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Asset Planning and Federal Taxation

HAVE YOU CHECKED YOUR BENEFICIARY DESIGNATIONS RECENTLY?

by David M. Watts, Jr.

Beneficiary designations are forms that are routinely completed for life insurance policies, retirement accounts and even some bank and investment accounts. The forms say who will receive the asset upon the asset owner's death. When a beneficiary designation is in place, it generally controls the disposition of the asset it is associated with, regardless of what one's will or other estate planning document says. As part of a periodic review of your estate plan, it is vitally important to review all of your beneficiary designations. This is particularly important when facing major life events such as divorce, the death of a beneficiary, birth of a child, or the marriage of a beneficiary to a less-than-desirable spouse. While Pennsylvania law does provide some protection in this area, as a practical matter insurance companies and retirement plan administrators are extremely reluctant to pay benefits to anyone other than the individual or individuals named on the beneficiary designation.

The Kennedy Case - The United States Supreme Court decision in Kennedy, Executrix v. Plan Administrator of the DuPont Savings and Investment Plan serves as a reminder of the need for retirement plan participants and IRA account holders to review their beneficiary designations on a regular basis, particularly when involved in a divorce.

Mr. Kennedy had named his spouse as the sole beneficiary of his benefits under the DuPont Savings and Investment Plan. He and his wife later divorced, and as part of the divorce proceeding, his former spouse signed a waiver of all of his employee benefits. Unfortunately, the waiver was not made in the form of a "qualified domestic relations order," which is the documentation procedure for allocating retirement benefits in a divorce proceeding under the federal retirement plan law known as ERISA. Following the divorce, Mr. Kennedy failed to change his beneficiary designation. Soon thereafter, he died, and then his former spouse subsequently died. The plan administrator of the DuPont Savings Plan concluded that the beneficiary designation on file was the controlling document and paid the benefits to the estate of the former spouse. The executrix of Mr. Kennedy's estate sued to invalidate the beneficiary designation.

The Supreme Court, in a unanimous decision, ruled that the beneficiary designation was undisturbed by the waiver in the state court proceeding. Essentially, the court ruled that the plan administrator had the right to rely on the plan documents that were available to the participant to name a beneficiary. That document named his former spouse as the beneficiary. If Mr. Kennedy had only changed the beneficiary designation after the divorce, he could have prevented the quagmire that followed. Unfortunately, he failed to do so.

Therefore, we recommend that you check these designations periodically to make sure that no life event has changed the intent of your distribution. Often beneficiary designations provide for a contingent beneficiary, which is essential if the primary beneficiary is deceased. If the primary beneficiary is deceased and a contingent beneficiary is not named, the IRA custody agreement will generally invoke a default mechanism that will distribute the funds to the IRA accountholder's estate. This is not desirable because the funds become subject to the decedent's creditors and many of the income tax advantages of the IRA will also be lost.

Beneficiary designations can also be very useful in planning to minimize the impact of estate taxes. Many estate plans provide for the creation of a trust benefitting the surviving spouse at the death of the first spouse that shelters assets from taxes when the surviving spouse dies, by keeping those assets out of the survivor's estate. In situations where the bulk of a decedent's wealth is in retirement plans and insurance policies — which typically name the surviving spouse as the designated beneficiary — it can be difficult to find assets with which to fund the estate tax-saving trust. However, if the trust is named as either primary or contingent beneficiary of the account, it is possible to direct the account to the trust instead of to the spouse. This technique is particularly useful for insurance policies, but can also be useful for other assets, such as retirement accounts, under the right circumstances. If you have any questions about the impact of your designations on your estate plan, or if we can be of any help in interpreting a plan document or beneficiary designation, please call us. ■

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TAX-ADVANTAGE CHARITABLE GIVING

by David M. Watts, Jr.

If you are charitably inclined, there are tax-advantaged ways to make a gift to a favorite charity while enjoying the income from that gift for your lifetime. Many educational and charitable organizations offer plans that combine the benefits of an immediate income tax deduction and lifetime income from the charitable gift. In most cases, you can make the gift in cash or securities, and sometimes even with real estate. Here is a brief overview of the major types of deferred charitable gifts.

- Many educational and charitable organizations offer a pooled income fund (PIF). A PIF closely resembles a mutual fund. When you make a gift to a PIF, it is merged with gifts of other donors, and you receive your allocable share of the income earned by the fund. Distributions from the fund are usually made quarterly and are taxable as ordinary income. There is no guarantee as to the rate of earnings; that depends on the fund's success. You get an immediate income tax deduction in the year in which you make a gift to a PIF. The amount of your deduction depends on a combination of your age and the fund's highest rate of earnings in the previous three years. The deduction will be less than the full value of your contribution, because it represents the present value of the funds that the charity will withdraw from the fund after your death.

- In a charitable remainder unitrust (CRUT), a separate fund is set up to hold your gift until your death, at which time it will become the charity's property. You decide at the outset on the annual percentage of the fair market value of the assets that you are to receive as income for life. For example, you may make a $50,000 gift to a CRUT and specify an 8% return. Your annual income will be $4,000. If the value of the CRUT assets drops in the next year to only $40,000, your income that year will be $3,200. If the value goes up to $60,000 in the following year, your income that year will be $4,800.

  Unlike a PIF, a CRUT is handled individually. Therefore, the charity may require a much larger initial contribution to a CRUT than to a PIF. Just as with a PIF, your deduction for a gift to a CRUT will be less than the full value of your contribution.

- A charitable remainder annuity trust (CRAT) is similar to a CRUT in that your gift to the charity is placed in an individual trust. The CRAT provides an annual payment of a fixed dollar amount for your lifetime. This differs from a CRUT, which provides a fixed percentage of the asset value. For example, say that you make a $50,000 gift to a CRAT that will pay you $4,000 a year for life, after which the trust principal passes to the charity. If the CRAT earns less than $4,000 a year, it will sell assets to make up the difference. If it earns more than $4,000, it will pay you $4,000 and add the excess to the trust principal. Your income tax deduction from a gift to a CRAT is based on your age and the amount of your annual payment. As a rule of thumb, the older you are, the larger the deduction, and the greater the annual payment, the smaller the deduction.

- With a charitable gift annuity, you make a gift to charity in exchange for a guaranteed income for life. This is very much like buying an annuity in the commercial marketplace, except that you get an immediate charitable deduction equal to the excess of what you paid over what the annuity is worth, based on IRS tables. Unlike the PIF, CRUT, and CRAT, your income from the charitable gift annuity is an obligation of the charity that does not depend on investment results. The rate of return on your gift annuity is not variable, as in a pooled income fund, or negotiable, as in a CRUT or CRAT. Instead, it is most likely to come from a table based on your age at the time of the gift. A portion of each year's payment is tax-free, because the tax law allows you to recover your original payment over your life expectancy. In the year when you buy the annuity, you get a charitable deduction for a portion of the purchase price, determined from an IRS table geared to your age.

If the idea of deferred charitable giving appeals to you, please give us a call. We can discuss the pros and cons of the various types of deferred giving, and arrive at an arrangement that is right for you. ■

PLANNING AND PAYING FOR LONG-TERM CARE (PART 4 IN A SERIES: MEDICAID/ MEDICAL ASSISTANCE) *by Scott Alan Mitchell*

As of January 1, 2012, the average cost of skilled nursing care in Pennsylvania is $8,112.13 per month. Recall that according to national statistics, approximately 50% of nursing care throughout the country is paid by Medicaid – more than double any other source of payment (private funds, Medicare, long-term care insurance, etc.). Medicaid is a joint federal and state program under which States receive federal funding to establish programs to "dispense" medical care (including skilled nursing care) to needy and qualifying individuals.

Each State's Medicaid program must comply with complex requirements imposed by federal statutes and regulations. As described by one federal court in Pennsylvania, these statutes and regulations are "one of the most completely impenetrable texts within human experience and dense reading of the most tortuous kind." The court further added, "The court has nothing but sympathy for officials who must interpret or administer the Act." This complex web of federal statutes and regulations is further exacerbated in that, as part of administering the Medicaid program, each State adopts its own statutes, regulations, and policies, all of which are subject to change from year to year and even month to month.

Pennsylvania refers to its Medicaid program as "Medical Assistance" (which I will reference as "MA" hereafter). According to recent statistics, benefits paid under Pennsylvania's MA program amount to approximately $14 billion per year – 55% of which are federal funds, and 45% of which are Commonwealth funds.

Before discussing eligibility requirements for MA benefits, a few preliminary points should be noted. First, when a nursing home resident receives MA benefits, the resident's care remains the same as a resident paying privately for his or her care. Contrary to the belief of some, nursing homes do not have "Medicaid wings" where MA residents are sent to receive inferior care. Second, although one or two homes in a given county might not accept MA, most homes accept MA – and so a potential MA resident is not destined to go to what many refer to colloquially as "the county home." Finally, when a nursing home resident's care is being covered by MA, the nursing home does not receive the full monthly payment that it would receive from a private-pay resident. As a result, nursing homes typically limit the number of MA residents that they can accept at any one time. Thus, if a particular nursing home is at full capacity with MA residents, an individual who lacks sufficient assets to pay privately for one or two years of care might be placed on a waiting list at that home until an "MA bed" becomes available, which could result in the individual needing to consider other homes.

To become eligible for MA benefits, an individual must be determined by a doctor and the local Office of Aging to actually need skilled nursing care. In other words, MA benefits are not available for personal care – and they are not available for an individual in skilled nursing care who does not truly need that level of care. Additionally, an individual must meet certain asset limits. As will be discussed further below and in subsequent parts of this series, certain assets are not counted as assets for purposes of MA eligibility. For a single individual, "countable" assets must be below $8,000. However, if the individual's gross monthly income is over $2,094, assets must be below $2,400.

For married couples, the spouse in the nursing home must have assets below the aforementioned limits. Additionally, the non-nursing home spouse (the "community spouse"), is entitled to retain one-half of the couple's "countable" assets, as valued on the first day the nursing home spouse entered the home. However, the one-half is subject to a minimum of $22,728 and a maximum of $113,640. Thus, if a couple's countable assets are $30,000, the community spouse may retain or protect $22,728; if a couple's countable assets are $190,000, the community spouse may retain $95,000; and if a couple's countable assets are $300,000, the community spouse may retain $113,640.

The following are examples of assets that are "exempt" or not "countable" for purposes of MA eligibility (which is to say that if an individual enters a nursing home, the community spouse may retain the below assets in addition to the one-half protected share referenced above):

1. Personal residence
2. One vehicle
3. Household furnishings/personal effects
4. Community spouse's retirement accounts (but not nursing home spouse's)
5. Life insurance policies with an aggregate face value of up to $1,500
6. Term life insurance policies
7. Real and personal property used in a trade or business, such as rental real estate
8. Pre-paid irrevocable funeral/burial policies and burial plots

It should be noted that with the exception of retirement accounts, whether an asset is in the name of the nursing home spouse, the community spouse, or both spouses is irrelevant to whether an asset is countable for purposes of Medical Assistance eligibility. Thus, moving all assets into the name of the community spouse – or titling one half of the assets in the nursing home spouse's name and

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PLANNING AND PAYING FOR LONG-TERM CARE *continued from page 3*

the other half in the community spouse's name – has no impact on initial MA eligibility. Rather, all countable assets in the name of either or both spouses are considered available assets for purposes of MA eligibility, and the community spouse initially is able to protect one half of the countable assets (subject to the above-referenced minimum and maximum).

It also should be noted that MA does not recognize prenuptial agreements. Thus, although a couple might maintain separately-owned assets under a valid prenuptial agreement, for MA purposes all countable assets of both spouses are considered available assets as part of the MA eligibility process.

To illustrate a sample asset calculation, assume that a married couple owns a house, car, and household furnishings. Additionally, the couple has $250,000 in investments, bank accounts, certificates of deposit, etc., and the nursing home spouse has an individual retirement account with a balance of $100,000. The couple's countable assets would be $350,000 (excluding the house, car, and household furnishings). Assume that the nursing home spouse can retain $2,400 in assets. Additionally, the community spouse can retain one-half of the countable assets – subject to the maximum of $113,640. Thus, the couple can protect $116,040, and the remaining "excess" assets total $233,960 – meaning that the couple cannot become eligible for MA unless and until the excess is either exhausted on nursing care or protected in some other fashion. ■

In part 5, I will discuss how excess assets are addressed and the various options that the law allows couples to protect some or all of these excess assets.

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