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2010 Health Care Reconciliation Act and New Medicare Tax – Planning Strategies Before 2013

By Julie L. Cavanaugh, Esq.

On March 23, 2010, President Obama signed into law the Patient Protection and Affordable Care Act, launching a new era of health care coverage for Americans. Furthermore, on March 30, 2010, President Obama signed into law the Health Care and Education Reconciliation Act of 2010. These two laws represent a massive overhaul of our nation's health insurance and delivery systems. In order to pay for this overhaul, there will be more than $400 billion in new taxes on employers and individuals.

Under these laws, a new 3.8% Medicare tax will be assessed beginning in 2013 on the lesser of (1) "net investment income"; or (2) the excess of "modified adjusted gross income" over the "threshold" amount. This new tax will be added to the new law's additional 0.9% Medicare payroll tax.

Net investment income. This is the sum of gross investment income over allocable investment expenses. In other words, it is the total of all interest, dividends, annuity income, rents, royalties, income of passive activities, and net capital gains from disposition of capital property not held in an active trade of business. Investment income does not include active trade and/or business income, distributions from IRAs or other qualified retirement plans, accumulation of cash surrender values within a life insurance policy, the inside build-up of annuities, or any income taken into account for self-employment tax purposes.

Modified adjusted gross income. This is simply an individual's adjusted gross income as found on IRS Form 1040, Line 37 (plus the net amount, if any, related to the foreign earned income exclusion).

Threshold amount. For married taxpayers filing jointly, the amount is $250,000. For married taxpayers filing separately, it is $125,000. For all other individual taxpayers, the threshold amount is $200,000.

The Medicare tax will also apply to estates and trusts, except for charitable remainder and other tax-exempt trusts. Taxable estates and trusts will pay the 3.8% surtax on the lesser of (1) their undistributed net investment income for the tax year; or (2) any excess of their adjusted gross income over the dollar amount at which the highest tax bracket for estates and trusts begins for the tax year (currently $11,200), but subject to inflation each year.

Looking at an example involving individuals, if Mr. and Mrs. Smith, filing jointly, have $500,000 of salary and $100,000 of net investment income, the 3.8% Medicare tax would apply to the $100,000 of net investment income, since it is the lesser of $100,000 and $350,000 ($600,000 minus $250,000). If Mr. and Mrs. Smith had no net investment income, the 3.8% tax would not apply to them. In most cases, this new Medicare tax will likely affect the net investment income of individual taxpayers. Even though there are a few years before individuals, estates, and trusts are subject to the Medicare Tax, implementing a strategy to mitigate the impact of the new tax should begin now. One solution is to maximize the contributions to qualified plans and IRAs, since distributions from those accounts are not subject to the Medicare tax.

Accumulating cash value within a permanent life insurance policy is another strategy available to mitigate the impact of the Medicare tax. Cash values within a permanent policy grow tax-deferred and distributions from cash values can be taken tax free by surrendering to basis and, thereafter, by policy loans. As long as a distribution from a life insurance policy would not otherwise constitute taxable income, it will not be subject to the Medicare tax. By comparison, income derived from portfolio investments which are not tax-deferred will be impacted immediately to the extent that the interest, dividends and/or capital gains causes the taxpayer's adjusted gross income to exceed the applicable threshold amount.

Other options to mitigate a client's exposure to the Medicare tax are rearranging a portfolio. Tax-exempt income from municipal bonds or funds will not trigger the Medicare tax. As mentioned above, the inside build-up of annuities are not subject to the Medicare tax. And, for individuals who already contribute the maximum amount to their qualified plans, a Roth conversion might be advisable. These clients would pay income tax on the converted amount at today's lower marginal tax rate while

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building an account from which future distributions would not be included in their modified adjusted gross income.

Another strategy to avoid or minimize the effect of the Medicare tax is to reduce one's modified adjusted gross income. Any Roth conversion before 2013 should deliver these tax benefits. A conversion in 2010 will allow a client to pay a conversion tax at 2010 tax rates, which will likely be lower than the tax rates in 2011 and beyond. There are no required minimum distributions from Roth IRAs, and any distributions taken from the Roth would not count as investment income under the Medicare tax. Moreover, an individual could sell non-qualified investment assets to raise the funds to pay the Roth conversion tax, thereby reducing the size of his/her non-qualified investments and decreasing his/her future net investment income.

While the Medicare tax will not be imposed on taxpayers, estates, or trusts until 2013, planning should begin now. It is going to be more important than ever for taxpayers in higher brackets to generate a significant portion of their income from tax-free interest on municipal bonds, tax-free Roth IRA withdrawals, and/or loans/withdrawals from permanent life insurance contracts. For most individuals, it undoubtedly makes sense for them to convert their traditional IRA into a Roth. The questions are: How much should the client convert, and when?

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Asset Protection Planning for the Elderly

By Brenna D. Mansfield, Esq.

The importance of asset protection planning for the elderly has grown as the costs of long-term health care continue to increase and insurance companies continue to cover fewer of the needs of its insureds. The increasing costs of nursing homes, assisted living, private care at home, etc., will continue to present significant challenges to elderly clients. And the failure to plan ahead means the loss of significant personal assets in many cases.

One common arrangement to help accomplish eligibility for needs-based government assistance (such as Medicaid) to cover the costs of long-term care, is to create what is known as an Irrevocable Income Only Trust ("IOT"), previously discussed in our June, 2010 E-Update.

The main reason for creating an IOT is to protect the grantor's assets should he or she need government assistance for long-term care in the future. To accomplish this goal, the IOT is by its terms irrevocable and allows for discretionary distributions of income to the grantor during his or her lifetime. The IOT provides that under no circumstances shall trust principal be available or distributed to the grantor. Accordingly, as long as the grantor retains the right to income only, then the principal of the trust will not be deemed an available resource or "countable" asset for Medicaid eligibility purposes.

However, under current Medicaid rules, there is a 5-year "lookback period" for uncompensated transfers or divestment of assets. Any uncompensated transfer made within the lookback period results in a penalty period of ineligibility for Medicaid benefits. The period of ineligibility does not begin when the transfer is made, but rather when the applicant applies for Medicaid benefits and is "otherwise eligible" for Medicaid (i.e., the person meets both the medical and financial eligibility criteria). The funding of an IOT is deemed a divestment for Medicaid purposes. If the IOT is created at least 60 months before applying for Medicaid benefits, the existence of the trust will not foreclose qualifying for the benefits, and the entire corpus of the IOT may be protected from the cost of long-term care. If the IOT is created within such 60-month period, then a portion of the trust may still be protected, depending on the specific client circumstances.

An IOT allows for the grantor to meet Medicaid's financial eligibility rules in the future, while also providing creditor protection for the grantor and the remainder beneficiaries; control over the ultimate distribution of trust assets; and federal tax advantages (as compared to a direct transfer/gift of the grantor's assets to his or her children), which are discussed in greater detail below.

Income Tax. The IOT is structured as a "grantor trust" under the Internal Revenue Code, since the grantor "derives benefits from the income of the trust". This means the grantor is responsible for paying all income taxes assessed against the trust. In other words, under the grantor trust rules, if a grantor is treated as an owner of any portion of a trust, the income deductions and credits payable by virtue of that portion of the trust are included in computing the taxable income of the grantor. A grantor is treated as the owner of any portion of a trust with respect to which certain rights are retained by the grantor (such as the right to receive discretionary distributions of income). Therefore, grantor trust tax treatment allows trust income to be taxed at the grantor's individual income tax rate, which is usually less than the compressed trust income tax rates for trusts.

Gift Tax. Under the terms of the IOT, the grantor retains a "limited power of appointment" over the trust property, which allows the grantor to name new beneficiaries or change the interests of the beneficiaries. Retaining a limited power of appointment provides a number of benefits, such as maintaining the ability to respond to changing family circumstances. This power also avoids having any transfers to the IOT treated as a completed or taxable gift for gift tax purposes. Although the transfer of assets to the IOT is an incomplete gift for gift tax purposes, distributions from the IOT to a beneficiary (other than the grantor) is considered a gift.

Step-Up in Basis. Because of the grantor's "limited power of appointment", the IOT is structured so that the trust assets

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receive a step-up in basis upon the grantor's death (i.e., upon the sale of the trust property after the grantor's death, the basis is the fair market value of the property on the grantor's date of death). This is a significant advantage over outright transfers or gifts to the grantor's children, since such transfers are subject to "carryover" basis rules (i.e., on the sale of the asset by the children, their basis is the parent's basis and the children are responsible for the capital gains tax on the appreciation).

Capital Gains Tax. Under the grantor trust rules, a grantor is treated as the owner of any portion of the trust with respect to which the grantor reserves the right to include or delete beneficiaries, such as the limited power of appointment discussed above. Therefore, the grantor is treated as the owner of any residence transferred to the IOT. Accordingly, the IOT is structured to preserve the capital gains tax exclusion (i.e., up to $250,000 for an individual if certain requirements are met) on the sale of any principal residence owned by the IOT.

Estate Tax. Since the grantor reserves the right to income under the terms of the IOT and retains a limited power of appointment over the trust property, the entire value of the IOT assets will be included in the grantor's estate for federal estate-tax purposes.

IOTs offer numerous benefits to clients who want to plan in advance for long-term care. The IOT allows the client to retain control over his or her assets during his or her lifetime, as well as the ultimate disposition upon death; provides creditor protection; establishes eligibility for needs-based government assistance; and offers several tax advantages as compared to outright gifts.

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Beneficiary Defective Irrevocable Trusts

By Julius H. Giarmarco, Esq.

The benefits of an intentionally defective grantor trust ("IDGT") are well known. First, the grantor's payment of the trust's income taxes is essentially a tax-free gift to the beneficiaries of the trust. Rev. Rul. 2004-64. Thus, the assets in the trust grow "tax free". Second, by paying the income taxes, the grantor is reducing his/her estate by the taxes paid and any future appreciation that would otherwise have been generated on the funds used to pay income taxes. Third, the grantor can sell assets to an IDGT (on installments) without any gain or loss recognition. Sales between a grantor and a grantor trust are disregarded for income tax purposes. Rev. Rul. 85-13. Fourth, a sale to an IDGT of a life insurance policy on the grantor's life can avoid both the three-year rule and the transfer-for-value rule. Rev. Rul. 2007-13. Fifth, an IDGT qualifies as an eligible S corporation shareholder. IRC Section 1361(c)(2)(A)(i). But, at such time as the IDGT is no longer a grantor trust, the trust must then "convert" to a Qualified Subchapter S Trust ("QSST") or an Electing Small Business Trust ("ESBT"). Finally, with proper design and drafting, grantor trust status can be "toggled" on and off for maximum flexibility.

The powers that are typically used to trigger grantor trust status for income tax purposes, but without causing inclusion of the trust's assets in the grantor's estate, are the following:

1. The power to substitute trust property with other property of equivalent value. IRC Section 675(4)(c).

2. The power in a non-adverse party to add charitable beneficiaries. IRC Section 674(b)(4).

3. The power to distribute income to the grantor's spouse. IRC Section 677(a)(1) and (2).

4. The power to use trust income to pay premiums on policies of insurance on the life of the grantor or grantor's spouse. IRC Section 677(a)(3).

5. The power of the grantor to borrow trust assets without adequate security. IRC Section 675(3).

That said, consider turning the tables and drafting the trust so that the beneficiary – and not the grantor – is taxed on the trust income. With an IDGT, the grantor cannot be a beneficiary or a trustee of the trust without adverse estate tax consequences (under IRC Sections 2036 and 2038). But, with a beneficiary defective irrevocable trust ("BDIT"), the beneficiary can be both the primary beneficiary and the trustee of the trust. The reason is that the beneficiary is not the grantor of the trust. Instead, the grantor is usually the beneficiary's parent or grandparent.

Although it may not be cited as precedent, PLR 200949012 provides planners with a road map on how to properly design a BDIT. Following are the facts in PLR 200949012:

1. The grantor proposes to create a trust for the benefit of beneficiary.

2. The beneficiary will be a co-trustee of the trust (along with two independent co-trustees).

3. The beneficiary will have the unilateral power to withdraw all contributions made to the trust. However, this power will lapse each calendar year in an amount equal to the greater of $5,000 or 5% of the value of the trust.

4. The beneficiary will also have the power, during his lifetime, to direct the net income and/or principal of the trust to be paid over or applied for his health, education, maintenance and support ("HEMS"), and this power will not lapse.

5. The beneficiary will have a testamentary limited (non-general) power of appointment to "re-write" the disposition of the trust assets upon his death.

6. The trust provides that neither the grantor nor the grantor's

spouse may act as a trustee, and that no more than one-half of the trustees may be related or subordinate to the grantor within the meaning of IRC Section 672(c).

7. The trust contains various provisions assuring that the grantor will not be treated as the owner of the trust for income tax purposes under IRC Sections 671 – 679.

The IRS ruled that the trust did not contain any provisions that would cause the grantor to be considered the owner of the trust for income tax purposes. Instead, the IRS ruled that the beneficiary will be treated as the owner of the trust for income tax purposes – before and after the lapse of the beneficiary's withdrawal rights. The IRS analysis was as follows:

1. The trust did not contain any grantor trust "triggers" under IRC Sections 673 (reversionary interests); 674 (power to control beneficial enjoyment); 675 (administrative powers); 676 (power to revoke); 677 (income for benefit of grantor); or 679 (foreign trusts).

2. Under IRC Section 678, the beneficiary will be treated as the owner because the beneficiary had the right exercisable solely by the beneficiary to vest trust principal or income in himself.

In order for a beneficiary to be deemed the owner of a trust (for income tax purposes) under IRC Section 678, the beneficiary must be given the unilateral right to withdraw all income or corpus from the trust and, if such power is "partially released", after the release the beneficiary retains such an interest in the trust that it would be a grantor trust with respect to the real grantor (if the real grantor had retained such interest). But, when the power gradually lapses in its entirety (by $5,000 / 5% per year), is IRC Section 678 status lost? According to PLR 200949012, the answer is "no". The ruling apparently treats a "lapse" as a "release" so that even if the unilateral right to withdraw eventually disappears (by $5,000 / 5% per year), the lapse would be partial only because the power to withdraw for HEMS remains. And the HEMS standard – if available to the grantor – would be a grantor trust trigger under IRC Section 677. Thus, under IRC Section 678, the beneficiary continues to be treated as the owner of the trust.

As to the beneficiary's estate tax consequences, the power to withdraw trust assets for HEMS does not create a general power of appointment and, therefore, does not result in estate tax inclusion. IRC Section 2041(b)(1). But, the unilateral right to withdraw principal is a general power of appointment that will cause the trust assets to be taxed in the beneficiary's estate (but only to the extent the power has not lapsed under the $5,000 / 5% rule). IRC Section 2041(b)(2). For example, if the grantor contributed $1 million to the BDIT, the unilateral power of withdrawal would lapse in 20 years (i.e., 5% x $1 million = $50,000), or even sooner if the trust assets grew in value.

A BDIT works particularly well where the beneficiary has a new business opportunity, but would like to keep the business out of his or her estate. The beneficiary convinces his/her parents or grandparents to give him/her an "advance" on his/her inheritance by making a gift to the BDIT. This will allow the beneficiary to operate the business (as the trustee of the BDIT). The beneficiary will also have access to the cash flow of the business, without inclusion in his/her estate (except to the extent the beneficiary's unilateral withdrawal right has not yet lapsed under the 5% / $5,000 power). The beneficiary can also sell assets to the BDIT without any gain or loss recognition. Finally, the beneficiary's payment of the BDIT's income taxes reduces his/her estate and is a "tax-free" gift to the remaindermen of the BDIT (i.e., the beneficiary's descendants).

In summary, a BDIT allows the beneficiary to achieve virtually all of his/her tax and non-tax planning objectives. When advising clients on estate planning matters, the planner should advise them to consider establishing BDITs for their children and grandchildren, and/or advise them to ask their parents and grandparents to establish a BDIT for themselves.

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