



Richard K. Newman
CPA/PFS, AEP
Director and Founder



Donald T. Cohen
CPA
Director and Founder



Jeremy Bloom
Director of Business
Development

Not a Good Time for Aggressive Asset Protection and Tax Planning

The French writer Antoine Rivarol was once quoted as saying that “the only thing wealth does for some people is to make them worry about losing it”. This concern may be at an all time high. There has been a perfect storm of events that have occurred over the past few years that has made many wealthy individuals very concerned about losing what they have. We’ve seen financial scandals and ponzi schemes where families have lost millions of dollars, and we’ve seen the meltdown of financial institutions that once seemed impervious to hard times. There have been dramatic losses in the stock markets and real estate values have plummeted nationwide. To add to these financial and economic woes, we have the real risk of higher federal income tax rates, especially for the wealthy, and the federal estate tax, once rumored to be dead, is suddenly very much alive. It’s no wonder many affluent clients are looking for ways to protect their assets from potential creditors and taxation. While there are many strategies available to do this, some are more aggressive than others. And the IRS has taken notice.

The IRS has taken a number of steps to curb tax evasion by the wealthy. In October of 2009, the IRS announced the creation of the Global High Wealth Industry Group which will target high net worth individuals. The concern expressed by the IRS is that these individuals use more sophisticated arrangements to hide income and the agents currently tasked with auditing these returns do not have the experience necessary to discover abuses. This new team will be staffed with more experienced agents dedicated to reviewing these tax returns.

Another step taken by the IRS has been their voluntary disclosure program for taxpayers with undisclosed foreign bank accounts which began on March 23, 2009. For those taxpayers who voluntarily came forward, the IRS agreed to reduce the penalties associated with unpaid taxes on off-shore accounts, limit the tax years they

would review (only 2003 through 2008), and most importantly, not recommend criminal charges to the Department of Justice.

Douglas Shulman, the Commissioner of the IRS, stated that participation in the amnesty program was nearly double the agency’s estimates with over 14,700 taxpayers coming forward to disclose off-shore accounts. Shulman stated that “we were flooded with people coming in the final days of the program”. Possible criminal charges related to tax returns include tax evasion (26 U.S.C. § 7201), filing a false return (26 U.S.C. § 7206(1)) and failure to file an income tax return (26 U.S.C. § 7203). Those who do not report foreign accounts may face criminal charges for each year their tax return failed to disclose the accounts. Shulman also stated that even though the program has ended they are still encouraging taxpayers with undisclosed foreign accounts to step forward claiming that “it will be much worse for them if we find them first”. The program ended on October 15, 2009.

In addition to being faced with a more inspired IRS, wealthy clients are also facing proposals for higher federal income taxes and the revival of the federal estate tax (if indeed it does leave us for a year in 2010). Considering the price tags of two ongoing wars, government bailouts, possible healthcare reform, and a substantial decrease in federal tax revenue, the only question appears to be *how* our taxes are going to increase, not *if*. And wealthier clients are in the cross-hairs. This only increases their desire for asset protection and tax saving strategies. While that desire appears to be strong today, it does not appear to be a good time for

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untested aggressive strategies. It appears now, more than ever, we should be getting back to the basics by recommending well established strategies. There are many ways to utilize trust agreements (such as domestic asset protection trusts), asset reallocation strategies (joint accounts) and statutory exemptions on assets (such as

personal residences, life insurance and annuities) to accomplish our clients' goals. Combining these strategies, like funding a spendthrift trust or beneficiary controlled trust with life insurance, can create substantial protection from creditors and taxation without the risks that are associated with more aggressive planning.

Appeals Court Confirms Treatment of Medicaid Compliant Annuities

The Deficit Reduction Act of 2005 established that a married couple may gain immediate eligibility for Medicaid by utilizing an annuity that complies with the provisions of that law. So-called Medicaid Compliant Annuities are not treated as an "available resource" for Medicaid purposes, they are treated as income. This allows the spouse who is not institutionalized to receive income while continuing to have the institutionalized spouse qualify for Medicaid benefits. The United States Court of Appeals for the Third Circuit recently confirmed this treatment in [*Weatherbee v. Richman*](#) (3d Cir., No. 09-1399, Nov. 12, 2009). The court stated that:

"42 U.S.C. § 1396p generally governs the transfer of assets by Medicaid applicants and their spouses. We find that the District Court properly stated that the changes brought about by the Deficit Reduction Act are not ambiguous and must be read within the larger context of the longstanding rule that community spouse income is not available to an institutionalized spouse. 42 U.S.C. §1396r-5. Therefore, contrary to the Department's interpretation, §1396p(e)(4) cannot be regarded as a basis by which it may deny eligibility for benefits where the annuity otherwise complies with the law. In this case it is clear that the community spouse gave up a "resource" in exchange for a guaranteed "income," as it is defined in 42 U.S.C. §1382a(2)(B). Moreover, the Department of Welfare's assertion that the annuity is a resource because it could be sold on a secondary market is fundamentally flawed. As we stated in a prior decision, impediments to a transfer that may incur legal liability for the owner of the asset preclude consideration of that asset as a resource. *James v. Richman*, 547 F.3d 214, 218 (3d Cir. 2008)."

In order to qualify as Medicaid Compliant Annuity, the annuity must either be funded with IRA or qualified retirement plan assets, or be an irrevocable, nonassignable annuity that is actuarially sound and provides for payments in equal amounts with no deferral and no balloon payments. 42 U.S.C. §1396p(c)(1)(G). In addition, the State must be named as beneficiary in the second position (i.e. remainder beneficiary after the community spouse or minor or disabled child) and named in the first position if such spouse or a representative of such child disposes of any such remainder for less than fair market value. 42 U.S.C. §1396p(c)(1)(F).

Happy Holidays from all of us at Newman + Cohen!

For questions or comments please contact (800) 966-9306

Richard Newman – ext. 2

Donald Cohen – ext. 1

Jeremy Bloom – ext. 8060

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