THE WALSHLAW REPORT

Experts in Estate Planning, Elder Law, Taxation, Business Law **Fall/Winter 2004**

MARYLAND ESTATE TAX CHANGES

On May 26, 2004, Governor Ehrlich signed the state's 2004 budget into law. Included in the budget act was a little-noticed last minute revision of the Maryland estate tax law by which the Maryland estate tax exemption was frozen at $1,000,000 (retroactively, to January 1, 2004). Previously, Maryland had tied its estate tax exemption to the federal estate tax exemption, which had increased to $1,500,000 on January 1, 2004 and is scheduled to increase to $2,000,000 on January 1, 2006 and $3,500,000 on January 1, 2009.

This de-coupling will have a significant impact on the estate tax, and estate planning, for many of our clients. Please recall that for estate tax purposes, the term "gross estate" does not mean just your probate estate, but also includes retirement plans, life insurance and revocable trusts. If your total gross estate is under $1,000,000, this change in Maryland estate tax will not affect your estate.

The most significant impact of the change in Maryland law will be in the estate planning for married couples if either spouse has a gross estate over $1,000,000. Most estate plans drafted for such couples previously relied on a formula tied to the available federal estate tax exemption. The exemption amount passed to a trust, usually referred to as a bypass trust in our documents, for the primary benefit of the surviving spouse. This was fine as long as the federal and Maryland estate tax exemptions were the same. However, if one spouse has a gross estate of, e.g., $1,500,000, use of this formula will cause that spouse's estate to pass entirely to the bypass trust.

That bypass trust will be exempt from federal estate tax, but will generate a Maryland estate tax of $64,400. Although it may make sense to pay some Maryland estate tax at the death of the first spouse in order to shelter $500,000 more in the bypass trust from potential additional federal estate tax later, (1) most of our clients have told us that they want to avoid *any* taxes at the death of the first spouse in order to maximize the amount that is available for the support of the surviving spouse, and (2) the surviving spouse might not have enough assets in his or her gross estate to worry about federal estate tax, particularly if future increases in the federal estate tax exemption occur as scheduled.

This problem becomes even more acute for larger estates as the federal estate exemption increases to $2,000,000 in 2006 and to $3,500,000 in 2009. At those levels, the additional Maryland estate tax generated will be $99,600 and $229,200, respectively.

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For most married clients, we recommend revising the division formula, so that it is tied to the lower of the federal or Maryland estate tax exemption. In this manner, no federal nor Maryland estate tax will be payable at the death of the first spouse, unless the surviving spouse elects to do so. By deferring the decision until after the death of the first spouse, the surviving spouse can make a better-informed decision then, based on the facts and circumstances at that time, rather than lock you into a formula now that might be to your disadvantage.

Clients with a taxable estate over $1,000,000 may wish to consider lifetime gifts to minimize, or perhaps even eliminate, the Maryland estate tax. This might make sense in the right circumstances, but there are some significant drawbacks to making lifetime gifts.

First, there is the obvious disadvantage of parting with a substantial portion of your wealth, when that wealth might be needed for your own care down the road. We understand that reluctance. In evaluating this possibility, we would look at whether you have Social Security and pension benefits that would provide a substantial income to you for life, and whether you have (or could obtain) long-term care insurance.

Second, for income tax purposes, most assets get a "step up" in basis for property passing by inheritance, which effectively wipes out any built-in capital gains taxes. This step up in basis does not apply to property acquired by a lifetime gift. If you intend to give away property that has a large built-in gain, the income tax results might tip the scale against making a gift. Although federal capital gains tax rates are at their lowest levels in post-war history, Maryland and its subdivisions tax capital gains in the same manner as ordinary income. If we expect that the donee is going to sell the gifted property, it might not make sense to make a lifetime gift for the purpose of avoiding a 13% Maryland inheritance tax if instead the donee will have to pay total capital gains taxes of 23%.

Third, Maryland allows a dollar-for-dollar credit against the Maryland estate tax for any Maryland inheritance tax payable. The Maryland inheritance tax does not apply to property passing to a spouse, child, grandchild, stepchild, sibling or parent. The 10% Maryland inheritance tax still applies to amounts passing to nieces, nephews, other relatives or friends. If your estate is passing to beneficiaries who are subject to the Maryland inheritance tax, the Maryland estate tax revision will not affect your estate and there would be no tax advantage to making gifts.

If this change to the Maryland estate tax affects you, please call us for an appointment to discuss appropriate measures to address this issue.

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Health Care Privacy Concerns

Back in 1996, Congress passed the Health Insurance Portability and Accountability Act (HIPAA). A major aspect of this law is restrictions, which went into effect in 2003, on disclosure by health care providers and insurers of a patient's/customer's medical information. As a result, you may have experienced difficulty in getting medical information for a family member when calling or talking to their doctor, pharmacy, hospital or health care insurer. Affected health care providers are forbidden from disclosing medical information to third parties without written consent from the patient/customer.

The vast majority of our clients have executed health care advance directives, including an appointment of a health care agent (which we often refer to as a "health care power of attorney"). One client has reported that even Medicare refused to speak with her on her injured husband's behalf until receiving a copy of his health care power of attorney. To insure that your health care agent can effectively deal with your health care providers and insurers when needed, you may wish to provide a copy of the health care power of attorney in advance to your doctor, pharmacy, Medicare, insurance company or other affected health care provider.

Elder Law Corner

Dealing with Alzheimer's Disease

Do you know someone who has been diagnosed with Alzheimer's Disease? If not, there is a good chance that you will know someone afflicted with the disease during your lifetime. According to The Alzheimer's Disease and Referral Center and The Alzheimer's Association, at least 4.5 million persons in the United States suffer from Alzheimer's Disease (AD). Most of those suffering from the affects of AD are over the age of 60. The disease affects approximately 3% of persons ages 65-74 and up to 50% of persons over the age of 85. The cause of AD is unknown and there is no known cure. Unfortunately, the disease is fatal and its effects are irreversible.

AD is one of the most common forms of dementia, a progressive condition marked by deteriorated cognitive functioning (forgetfulness, disorientation in time and place, inability to follow directions, inability to maintain personal hygiene or nutrition, and much more). Because AD affects a person's ability to perform the activities of daily living (eating, bathing, toileting, and dressing), complete 24-hour skilled nursing long-term care is eventually needed. Furthermore, because AD lasts from 3 to 20 years and it's victims require special care, it significantly increases the already high costs of long-term care thereby causing enormous financial hardship in the lives of individuals and their families. In most cases, the financial costs of AD are simply too much for the vast majority of families to handle.

From an estate planning perspective, AD is particularly worrisome because it eventually renders the individual incapable of executing important legal documents. For this reason, if you or a friend or loved one have been diagnosed with AD, it is important to immediately plan for the future if possible (in the early stages of AD, you may still be capable of completing important legal documents) by putting into place or revising your will or trust, executing a general durable power of attorney and advance health care directives, and making sure that assets are properly titled and allocated. These documents will facilitate the orderly and desired distribution of your property, and will provide for the management of your property and health care at the time of your incapacity. Taking these steps will save you and your family time, trouble, and money, and will give you peace of mind going forward.

Planning and evaluating for future eventualities is the key to dealing with Alzheimer's Disease.

With the proper estate planning documents in place, individuals diagnosed with AD should likewise begin to plan for their continuing care throughout the stages of the disease without delay. Independent living, adult day care, home health care, assisted living, and nursing home care options should be completely evaluated and nursing home care plans developed. An evaluation of the individual's financial status and ability to provide for their own long-term health care is a necessity. The Medicaid rules (called Medical Assistance in Maryland) should be discussed in detail including strategies for asset protection and gifting where appropriate.

While the slowly progressive nature of Alzheimer's disease allows time for some individuals with an early diagnosis to plan for its inevitabilities, it matters not what stage of the disease your friend or loved one may currently be going through. Planning and evaluating for future eventualities is the key to dealing with the AD. As knowledgeable elder law and estate planning attorneys, we assist individuals and their families in evaluating all of the issues and information surrounding Alzheimer's and other diseases that families who may be dealing with the disease without the benefit of advanced planning about cause disability and incapacity. We also advise guardianship issues. We provide consultations and evaluations at facilities, your home, or our office.

The Principal Residence and Your Estate Plan

A Quick Clinic

The principal residence often represents the largest asset in an estate. Although the sale of a residence after the owner's death can generate a substantial cash gift for beneficiaries of the estate, in many cases the residence must still serve as the home by one or more survivors. This often is the case when one spouse dies and the surviving spouse needs to remain in the residence. When preparing an estate plan, most married couples intend for the surviving spouse to be permitted to remain at the residence as long as they wish. Planning for this outcome can be tricky and has a unique set of issues to consider. To help you protect this most valued asset, we have summarized some basic concepts in real property. (This is a basic explanation which does not discuss the use of trusts).

The Importance of Title - In Maryland, there are four basic ways in which title to property is held: 1) sole ownership, 2) tenants-in-common, 3) joint tenants with right of survivorship, and 4) tenants-by-the-entireties. Most of us own our homes either as sole owners or as tenants-by-the-entireties (simply, married joint tenants). Married couples who own property as tenants-by-the-entireties are guaranteed the right of survivorship. That means that whichever spouse survives will take sole title to the home by operation of law. A sole owner must direct who takes title after death through a will. If a sole owner has not done so, the property will pass through intestate succession (fractional portions based on survival of a spouse and other heirs).

Probate v. Non-Probate - Although many married couples own their residences jointly (by-the-entireties), it is not uncommon to have one spouse be the sole owner of record. This may not present a problem as much as a choice when preparing an estate plan. If the owner continues to hold sole title to the residence and he/she were to die first, that property would pass through their probate estate. That is not necessarily a good thing or a bad thing, just something to be considered as part of the individual's estate plan. If, however, it is the intention of the owner-spouse to avoid leaving a probate estate, the title of the property must be transferred from sole ownership, either to both spouses as tenants-by-the-entireties, thereby securing title in the surviving spouse and avoiding the probate estate, or by some other arrangement such as a trust or a legal life estate. Transferring title in this manner is a "no-consideration" transfer and can be accomplished with relative ease and little expense.

Troubled Waters: Property Subject to Mortgage - In addition to being our largest asset, the home is also often our single largest source of debt. This has become even more true these days with low interest rates spawning home equity lines of credit, home equity loans, and home equity everything else. It is important to understand that these loans/lines of credit are additional mortgages. That is to say, they are secured by the value of your home above and beyond the outstanding debt on the first mortgage.

When preparing estate plans, it is critical to take any mortgage on the residence into consideration. If a residence passes to a surviving spouse subject to a mortgage and that spouse does not have the means to pay the mortgage, the residence could be lost in foreclosure. This is the worst possible outcome for a decedent who intended for their surviving spouse to remain comfortably in the family home.

1. Pay Off The Mortgage **-** The best way to avoid this outcome is by ensuring the mortgage does not pass to the survivor along with the residence. Below are some basic ways to accomplish that goal.

- *Life Insurance* - The simplest way of protecting your surviving spouse is by ensuring a sufficient amount of life insurance benefits exist to pay off any existing mortgage. The safest choice is purchasing a "whole" life insurance policy as early as possible. These policies will last until the death of the insured, so you don't have to worry about the policy expiring. This is in contrast to the "term" policy which generally has an expiration date. Many people often have life insurance policies through their employers. These policies are almost always "term" policies which expire, or are substantially reduced, upon or shortly after retirement. Remember, when considering life insurance policies, the older you are, the more expensive the premiums.

- *Mortgage Life Insurance* - Another version of the basic life insurance is mortgage life insurance. This is an insurance policy tied to your mortgage. Simply put, whenever the insured individual dies, this policy will pay off the existing mortgage on your home. Many of these policies will even follow the insured from home to home and mortgage to mortgage. Though, as with basic life insurance, the longer you wait to purchase the policy, the more expensive.

- *Ensure Supplemental Assets Exist* - Although this is certainly easier said than done, an individual can direct the mortgage be paid out of their estate. In order to do this, there must be sufficient assets in the estate. These assets must be readily liquid in order to generate the cash needed to pay off the mortgage. For example, if an individual directed their most valuable property be given away as a specific bequest, there may not be enough assets in the residuary estate to pay off the mortgage on the principal residence.

2. Who Is On The Hook? - If these options are not realistic and the property will have to pass subject to the mortgage, also consider that if the mortgage is in one spouse's name, the surviving spouse may or may not be able to assume the existing mortgage. With so much refinancing going on these days and interest rates creeping up from all-time low rates, many of those mortgages are NOT assumable. If that is the case, it would be best to get the other spouse onto the mortgage now to avoid this problem. You will usually have to put the other spouse on the deed as well, if solely owned.

3. Conclusion - Properly arranging your estate plan to protect the principal residence is of utmost importance. But, by understanding the potential problems, you can look at your individual situation and take the necessary steps to ensure the safe passage of your home.

Nobody likes Capital Gains Taxes

The Private Annuity Trust

So, you have made some good purchases over your lifetime. A few stocks, some bonds, maybe even some real property. Those properties blossomed and are now worth a pretty penny. The problem is, that if you sell these properties to finally realize the fruits of your labor, the capital gains taxes will put a sizeable dent in your net value. The private annuity trust may be a good option for you. With this trust, you can "sell" your appreciated property in exchange for an annuity equal to the fair market value of the property plus interest. The trust then makes annual annuity payments to you based on the value of the property sold in exchange for the annuity. The real benefit is that you only pay capital gains taxes on the annual annuity payments. Even though you have effectively sold all of your appreciated property, the capital gains taxes are stretched over the lifetime of the annuity. Although your gains are also stretched out, you have secured a steady annual flow of income and avoided paying large up-front capital gains tax. In addition to recovering the principal value of the property through annuity payments, you are earning interest on the principal, thereby increasing your overall net cash flow with this trust as opposed to selling the property outright.