Tax and Business Law Report

A Newsletter from the Tax & Corporate Practice Group

FLASTER GREENBERG

ATTORNEYS AT LAW • A PROFESSIONAL CORPORATION

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Medicaid Planning Technique Eliminated

By Elaine J. Petruzziello

Elaine J. Petruzziello

Medicaid is a joint federal and state program that pays for long-term health care services for the aged and disabled with low income and few resources. One of the most important and well known benefits provided for eligible recipients by Medicaid is nursing home care. The Medicaid applicant who needs nursing home care (the "applicant spouse") must qualify by meeting both an income and a resource test. This often engenders planning for such contingency by "spending down" assets over the resource limit. Indeed, attorneys and accountants routinely assist their clients with strategies designed to allow the applicant spouse to qualify for Medicaid without impoverishing the spouse who does not need the care (the "healthy spouse").

Medicaid looks at the resources of the applicant and healthy spouses and categorizes them as "available" or "exempt." Generally, the applicant spouse can retain only $2,000 of available resources, plus any exempt resources. Recognizing the ongoing needs of the healthy spouse who continues to reside in the community, both federal and New Jersey Medicaid Regulations (the "Regulations") permit the healthy spouse to retain a portion of the couple's available assets (the "Community Spouse Resource Allowance" or "CSRA") to meet those needs. In addition, prior to the revisions in the New Jersey Medicaid Regulations, Medicaid planning often entailed transferring assets above the CSRA to commercial and private annuities or to a community spouse annuity trust ("CSAT") established to further benefit the healthy spouse. If properly structured, the annuity payments could be provided to the healthy spouse, and assets used to purchase annuities or establish the CSAT were deemed to be *unavailable* for purposes of Medicaid eligibility of the applicant spouse. This technique greatly reduced the amount required to be "spent down" in order to qualify for Medicaid and simultaneously preserved assets for the benefit of the healthy spouse. *See*, Health Care Financing Administration ("HCFA") Transmittal 64 (1994) and 42 U.S.C. 396p(c)(2)(B)(i).

Even though New Jersey had initially permitted CSATs after HCFA Transmittal 64 was issued in 1994, New Jersey changed its policy in mid-July 1999 indicating that CSATs were deemed to be "available resources." New Jersey invited spouses with pending applications and assets in excess of the resource limit at that time (when the CSAT became counted as an available resource) to convert the CSAT into an unavailable resource, by changing it to a commercial annuity and

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Editor's Note...

Richard J. Flaster

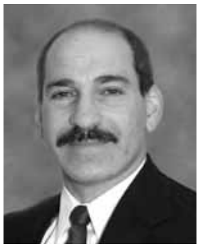
As the services required of our Corporate Practice Group expands, we continue to search for candidates with exceptional credentials and experience in tax, corporate and estate planning to join our firm and enhance the capacity of this department. Your referral of suitable candidates would be appreciated and can be sent to my attention at Rick.Flaster@flastergreenberg.com.

Again, with the objective of broadening our base of readership, we are still planning to turn to e-mail transmission of this Report rather than distributing copies by mail. ***If you provide us with your e-mail address and the e-mail addresses of colleagues who would be interested in receiving Tax and Business Law Report, we would be pleased to include that information in the newsletter's database. Please send that information to me at Rick.Flaster@flastergreenberg.com.*** ◆

In This Issue. . .

Notice to IRS of Taxpayer's Last Known Address

By Alan H. Zuckerman



Alan H. Zuckerman

Whenever the IRS is required to send notices to a taxpayer, it must send it to the taxpayer's "last known address," and the taxpayer is then deemed to have received the notice. In a recent case, the Tax Court held that the taxpayer's filing of Form 2848 Power of Attorney (authorizing his new accountant to represent him before the IRS) put the IRS on notice of the new address and became the taxpayer's "last known address." *Hunter v. Comm.*, T.C. Memo 2004-81 (3/23/2004).

Based on this conclusion, the Tax Court dismissed a deficiency against the taxpayer, because the IRS did not send the notice of the deficiency to the address of the taxpayer as listed on the Form 2848.

Observations:

- Other federal courts have reached similar results with respect to a taxpayer's address as set forth on a Form 2848 Power of Attorney. See *Rizzo v. Davis*, 43 AFTR 2d 79-985 (W.D.Pa. 1979) and *Johnson v. Comm.*, 45 AFTR 2d 80-775 (5th Cir. 1980).
- To avoid this issue, the taxpayer should file a Form 8822 (which is the official IRS form for notifying the IRS of the change of address) whenever the taxpayer changes addresses. ◆

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naming the State as a remainder beneficiary upon the death of the healthy spouse. However, in a recent case, a Medicaid applicant declined the invitation and sued the State's Commissioner of the Department of Human Services. He lost at the trial level, with the Court upholding the State's rejection of the CSAT as an unavailable resource. *Johnson v. Guhl*, 91 F Supp 2d 754 (D.N.J. 2000). Now, the Third Circuit has upheld that lower court decision, finding that even though the CSAT is an irrevocable trust, which provides a stream of payments to the healthy spouse, the healthy spouse is not prevented from sharing those payments with the applicant spouse, and this makes the payments available resources for the applicant spouse. *Johnson, et al. v. Guhl* (3rd Cir., No. 01-3774, 2-6-04).

Observations

- The CSAT has been eliminated as a Medicaid planning technique in New Jersey.
- The budget crisis atmosphere prevalent in New Jersey for the past few years has prompted the State to look at every opportunity to expand the scope of the applicant spouse's "countable resources" for purposes of determining Medicaid eligibility. Further, in recent revisions to the Medicaid Regulations, the State has also eliminated the commercial and private annuity Medicaid planning technique, by treating these annuities as available resources (on the rationale that such annuities can be sold on the secondary market and converted to cash).
- Despite the elimination of these techniques, Medicaid planning can still save thousands of dollars if undertaken far enough in advance of needing Medicaid benefits. ◆

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Tax Basis Differences on Insured Stock Buyout for Cash vs. Accrual S Corporation

By Richard J. Flaster

Richard J. Flaster

If life insurance is utilized for an S corporation's buy/sell redemption arrangements, receipt of the insurance proceeds will create a new tax basis position for the remaining shareholders, with the magnitude of the difference dependant upon several factors, including whether:

- The agreement provides for stock ownership to be effectively terminated as of the date of death or upon the date of the actual physical transfer of the stock;
- The corporation closes its books on the date of transfer pursuant to a Code §1377(a)(2) election or allocates income and loss on a proportionate *per diem* basis;
- The corporation uses the cash or accrual method of accounting; and/or,
- The shareholder died early or late in the taxable year.

Cash Basis Taxpayer: If the corporation is on the cash basis method of accounting and the agreement provides that shareholdings become effectively redeemed by the corporation as of the *date of death* of a shareholder (even though the mechanics of transfer are inevitably deferred), this should preclude the shareholder's estate from sharing in post-death allocations of pass-through items giving rise to either taxable income or basis increase.

As a cash basis taxpayer, it seems that the *date of collection* of the insurance proceeds will govern the date that will determine income or basis-increase arising from the receipt of the insurance proceeds. If the corporation and shareholders consent to an "interim closing of the books" as of the date of death under Code §1377(a)(2), then the later receipt of the insurance proceeds by a cash-basis corporation should cause any income or basis-increase engendered by the insurance proceeds to be allocated solely to the post-death period and, hence, only to the surviving shareholders.

Accrual Basis Taxpayer. In contrast, a recent Private Letter Ruling has confirmed that if the S corporation is an accrual basis taxpayer, the right to the insurance proceeds accrues as of the *date of death* (viz., when the right to the insurance benefit becomes fixed and certain). This date controls whether income or basis increase resulting from receipt of insurance proceeds must be allocated to the pre-death period. Presumably, it would then be allocated between the deceased and surviving shareholders on the basis of their relative proportions of shareholdings as of that date. Further, if the corporation and shareholders do not elect an interim closing of the books, then the items of income and basis-increase will be allocated on a *pro rata per diem* basis throughout the year.

...the items of income and basis-increase will be allocated on a pro rata per diem basis throughout the year.

Observations:

- ***For a cash basis S corporation:*** To maximize the increase in basis to the surviving shareholders in an insurance-funded redemption that is effective as of the date of death, the election of an interim closing of books should cause the entire basis-increase resulting from the insurance to be allocated to the surviving shareholders. (This result should be generally equivalent to that achieved in a cross-purchase arrangement.)
- ***For an accrual basis S corporation:*** To maximize the increase in basis to surviving shareholders in an insurance-funded redemption, do not elect the interim closing of books. Otherwise, the *pro rata per diem* allocation method will allocate more of the resulting basis-increase to the surviving shareholders, particularly if the deceased shareholder died early in the corporation's taxable year, so that the post-death period comprises a greater proportion of the full year than the pre-death period.
- ***Query:*** Is the basis allocated to the *deceased shareholder* absorbed by the usual basis-step-up procedures of Code §1014 and thus wasted? It would seem so. However, to the extent it is allocated to the *estate of the deceased shareholder*, such basis-increase should result in a capital loss to the estate. ◆

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