driver's license, has his or her car registered, etc. Plus, Massachusetts may ask a taxpayer to attest to this information in an affidavit, and may also look at this information on a five-year lookback basis. Bottom line – you may be considered a Massachusetts resident even if you spend less than half a year here, so please talk to your accountant or to us if you are not certain.

Prepaid Tuition May Qualify For Gift Tax Exclusion Purposes: As many of you may already know, under Section 2503(e) of the Internal Revenue Code, donors may make gifts without gift tax implications by paying certain tuition costs and medical expenses of the donee directly to the qualifying educational or medical institution. The IRS has permitted an expanded use of this type of gift. For example, in a Private Letter Ruling (“PLR”) issued by the IRS in 2006, Grandparent wished to prepay the tuition for six grandchildren through the twelfth grade. Grandparent proposed entering into written agreements with the school (which was a qualified educational organization), where the agreement would state, among other things, that the prepayments would be made directly to the school, for specified tuition costs, be nonrefundable, and be subject to forfeiture should the respective grandchild cease attending the school. The IRS ruled that the prepayments would constitute qualified transfers excluded from the gift tax under Section 2503(e) and also ruled that the transfers would not constitute generation-skipping transfers for GST tax purposes. Those wishing to make gifts of tuition costs may wish to consider such a strategy. For example, someone with a short life expectancy and a taxable estate and who has a number of children or grandchildren who could benefit from such gifts could be a good candidate for this strategy. We caution, however, that a PLR is directed only to the taxpayer requesting it and cannot be relied on or used as precedent by others.

Mortgages – Reversed! Reverse mortgages are special types of loans on a principal residence for a homeowner age 62 or older. The primary difference from a conventional mortgage is that a reverse mortgage does not require repayment until the borrower stops living in the principal residence for a period greater than one year, sells or transfers the principal residence, or dies. A reverse mortgage can be used to pay off an existing mortgage in order to reduce expenses and improve cash flow or it could be used to supplement income in order to pay expenses. There are various options to receive the payments, which range from taking a lump sum to arranging a monthly payment or line of credit. In considering a reverse mortgage, it is important to note that the loan and closing costs are substantially higher than a conventional mortgage or home equity line. Such costs could range from \$10,000 to \$20,000, although they are typically rolled into the amount borrowed, whereas the closing costs for a conventional mortgage would typically be under \$5,000.

And The GRATs Just Keep Rolling Along. Are you financially comfortable? Got enough? If so, and if you wish to pass along the growth of your estate to your children gift tax free, a technique called “Rolling GRATs” may be for you. How does it work? Typically, Parent begins with the creation of a “GRAT” – a special trust called a grantor retained annuity trust. Parent then transfers marketable securities (stock) into the GRAT and retains an income interest in the GRAT for a two-year period. The income interest is defined by IRS rules and interest tables, and basically, the GRAT is structured so that whatever goes into the GRAT comes back out to Parent (remember, we want you to remain comfortable!). The appreciation of the assets beyond the IRS interest rate goes out to the children at the end of the two-year term.

Here is a simple example: In February 2007 when the applicable federal rate is 5.6%, Parent creates a two-year GRAT and funds it with a \$2 million stock portfolio. Over the next two years, the GRAT pays Parent roughly \$2.1 million in annuity payments based upon the IRS tables. The large payout is necessary to reduce the “remainder interest” in the children to zero and thus to reduce the “gift” to the children to zero. Assuming the portfolio grows by 10% – outperforming the 5.6% federally assumed rate of return – at the end of the GRAT term the children receive about \$100,000 even though under IRS rules no gift has occurred! If Parent continues to “roll” the GRAT annuity payments into new GRATs, the growth of the amount to the children over, say, a ten-year time period, can be dramatic.

A Legacy Of More Than Money: When we think of our estate and estate plan, we generally think of “who gets what,” thoughtfully providing for financial security for our loved ones and future descendants, with a minimum of taxes, of course. Nothing wrong with that. But are we missing something even more important? Why shouldn’t we leave them with some of our even more valuable “possessions?” Such as our thoughts on how they should regard the financial wealth we leave them, whether great or small, the standards by which we lived and conducted our own lives, the values we used in raising our family, and so on. All too often our thoughts and efforts are focused on the material issues. Today, we find more and more of our clients are considering what is called an “ethical will,” designed to carefully consider and impart to their heirs the emotional, character, and philosophical principals they would like those heirs to keep in mind in accepting their material legacy. In addition, ethical wills can be invaluable to convey instructions and wishes to a trustee, who will be making important decisions regarding the welfare, education, and general lifestyle of children, grandchildren, and other beneficiaries. Some of our clients undertake the writing of an ethical will “on their own,” with guidance from us as to the broad outlines of such a document. A more polished document can result where the client collaborates with an outside expert whose work we admire and recommend. In both instances, the ethical will adds meaningfully to the overall plan.

