

2010 Tax Code Changes and The Effect on Medicaid Planning

The New Law. There is currently no federal estate tax or generation-skipping tax for decedents dying in 2010 unless Congress passes new estate tax legislation this year. The federal estate tax will return in 2011 with a \$1 million exemption (\$2 million for married couples with basic planning) and the generation-skipping tax exemption will return at \$1 million, indexed for inflation. This means that a person with assets of \$10 million, \$20 million or even \$100 million who dies in 2010 will not pay a dime of estate tax. However, assets a decedent owns and passes on to a beneficiary at death will receive little, if any, step-up in basis, thus creating a large capital gains tax problem for the beneficiary who acquires the property.

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As of January 1, 2010, IRC Section 1022 became effective and substantially changed the rules for obtaining a step-up in basis for real property or appreciated assets passed to a beneficiary at the death of the property owner. Section 1022 replaced the prior rule, IRC Section 1014, which expired on December 31, 2009, along with the estate tax.

What does it mean? Section 1022(d)(1)(A) allows a step-up in basis up to \$1.3 million for an individual and \$3 million for a surviving spouse (as long as it is received outright or as qualified terminal interest property) in property owned by, and transferred from, the decedent at the time of the decedent's death.

An illustration: Harry, a single person, owns a home worth \$2 million at his death. He bought his home 20 years ago for \$200,000. Harry's Will leaves everything outright to his daughter, Kathy, at his death. If Harry dies in 2010 while Section 1022 is in effect, Kathy will receive Harry's property with a basis of \$1.5 million, not \$2 million. Once Kathy sells the property, she will pay capital gains on the difference between the selling price and \$1.5 million.

Planning Note: In 2010, property passing at death may receive little or no step-up in basis at death, resulting in larger capital gains when the property is sold.

The Effect on Irrevocable Trust Property - Muddy Waters.

There is no clear answer as to the effect of Section 1022 on property held in an irrevocable grantor trust (often referred to as a Medicaid Asset Protection Trust), which is commonly used as an asset protection tool in Medicaid planning. Some experts believe that property held in an irrevocable grantor

trust will not get any step-up in basis at the grantor's death, and others believe the opposite. What is clear is that the lack of step-up for property held in an irrevocable trust is only applicable to property transferred by grantors who die in 2010 or while Section 1022 is in effect. The value of irrevocable grantor trusts in Medicaid planning has not changed - these trusts are still a valuable tool for asset protection.

Planning Note: The usefulness of irrevocable trusts in Medicaid planning has not changed even though property held in an irrevocable trust may not receive a step-up in basis if the grantor dies this year.

The Effect on Life Estate Property - no step-up in basis. There is no support in Section 1022 for a life estate holder to be considered an owner for purposes of a step-up in basis. Therefore, it appears that property held subject to a life estate interest will not receive a step-up in basis at the death of the life estate holder during 2010 or while Section 1022 is in effect.

The Effect on the 121 Exemption - remains intact. IRC Section 121 provides for a \$250,000 exemption from capital gains for a single person who sells his/her home, and a \$500,000 exemption for a married couple who sell their home. It appears that the Section 121 exemption will still be available for assets held individually, or in an irrevocable Medicaid Asset Protection Trust, assuming the appropriate rights to the home were retained in the trust. There were no changes to the grantor trust rules that would prevent the Section 121 exemption from applying to property held in a Medicaid Asset Protection Trust.

Planning Note: Life estate property will not get a step-up in basis in 2010, but the 121 exemption on homestead property remains.

What Happens Next? Congress could enact federal estate tax legislation this year --retroactive to January 1, 2010, or effective on some later date - and Section 1022 would then likely be repealed. Whether the new legislation would be retroactive is unknown. It is also possible that Section 1022 could be repealed even if new estate tax legislation is not passed this year. Absent further action from Congress Section 1022 will expire on December 31, 2010. *Remember -- these rules are only applicable to those persons who die while these provisions are in effect, not to trusts or life estate deeds that are drafted while these laws are in effect.*

Staying the Course. Although Section 1022 makes it difficult to obtain a step-up in basis for death occurring in 2010, this provision will not be around past 2010. Absent further changes in the law, the latest date that the step-up in basis provisions will return is January 1, 2011, when the estate tax is reinstated. And, these provisions only affect property with a low cost basis. Cash assets like checking accounts, CDs and savings accounts are unaffected by this legislation.

Planning Note: The 2010 legislation only affects property with low cost basis, not cash assets like CDs, checking accounts and savings accounts.

Conclusion. The changes to the tax code can seem very confusing. Luckily, these changes are only in effect for a short time (up to a year maximum) and only affect those persons who die this year or while

these provisions are in effect. And while it is necessary to stay abreast of these new rules, it is also important to remind seniors and their loved ones of the importance of planning early to protect assets from the rising costs of long-term care.

Below are links to the full text of each Internal Revenue Code Section referred to above:

IRC 121: http://www.law.cornell.edu/uscode/uscode26/usc_sec_26_0000121----000-.html

IRC 1014: http://www.law.cornell.edu/uscode/uscode26/usc_sec_26_0001014----000-.html

IRC 1022: http://www.law.cornell.edu/uscode/uscode26/usc_sec_26_0001022----000-.html

IRC 2511: http://www.taxalmanac.org/index.php/Internal_Revenue_Code:Sec._2511._Transfers_in_general

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