[[

FINANCIAL PLANNING FOR THE THIRD MILLENNIUM

VOLUME II

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PART I

INDIVIDUALS ENGAGED IN BUSINESS

This section of the book is for those persons who are or will be engaged in business. Obviously, one of the best ways to make money is to earn it. There are, in practice, only three legal ways to earn money: working for others, working for yourself or winning a lottery. Only the first two methods are dependable and, as to them, there are benefits and drawbacks with each.

As an employee, a person has the stability of knowing that fixed paycheck will be coming in each week. The drawback is that the employee does not share in the profits of the business and does not have the time to form his business. In contrast, a person in business for himself shapes his own destiny. No money is earned unless the person earns it himself. When no client comes into the office for advice or services, the lawyer does not earn any money. At that point, five degrees do not earn the money that a hamburger flipper with McDonald's makes. A self-employed business, however, has the opportunity to make more money annually than a salaried employee doing the same work. In addition, a self-employed person can set the hours, goals and objectives because he owns the business. A person who decides to go into business for himself or with others is to be congratulated.

CHAPTER 1

PARTNERSHIPS

Two or more people who are not married to each other and wish to conduct a business together have only three options available in structuring the business. They may incorporate and operate as a corporation, they may operate as a partnership or they may form a limited liability company. Corporations are discussed in the next chapter followed by the chapter on limited liability companies.

Partnerships are used because they are simple. A partnership is not required to be in writing to be legal; although it makes a great deal of sense to have it in writing. Partnerships are usually created between family members or close friends. There are two types of partnerships: general partnerships, which are discussed in this chapter, and limited partnerships, which are discussed in Chapter 10.

While general partnerships are simple to form and operate, that does not mean they are unregulated. On the contrary, a complete body of partnership law has been developed both by case law and statutory law. The rights and obligations of partners and those persons dealing with partnerships are covered by a state's general partnership law in the absence of written agreement of the partners to the contrary.

This chapter is intended to educate the reader about the differences between partnerships and corporations, but, most importantly, it is intended to raise the awareness of what is legally required of persons doing business in the form of a partnership. It is important that anyone considering the possibility of forming a partnership possess a good understanding of the rights and obligations that arise from a partnership arrangement.

I. THE UNIFORM PARTNERSHIP ACT

The National Conference of Commissioners on Uniform State Laws wrote the Uniform Partnership Act (UPA). The Act has been adopted by every state except Louisiana. The UPA provides the rules on how a partnership is to operate when the partnership agreement does not have sufficient detail: the UPA fills in the blanks in a partnership agreement. The partners can agree not to use the UPA provisions. They can write their own replacement provisions if they elect to do so.

II. DEFINITION

A partnership is two or more persons or entities working together as co-owners to run a business for profit. The Internal Revenue Code defines a partnership in Section 761(a) as:

> "a syndicate, pool, joint venture or other unincorporated organization through which...any business is carried on...and is not a corporation, trust or an estate (meaning sole proprietorship)."

A partnership may be formed by a written agreement, or it may be formed by an oral agreement of the parties. The factors that determine if a partnership exists are:

1. Whether the parties intend to form a partnership, and
2. Whether they intend to make a profit from the activities.

Once the foundational elements of a partnership are met, the partnership is formed and governed either by the terms of the written agreement or the UPA or (in the case of Louisiana) its own state partnership law.

A joint venture is a partnership that was created to accomplish a narrow purpose. Most partnerships exist to make a profit while engaging in a particular type of business. A joint venture seeks to make a profit usually on a one-time basis. The joint venture automatically terminates when the purpose of the partnership is completed. An example of a regular partnership is where two persons form a cement- paving company. An example of a joint venture is where two persons agree to work together to pave just one job. A joint venture, as with a regular partnership, is governed by the partnership law of the state where it is formed. Like any partnership, the agreement should be in writing or else its provisions will be set by the state. Except for the limited purpose of the joint venture, it has the same issues, problems and elements of a regular partnership.

III. TAX TREATMENT

Partnerships are treated for federal tax purposes as "pass-through" vehicles. All profits and losses of the partnership pass through the partnership and are attributed to the partners. The effect of this pass through of profits and losses is that the partnership itself is not taxed. Partnership income is not subject to double taxation as is the income of a regular C corporation. To achieve this same tax benefit for small corporations, Congress created the S Corporation.

The partnership does not pay any taxes on the income from the partnership. All partnership profit and loss is passed through to the partners. The partnership files its Form 1165 partnership return and its K-1 to inform the IRS how the profit and loss is being allocated to each partner. Each partner is treated for tax purposes as a self-employed individual. Each partner is required to estimate his share of the partnership income and make estimated quarterly payments to the IRS.

Under the 1986 Tax Reform Act, profits and losses passing through to partners retain the same character they had in the partnership. A passive profit or loss to the partnership remains a passive profit or loss to the partner. The same treatment exists for an active profit or loss. A partner who materially participates in the partnership business will receive his portion of the attributed profits and losses and declare them "active" for tax purposes. A partner who does not actively participate in the partnership business will likewise receive all of his share of the profits and losses and will declare them "passive."

Generally a joint venture is treated the same as a partnership for tax purposes. There are certain Internal Revenue Code differences or elections, however, that pertain only to joint ventures:

1. The joint venture, like a partnership, must file an informational return except for certain real estate joint ventures.
2. The joint venture makes tax elections for computation of its taxable income.
3. The joint venture can adopt its own tax year but it must have I.R.S. permission to use a tax year different from any principal partner.
4. A joint venturer, one of the partners in the joint venture, may enter a business transaction with the joint venture and be treated as an outsider for tax purposes.
5. The members of the joint venture may elect to be excluded from some or all of subchapter K of the Internal Revenue Code (which defines how partnerships are taxed) if the joint venture is basically a passive investment .

The above tax aspects of joint ventures give them a better degree of flexibility than general purpose partnerships.

IV. PARTNERS' LIABILITY FOR PARTNERSHIP DEBTS

The main drawback to any general partnership is the fact that the partners are personally liable for the debts of the partnership. By forming a partnership the partners have agreed to guarantee payment of any debts or judgments taken against the partnership. Partners are not liable for the personal non-partnership related debts of the other partners.

Under the Uniform Partnership Act the partnership (and thus the partners) are liable for "any wrongful act or omission of any partner in the ordinary course of the business of the partnership. Where loss or injury is caused to any person by the partnership, the partners are individually liable for payment of the damages. In addition, the partners are liable for money damages that arise from the actions of any partnership employee or the other partners during the course of their work for the partnership. Example: A partner is involved in a car accident and kills two people while engaging in partnership work. All of the other partners will be liable to pay the damage award that the heirs of victims receive in wrongful death action against the partnership. If the award is $1,000,000 and the partnership only has assets of $200,000, a personal judgment will be taken against each partner for $800,000.

This is the main drawback of the partnership. The general rule of thumb is if a partnership is formed and it has employees, the partners should either carry a great deal of insurance or incorporate. Either of these entities will carry their individual personal liability for the partnership's debts.

V. FIDUCIARY DUTIES OF PARTNERS

By law each partner is an agent of the partnership. Each partner owes fiduciary duty to the partnership and to the other partners to act in their best interests. Some of the most important things that partners cannot do are:

1. A partner may not usurp a partnership benefit. This means that a partner must give the partnership the right of first refusal on any business opportunity he discovers that may benefit the partnership. Example: The partnership is in the paving business, and a partner finds that a school is intending to repave its parking lot. The partner cannot bid on the job for himself without first informing the partnership of the job and giving the partnership the option of bidding.
2. A partner may not divert partnership assets for his own personal use. Such conduct is a breach of trust and may even expose the partner to criminal liability.
3. The partner must fully disclose all material facts affecting the partnership and its affairs to the other partners.

A partner who breaches any of these duties may be sued by the other partners for their lost profits or other damages suffered as a result of the partner's misconduct. If a partner usurps a partnership benefit, he may be ordered to pay all of the profits realized from the transaction to the partnership on the theory that the partnership should have received it.

VI. AUTHORITY TO ACT FOR PARTNERSHIP

In a general partnership each partner has full authority to act on the partnership's behalf in the normal course of its business. Each partner can bind both the partnership and the other partners to contracts that the other partners never authorized or approved. This unlimited power on the part of one partner to bind the partnership and the other partners is the biggest concern of most investors. The partners may agree to limit their authority to bind or act on behalf of the partnership.

People dealing with a partnership are entitled to assume that any general partner has the right and power to act for the partnership in the normal course of its business. Even though a partner may actually have limited authority to act for the partnership, the apparent authority of the partner may nevertheless bind the partnership to contracts with third parties. Contracts entered with people who did not actually know the partner lacked authority are binding on the partnership.

Moreover, there are some acts that a general partner can never do unless the authority is specifically granted in a partnership agreement. Anyone dealing with a partner is presumed to know that he cannot execute a valid contract in these special areas unless the partnership agreement gives him the specific authority to act.

The Uniform Partnership Act states the following acts are invalid and not binding on the partnership unless the partnership agreement expressly states that a partner has the authority:

1. Transfer of a partner's interest to another.
2. Conveyance of partnership property.
3. Mortgaging of partnership property.
4. Confession of a judgment against the partnership.

5. Submission of partnership claim to arbitration.
6. Performing any act that would make it impossible to continue the business of the partnership.

Anyone dealing with a partnership should always ask to review the partnership agreement to assure himself the partner executing the contract does indeed have authority.

VII. CONSIDERATIONS BEFORE DECIDING TO FORM A PARTNERSHIP

Before forming a partnership, the parties should consider the following issues and decide for themselves how they should be addressed:

1. Name of the partnership.
2. Term of the partnership.
3. Purpose of the partnership.
4. Scope of objective: joint venture or partnership.
5. Capitalization: funding the partnership.
6. Distribution of profits and losses.
7. Admission of new partners.
8. Expulsion of old partners.
9. Withdrawals of contributed assets.
10. Expense accounts.
11. Salaries and draws of income by partners.
12. Responsibilities of partners.
13. Dissolution of the partnership.
14. Staffing and management.
15. Comparison with the alternative of incorporating.

16. Extent of possible personal liability for partnership debts.

These are important considerations. They are not the only ones. Each partnership is different because each is composed of different people with different viewpoints. What must be remembered is that anything not covered in the partnership agreement will be decided in accordance with the state's Uniform Partnership Act. If the partners do not want the UPA to apply on a particular point, they must expressly create their alternative provision.

VIII. RIGHTS OF THE PARTNERS

All partners have certain basic rights in a general partnership. These rights are:

1. To insist on a partnership accounting. Along with this right is the right to have the books examined by an outside accountant.
2. To dissolve the partnership in accordance with the terms of the partnership agreement or the Uniform Partnership Act of the state.
3. To restrain the partnership from performing acts prohibited under the partnership agreement.
4. To bring legal action for breach of the partnership agreement.

These are implied rights in any partnership agreement. Provisions in partnership agreements that waive such rights are usually found to be invalid and against public policy.

IX. PROFITS AND LOSSES

One of the most important issues in any partnership is how profits and losses are divided. After all, the partners formed the partnership in order to conduct a business to make money. Therefore, it is important to know the manner of accounting and distributing partnership profits and losses.

Under the Uniform Partnership Act all profits and losses of a partnership are divided equally among the partners. The equal division of profits and losses occurs even if the partners own unequal interests in the partnership or have contributed unequal amounts of work or property to it. The partners can agree to an unequal division of profits and losses. Unequal divisions are usually based on partnership ownership interests or contributions. Any agreement for an unequal division of profits and losses should be detailed with particular clarity in order to make clear that the UPA does not apply.

X. PARTNERSHIP PROPERTY

Under the Uniform Partnership Act property which is titled in the partnership name is owned by the partnership. A partner who contributes property to a partnership gives up ownership in the property. Likewise, property purchased with partnership funds is owned by the partnership. The property held by a partnership can be legally sold, transferred or conveyed only by the partnership. Since partnership property is owned by the partnership, it cannot be directly attached to satisfy any court judgment against a partner. A partner's ownership interest in a partnership can be attached and sold by a creditor, but not the underlying property in the partnership.

XI. ADDITION OF NEW PARTNERS

The Uniform Partnership Act requires unanimous consent of all partners before the admission of new partners. Unless the partnership agreement has a clause to the contrary, the UPA requirement controls, and the admission of new partners requires unanimous consent. Requiring unanimous consent makes sense. If unanimous consent is not required, new partners can be added over the objections of existing partners who would not be in the partnership had they known the identity of the new partners. The personal liability of each partner being at risk, it is essential that each retain the right to select whom he will share this responsibility.

Under the Uniform Partnership Act a new partner is liable for the partnership debts incurred before becoming a partner only to the extent of the amount of his contribution to the partnership. The partner is liable, as any partner, for all of the partnership debts incurred after becoming a partner. Example: George joins an existing partnership which owes $200,000 in debts. George contributes $50,000. After he joins, the partnership adds another $100,000 to its debt. George is liable for $150,000 of the total partnership debt: $50,000 of the pre-existing debt plus $100,000 debt after joining. The other partners are liable for the whole

$300,000.

XII. TAX EFFECT OF CONTRIBUTING PROPERTY TO A PARTNERSHIP

A tax consideration that all persons forming a partnership should bear in mind is the tax consequence of contributing services for an equity interest in the partnership. Under federal tax law a partner has to recognize as income the value of partnership interest purchased by services rendered or to be rendered. A person cannot acquire a partnership tax free by bartering services. Example: George agrees to become a partner by providing services. The partnership interest acquired will be worth $10,000. George will have to report the $10,000 as income on his tax return.

The tax consequence of purchasing a partnership interest with services may result in the transaction not being financially worthwhile personally. Often those who contributed services and perhaps some money resent the partner who contributed only money. In a successful partnership it is common for the partner who contributes most of the work to feel slighted when a partner who does less but who contributed the start-up capital receives a bigger share of the partnership by virtue of that capitalization.

XIII. ASSIGNABILITY OF THE PARTNERSHIP INTEREST

Generally, a partner may freely sell or convey his interest in the partnership unless the partnership agreement says otherwise. If the other partners do not approve of the transfer, they can usually dissolve the partnership. The remaining partners do not have to dissolve the partnership if they object to the transfer.

The Uniform Partnership Act protects the remaining partners by authorizing them to restrict the rights of the new partner. The remaining partners may continue partnership operation as before but not accord the new partner all of the rights of a full partner. Example: The new partner could have the right to receive the selling partner's share of profits but be prohibited from demanding an accounting or inspecting the partnership books or participating in management of the business.

XIV. EXPULSION OF A PARTNER

Partnerships which have a large number of partners sometimes have a provision in the partnership agreement which permits the expulsion of a partner without the dissolution of the partnership. Expulsion clauses in partnership agreements are valid if they exist to protect the partnership from harm caused as a result of the expelled partner's breach of the partnership agreement or fiduciary duties.

The procedure for the expulsion must be in the partnership agreement. An expulsion is obviously against the wishes of the expelled partner. Therefore, the courts will narrowly construe an expulsion clause to determine if it violates state law or is otherwise against public policy.

XV. TERMINATION OF A PARTNERSHIP

Termination means that business is no longer being carried on by the partnership except to the extent necessary to discharge its affairs. A partnership will one day end. It is not like a corporation that has perpetual existence. The partnership agreement usually lists the conditions under which a partnership will terminate. A partnership agreement may have a clause in it stating that the partnership will terminate:

1. When the partnership purpose is accomplished (in a joint venture).
2. On a certain date stated in the partnership agreement.
3. If a partner becomes insolvent or bankrupt. Under the Uniform Partnership Act when a partner files for personal bankruptcy, the partnership is automatically terminated even though the business may itself be solvent. When a partner goes bankrupt, the relationship with the partnership and the other partners changes. By filing for bankruptcy protection, the filing partner is no longer liable for the partnership debts. The liability for payment of partnership debts remains with the partners who did not file bankruptcy. It is this general release of liability for the partner filing bankruptcy that gives rise to the termination of the partnership. The partners can agree not to have the partnership dissolved automatically upon the bankruptcy of a partner by a provision in the partnership agreement. Unless the partnership agreement states otherwise, the UPA will apply, and the partnership will be terminated upon the bankruptcy of a partner.
4. If a partner dies or becomes disabled.
5. If any partner withdraws from the partnership.

Without a clause in the partnership agreement stating otherwise the law is that a partnership terminates on the death of a partner or upon a partner's resignation.

Under the Uniform Partnership Act a court may order dissolution of a partnership for the following reasons regardless of specific clauses in the partnership agreement stating otherwise:

1. A partner has been found insane by a court.
2. A partner is incapable of performing his duties under the partnership agreement.
3. A partner's conduct has prejudicially affected the ability of the partnership to carry on its business.
4. A partner has repeatedly breached the partnership agreement.
5. The partnership can only do business at a loss.
6. Equitable reasons support the dissolution.

A lawsuit seeking termination on any of these grounds will be difficult and costly to prove. An alternative is for the partnership agreement to have an expulsion provision permitting expulsion of a partner for any of the above six reasons.

Termination of a partnership is accomplished in three steps:

1. The decision to terminate is made either by the partners or by law through the application of the provisions of the Uniform Partnership Act.
2. The existing business of the partnership is discharged. Under the Uniform Partnership Act each partner remains liable for the debts of the partnership incurred during discharge of the partnership affairs.
3. The final cessation of business, the payment of creditors, taxes and final division and distribution of the remaining assets to the partners takes place.

After a partnership has been dissolved and its assets liquidated, the distribution is made as follows to the extent of partnership assets:

1. All federal and state taxes are paid.
2. All employee wages and benefits are paid.
3. All secured liabilities are paid.
4. All unsecured liabilities are paid.
5. Remaining funds are divided among the partners in accordance with their percentage of ownership interest in the partnership.

The proceeds received by a partner in the dissolution of a partnership are a return of the partner's investment. Any gain or loss in the dissolution is treated as a capital gain or loss. For example, assume that a partner paid $4,000 for stock and got back $3,000. The partner had a $1,000 capital loss. Likewise, if the partner received $6,000, he would have to recognize a $2,000 capital gain.

Depending on the complexity of the partnership business, termination may be quick, or it may be a long and involved process. Until the partnership is fully terminated, the individual liability of the partners continues. If at the time of termination the partnership does not have enough assets to pay all of its debts and liabilities, the partners must pay the remaining balance. Under the Uniform Partnership Act if the partnership is insolvent along with the some of the partners, the remaining solvent partners must pay all of the outstanding debts and liabilities of the partnership.

Example: The partnership owes $2,000,000 with assets of only $1,000,000, and three of the four partners are insolvent. The remaining partner, who may only own 10% of the partnership, must nevertheless pay the entire $1,000,000 outstanding debt of the partnership. It is to allay this possibility that the UPA states a partnership is dissolved when a partner files for bankruptcy protection.

The Uniform Partnership Act states that a partnership does not pay interest on a partner's share of proceeds under a dissolution except for time "after the date when repayment should have been made." In other words, if the partnership is late in making a distribution after the dissolution, it must pay interest for the time of the delay. As with most provisions of the UPA, the partners can make an agreement not to have this provision apply. Moreover, the partnership agreement can require the partnership to pay interest on a partner's distributed share from the date the dissolution plan is adopted rather than the date the distribution could be made.

XVI. TAX TREATMENT OF CONTRIBUTED PROPERTY

A partner who contributes property to a partnership does not recognize gain or loss on the transfer to the partnership. Example: A partner contributes real estate to the partnership which has a basis (cost) of $200,000 to the partnership. The property has a fair market value of $1,000,000. If the partner had sold the property, he would have paid capital gain on the $800,000 profit. By contributing the property instead, the partner does not realize any capital gain. The partnership, which receives the property, will have the contributing partner's basis in the property, not its fair market value at the time of transfer. When the partnership sells the property for $1,000,000, there will be a capital gain to the partnership of $800,000, which will be passed to the partners.

XVII. COMPARISON WITH A SUBCHAPTER S CORPORATION

A partnership is subject to its own peculiar tax treatment under federal tax law. Most unincorporated associations and trusts that conduct business are taxed as though they were corporations. Partnerships, however, are treated differently. In a partnership the income is attributed to the partners according to their percentage of partnership interest. The partnership pays no income tax itself on the federal level. Example: A partnership earns $1,000,000. It will pay no taxes. Each partner will include his pro rata share of the $1,000,000 on his personal tax returns. Assuming a 28% federal tax rate, the partners will pay a total of $280,000, not the total $519,200 that a C corporation and its shareholders must pay.

An S corporation is a corporation that is allowed to pass its income to the shareholders. In that respect, it resembles a partnership. The major differences between a partnership and an S Corporation are:

1. Partnerships may admit anyone as a partner and may have

any number of partners; whereas S corporations are limited to 35 members of special status.

2. Partnerships can divide profits and losses in a manner not related to the partners' ownership interests. By contrast S corporations must divide profits and losses among the shareholders according to their percentage of stock ownership. In most cases these differences are not important because the S corporation usually does not want additional shareholders and does want profit and losses allocated according to shareholder investment.

3. Partnerships thrust personal liability onto each partner. The most important difference between S corporations and partnerships is that there is no personal liability on the part of the shareholders for the corporation's debts. By comparison, the general partners (but not limited partners) have personal liability for the partnership debts.

Persons considering doing business as a partnership should weigh the relative merits of both a partnership and an S corporation and elect the one that best suits their type of business.

XVIII. FICTITIOUS NAME

Most states require a partnership to file a fictitious business name if they are doing business with the public. All states require a partnership doing business under a name other than its own to file a fictitious business name statement. The purpose of a fictitious name statement is to give notice to the world concerning who actually is running the business. Usually the filing is in the county clerk's office where the business is run under the fictitious name. If the partnership does business under a fictitious name in several counties, the filing must be in every county where it does business.

XIX. A FEDERAL IDENTIFICATION NUMBER

Any employer is familiar with the federal identification number (FIN). All employers are required to have one. A sole proprietor who has no employees is not required to have an identification number because his social security number is used instead. Once a partnership is formed, it needs an identification number because the partnership is also an employer.

A federal identification number is obtained by filing Form SS-4 with the IRS. It should be filed as soon as possible after the partnership is formed. A sole proprietor who joined a new partnership will need a new identification number. The old number used by the sole proprietor in the previous business will not transfer to the new partnership.

XX. TAX WITHHOLDING

When a new partnership is formed, all of the partnership's employees are required to fill out new W-4 forms (Employee's Withholding Exemption Certificate). Everyone, except the partners, who receives compensation for work is an employee and is required to fill out the W-4 form. Since the partners are owners of the partnership and have to make estimated payments every quarter on their earnings, they are not required to fill out W-4 forms.

As an employer, the partnership must withhold federal income tax and social security tax along with all mandated state withholding from the salaries of employees. These taxes are withheld and reported on a calendar year basis regardless of the tax year of the partnership. The returns for the tax withholding and the deposits are submitted to the IRS on a quarterly or more frequent basis.

The amount withheld from an employee's paycheck by the partnership is based upon the employee's wage level, marital status and the number of allowances claimed on the W-4. The Internal Revenue Service will provide the partnership with information and assistance in calculating the proper amounts to be withheld. Partners are not considered employees. Consequently, partners are denied many of the tax advantages available to normal employees. Deductions for fringe benefits furnished employees are not available as deductions for fringe benefits provided to the partners. Since there is no withholding from partners for social security and other taxes, each partner must submit his own tax prepayments.

XXI. PARTNERSHIP TAX RETURNS

A partnership is treated differently than a regular C corporation. Profits and losses of a partnership are passed through to the partners and are not taxed by the federal government. Even though income from a partnership is not taxed at the federal level, an annual U.S. Partnership Tax Return (Form 1165) must be filed. Form 1165 must be filed within three months and 15 days of the end of the partnership tax year. Form 1165 is an information return that the IRS requires to assure that the partners are actually reporting their share of the partnership income. The IRS provides Publication 541, "Tax Information on Partnerships," to assist partnerships in their tax filing.

A tax year is the annual period for which a partnership calculates its tax liability. The Internal Revenue Code requires the partnership to use the tax year adopted by the principal partners. Principal partners are defined under the Internal Revenue Code as anyone owning over a 5% interest in the partnership. A partnership is required to file and pay its federal withholding return (Form 941) quarterly. The return is required to show the income and social security taxes withheld from the employees' wages as well as the matching social security contributions by the partnership. The partnership is required to deposit the federal income and social security taxes monthly in an approved commercial or federal reserve bank.

The partnership is required to furnish an annual Wage and Tax Statement (Form W-2) to every employee prior to January 31 of each year for the previous calendar year. The W-2 must show the total wages paid and the amounts deducted for income and social security taxes. The partnership must submit the original of each employee's W-2 and the annual Transmittal of Income and Tax Statement (Form W-3) to the Social Security Administration no later than the last day of February for the previous calendar year. For example, the Income and Tax Statement must be filed by the end of February 1993 for a partnership's tax year 1992.

XXII. FEDERAL UNEMPLOYMENT TAX

Another tax that a partnership may be required to pay is the Federal Unemployment Tax (FUTA) if the partnership:

1. Paid wages over $1,500 during any calendar quarter, or
2. Had one or more employees at least one day a week for 20 weeks. The weeks do not have to be consecutive.

FUTA taxes are paid entirely by the partnership. There is no withholding from the employee's wages. The partnership receives a credit for any state employment taxes that it pays or for having been given a favorable experience rating by the state. Just as with withholding taxes, the partnership must deposit the tax with an authorized commercial or federal reserve bank within one month of the close of the quarter.

XXIII. STATE TAXES

Unless a partnership does business in a state which has no income tax (of which there are very few and getting fewer), it will have state tax laws with which to comply. Partnerships are treated by the state tax codes in nearly the same manner as they are treated by the Internal Revenue Code. State tax laws view partnerships the same as federal laws as being pass-through vehicles for the partnership income and deductions. All profits and losses of the partnership "pass through" meaning that they are attributed to the individual partners according to their ownership interests in the partnership.

The effect of this pass through of profits and losses is that the partnership is not taxed, and there is no double taxation of the partnership income as there is with a regular corporation's income. Individual state laws can vary from the federal tax law on specific items, but overall they are quite similar in concept.

XXIV. LIMITED LIABILITY PARTNERSHIPS

The most important change in partnership law since the creation of the limited partnership is occurring now. A new form of partnership has been enacted by some states called the **REGISTERED LIMITED LIABILITY PARTNERSHIP or just the LIMITED LIABILITY PARTNERSHIP (LLP).** The limited liability partnership is a cross between the two existing types of partnerships: the general partnership and the limited partnership. On the whole, a LLP is the treated the same as a general partnership except for the fact that the LLP provides a degree of protection to the partners for the liabilities of the partnership. A LLP must, the same as any other type of partnership, be composed of two or more persons, trusts, or companies who have joined together to engage in a business for profit.

The driving force behind the enactment of LLP Acts is that professionals are permitted to practice their profession through the use of the LLP. As discussed in the chapter, **LIMITED LIABILITY COMPANIES** some states, most notably California, do not permit professionals to do business through the use of a limited liability company, LLC. In such states, professionals are limited to doing business in a corporate form, as either a regular corporation or subchapter S to limit their liability for the debts of the business. In order to allow professionals to get together and conduct their profession with a degree of limited liability, some states have enacted limited liability partnership acts. California is a state that does not permit professionals to operate through a LLC and instead adopted in October 1995, one year after the enactment of its LLC Act, a LLP Act. In April 1997, Hawaii, as the last holdout, implemented a limited liability company act. Now, all fifty states along with the District of Columbia, have enacted a limited liability company act permitting limited liability companies to be formed under their laws and also permit foreign limited liability companies to conduct business within their borders.

A LIMITED LIABILITY COMPANY OFFERS THE OWNERS (MEMBERS) THE SAME DEGREE OF FREEDOM AND OPERATION AS AN LLP ALONG WITH EVEN GREATER PROTECTION FOR LIABILITY FOR THE BUSINESS'S DEBTS. Usually, if a person can do business in either the LLC or the LLP form, the LLC form is better. As stated above, however, not all states permit their professionals to do business in the LLC business form.

Therefore, in such states, the LLP is the only alternative to a forming a corporation if it is available in the person's state

A. STATUS OF THE PARTNER

The LLP is for most purposes the same as a general partnership. All of the discussions previously, in this book, regarding a general partnership except for the personal liability of the partners applies to the LLP. A partner of a LLP is a general partner not a limited partner. One of the major differences between the LLP and a general partnership is that the LLP is governed and managed by a written partnership agreement whereas the general partnership is not required to have a written partnership agreement. **THE GENERAL PARTNERSHIP AGREEMENT IN THIS SERIES' PARTNERSHIP BOOK CAN BE USED BY A LLP IN STATES PERMITTING LLP'S.**

As with a general partnership or limited partnership, the partners are the owners of the partnership in accordance to the terms and conditions set forth in the partnership agreement. As with any partnership, the partners are responsible for the management of the partnership either directly or through management which they elect or appoint. The partnership agreement will govern, when stated, those disputes that normally arise during the normal course of business. When the partnership agreement does not cover such instances, the normal business disputes or matters are handled by the majority vote of partners. When the dispute in question is outside the normal course of business, the dispute can only be resolved by the unanimous vote of the partners, RUPA section

401(J).

One of the common concerns that arise in the creation of a partnership, be it a general partnership, limited partnership or LLP, is how the partnership can be capitalized. Every business needs money to operate and a partnership is no different. The question is, however, how the partnership will get its money and what would happen if the company fails. Partnerships almost always have to rely on capital contributed by their partners. The issue is, then, whether the capital will be treated as a loan or the purchase of an equity interest. Loans have to be repaid but do not entitle the lender to an ownership interest in the partnership. Whereas a contribution to equity is not repaid but does purchase a percentage of the partnership. This issue is important if the partnership fails and there is not enough cash to return the capital to the partners after the payments of the partnership debts. The law is settled on this point it is in practice that difficulties arise. Any partner, even for a LLP, can lend money to the partnership and transact business with it in accordance with state law. On dissolution of the partnership, the partners stand on the same footing as regular creditors to the extent of their loans and equity interest remain separate. The treatment of loans by partners to the partnership is the same for LLP's as with other types of partnership as discussed in the earlier termination chapter.

B. A PARTNER'S LIMITED LIABILITY FOR THE PARTNERSHIP DEBTS

In a general partnership, the partners are jointly and severally liable for the debts of the partnership. In a limited partnership, the general partners are jointly and severally liable for the debts of the partnership while the limited partners are not liable for those debts. The difference derives from the fact that the limited partners have no management and control of the limited partnership and therefore no liability.

Since the LLP is a cross between the general partnership and limited partnership, so too is the liability of its partners for the LLP's debts. Generally, partners are jointly and severally liable for the debts of the LLP except that they are specifically held not to be liable, neither directly or indirectly, for the negligence, wrongful acts or misconduct of the other partners. This generally means that if one partner injured another person in the course of the partnership's business, that partner might be personally liable for the damages along with the assets of the partnership but not the other partners. In contrast, if an employee injures a person while in the course of the partnership business, both the partnership and the partners themselves are usually liable for the damages. However, state law is controlling and not all states with LLP Acts treat the issue of liability the same. Some states, for example, extend a partner's limited liability to acts committed by agents and employees while both New York and Minnesota go even further and limit all partner liabilities for all obligations of the LLP. Partners of a LLP still remain liable for their own wrongful misconduct. In addition, most states having LLPs hold partners liable for the misconduct of persons under partners management, control or direction which is rather straight forward.

The rights of creditors of a LLP are determined by state law. As stated above, partners of a LLP possess some degree of limited liability for the debts of the partnership. If a creditor’s debt is of the type for which a partner is not liable, then a creditor cannot seek payment of the debt from the partner. If the debt is one for which limited liability does not apply, then the creditor can seek collection from the partners. Generally, a partner is not liable for the errors and omissions of the other partners, employees or agents of the partnerships. To know the extent of the limited liability, the state LLP Act must be reviewed.

C. **SPECIAL REQUIREMENTS FOR THE LLP**

A general partnership has no formal requirements. A general partnership is usually not required to have its partnership agreement in writing or to file anything with the state. A limited liability partnership however must do both. A LLP needs the partnership agreement in writing, the one in this book would suffice in order the form a LLP.

A LLP, unlike a general partnership, is also required to file an application with the Secretary of State or the Department of Corporations, as the case may be, to become registered as a LLP hence the second name, REGISTERED LIMITED LIABILITY COMPANY. The application form can be acquired upon request from the Secretary of

State's office if an official one is required. Some states that have LLP Acts do not have official application forms but simply require that the application be typewritten stating information required to be produced under the state's LLP Act. The application, itself, is extremely easy to complete. The basic information to be provided is the name of the partnership, name and addresses of the partners, the business address of the LLP and the agent for service of process of the LLP. In essence, this information is the same required by a Certificate of limited partnership. Usually, only one filing is required with the Secretary of State. Delaware, however, requires an annual renewal filing for a LLP. Most states also require that a LLP formed in another state which wishes to do business in the state to register with the Secretary of State as well. For such states, the failure of a foreign LLP to register would strip the LLP of its limited liability protection for its partners in those states where it fails to register.

All LLP Acts require that the name of the company contain with the words "limited liability partnership" or the abbreviation "LLP". The name, as with any company can not be so similar to another company as to be deceptive.

D. CONVERSION OF A GENERAL PARTNERSHIP TO A LLP

The states that permit LLPs also permit general partnerships to be converted into LLPs. The conversion is simple and, in essence, the same as the formation of a new LLP. The general partnership will file with the Secretary of State and application for conversion which contains the basic information as an application from a new LLP along the name of the original general partnership which is being converted. Conversion does not alter or change the partners' liabilities for the company that were incurred prior to the conversion. Prior to the conversion, each of the partners was personally liable for the payment of all of the debts of the partnership. After the conversion, each of the partners still remain personally liable for payment of all of the debts and obligations of the partnership incurred prior to the conversion. Only the new debts and obligations incurred by the partnership following the conversion will be governed by the limited liability provisions of the state's LLP Act.

From a tax standpoint, conversion should not result in a taxable event to either the partnership or any of the partners. In contrast, when a regular corporation converts to a subchapter S status or into a limited liability company, that is considered to be a taxable event. As such, the conversion of a corporation could result in its assets being reappraised and taxes paid on what the IRS would consider to be paper distributions. In such cases, more than the business form is being changed; the tax status is also being changed from a corporate tax status to that usually of a partnership. Conversion from a general partnership to a LLP would not be taxable event because the entity still remains a partnership for tax purposes only the precise business form changes not tax status or ownership.

E. **OPERATING A LLP IN OTHER STATES**

As stated above, not all states permit a limited liability partnership to be formed under its state law. Therefore, if an LLP wishes to do business in another state, a review of the law of that second state should be conducted. If the second state permits LLPs to formed under its state law, then there is no problem with doping business in that state. The United States Constitution's Full Faith and Credit and Privileges and Immunities Clauses would require the second state to permit the foreign LLP to operate with limited liability for its partners. Constitutional issue arises when the second state does not permit LLP's to operate under its state law. In this situation, permitting a foreign LLP to operate with limited liability for the partners would permit non-citizens an advantage not available to its own citizens. The result could be that citizens in the second state would form LLP's in another state just to come into the home state and operate.

The issue of foreign operations of the LLP also came up for limited liability companies. Now, all states along with the District of Columbia have limited liability company acts. Prior to adopting such acts it was very unclear as to whether a limited liability company doing business across state lines would have limited liability protection for its members.

For LLP the projected future is different. Most states do not have a LLP Act even though they have a LLC Act. The reason for this is that most states do not prohibit professionals from doing business in the form of a limited liability company. The main reason for having a LLP is that the partners are not permitted to form a LLC. A Limited Liability Company is usually better than a LLP because it generally gives a greater degree of protection from the company's debts while providing the same flexibility of the LLP. Therefore, states that permit professionals to form LLCs see no reason to enact LLPs. It is always important to review state law when considering to do business in the LLP form. A LLP valid in one state may not, in the end, be held to bestow limited liability protection for its partners for acts committed in another state that does not recognize LLPs. In that situation, it may be possible for the LLP to form a LLC in the second state and conduct business in the second state as the LLC. Partnerships can be members of an LLC. All of which means that doing business in other states requires care and compliance with the laws of each of the appropriate states.

CHAPTER 2

DOING BUSINESS AS A CORPORATION

I. INTRODUCTION

A corporation is an artificial entity created in conformity with a particular state's law. As a distinct legal entity, a corporation is considered to be separate and apart from all of the people who own, control or operate it. A corporation holds most of the rights of a legal person. A corporation is able to execute contracts, incur debts, hold title to both real and personal property and pay taxes. The attractiveness of a corporation stems from the very fact that it is held to be a separate legal entity from its owners (the shareholders), which gives it unique advantages over both a sole proprietorship and a partnership as an entity for conducting business.

A corporation is said to have perpetual existence: a corporation will legally exist forever unless it is dissolved or terminated under state law. One of the main grounds for a corporation's existence being terminated is its non-payment of taxes. Usually, as long as a corporation pays it taxes, it will remain in effect.

A corporation's perpetual existence is an important advantage over other forms of business. A partnership terminates upon the death of a partner, and a sole proprietorship also terminates upon the death of the owner. A corporation continues regardless of the death of a shareholder. The perpetual existence of a corporation is one of its most compelling features. The fact that a corporation continues regardless of the death of shareholders gives it stability. Most people are reluctant to invest in a business that is not a corporation and that may terminate upon the sudden death of any key person. Likewise, most lenders will not loan money to a partnership because it could suddenly terminate upon the death of a partner. The stability of a corporation derives from its continuity of existence beyond that of its shareholders.

The main advantage that a corporation has over a sole proprietorship or a partnership is that the shareholder is not personally liable for the debts of the corporation or the actions of the employees. Consider a partnership or sole proprietorship. If a partner or employee does an act in the scope of their employment that injures another person, each of the partners or the owner (of the sole-proprietorship) is personally liable to pay for the resulting damages. On the other hand, the most any shareholder can personally lose if a monetary judgment is taken against the corporation are the assets he contributed to the corporation in payment for his stock.

This limited liability for corporate shareholders is vastly different from a partnership or sole proprietorship where the owners are totally liable for all debts of the business. The creditors of the business can seek and attach every dollar and piece of property that a partner or sole proprietor owns in order to settle a judgment against the partnership or sole proprietorship. Such personal attachment of the assets of a shareholder is not allowed to satisfy corporate debts. The reason most people incorporate is to avoid this unlimited liability for the debts of the business. Few people would ever invest in a business if they would be risking everything they had earned or would earn in the future.

Several years ago, a person who owned a fast food franchise visited a corporate attorney for general tax advice. Since he was not incorporated, the attorney suggested that he incorporate so as not to be personally liable for any of the acts of his employees. The client, however, decided to rely on his insurance policy to protect him from any personal liability. As if on cue, less than three months later, the attorney opened his newspaper to read in the headlines that one of client's employees had hepatitis and passed it to over three hundred patrons. One person had died, another person had irreversible brain damage and the rest had varying degrees of discomfort. Later that day, the client called the attorney and asked what could be done to limit his liability. Unfortunately, the attorney had to explain that if the client's insurance did not cover all the damages that would be awarded, he would have to pay the difference. The upshot was that the client faced the prospect of bankruptcy simply because he had not incorporated. Had the client incorporated, he would not have had to face the possibility of personal judgments of hundreds of thousands of dollars in damages because of the acts of an employee. The moral of this all too true tale is that whenever a business has employees, the owners must either carry a great deal of insurance or be incorporated (or if the state permits being doing business as a limited liability company as discussed in the next chapter) in order to be protected from any judgments obtained as a result of the employees' or other partners' actions. Incorporation acts as a one-time insurance premium.

In addition to limited liability, special tax treatment for small corporations make them as attractive as partnerships. Normally, except for S corporations, the federal government taxes corporate income twice. Corporate income is taxed when the corporation first earns it, and it is taxed again when distributed to the shareholder. The federal corporate tax rate is:

1. 15% of the first $50,000 of taxable income.
2. 25% of the next $25,000 of taxable income.
3. 34% of the remainder over $75,000 of taxable income.

Corporations having income between $100,000 and $335,000 are taxed at a 39% rate.

When after-tax income is distributed to the shareholders as dividends, the shareholders must include it on their tax returns as income. The shareholder has to pay income tax on the income he receives that has already been taxed as corporate income.

One alternative to this double taxation is for a small corporation to pay most of the income as legitimate salaries to the shareholders for work done. A salary is deductible by the corporation whereas a dividend payment is not deductible. Thus if the income can be paid as salaries, corporate taxes are reduced.

The taxing of a regular corporation is regulated by subchapter C of the federal tax code: it is called a "C corporation" and is subject to a different taxing structure than either a partnership or sole proprietorship. A special corporation whose taxing is regulated by subchapter S of the federal tax code is called an "S corporation" and is taxed quite differently from a C corporation.

The income tax of a C Corporation is subject to double taxation. It is taxed first when the corporation files its corporate tax return. The C corporation is taxed again when the corporation pays dividends to its shareholders: the dividends that a shareholder of a C corporation receives are includible in the shareholder's income on his Schedule B of Form 1040. Example: A C Corporation had $1,000,000 in net profit. It will pay approximately $340,000 in taxes. After it distributes the remaining $640,000 to the shareholders, they will have to pay taxes on it again. Assuming the shareholders' tax rate is 28%, the shareholders will pay an additional $179,200 in taxes. The total tax on the corporate income is $519,200 which means that the joint tax exceeds 51%.

Partnerships provide more flexibility than S corporations in a few areas:

1. Partnerships may admit anyone as a partner and have any number of partners; whereas S corporations are limited to 35 members of special status, and
2. Partnerships can divide profits and losses in a manner not related to the partners' ownership interest. In contrast, S corporations must divide profits and losses among shareholders in proportion to their percentage of stock ownership.

Generally, these differences are not important because the S corporation usually does not want additional shareholders and does want profit and loss allocated according to stock ownership.

An individual who incorporates a business is given the opportunity to employ certain tax advantages called fringe benefits. A corporation is allowed to deduct from its pre-tax income the costs of certain fringe benefits that are not deductible by persons in a partnership or sole proprietorship. One of the main areas of tax advantage is in retirement plans. A corporate employer may contribute, tax free, significantly more to the employees' retirement plan than a self-employed person's Keogh plan. In addition, employees of corporate plans may borrow amounts to a maximum of $50,000 of the funds contributed to a plan without penalty which is not the case with Keogh plans. Other fringe benefits that are deductible by a corporation but not by a partnership or sole proprietorship are health, life and disability insurance and a $5,000 death benefit. These benefits are deductible by the corporation and usually are tax free to the corporate employee.

The costs for incorporating a business vary somewhat from state to state. In California the costs for filing the Articles of Incorporation and the minimum franchise tax fee is about $915. In addition, the corporate books, which include the minute book, stock book and the corporate seal, cost between $75 and $125. Attorney fees are normally $800 to $1,000 in California. Most states are not as expensive as California and charge $300 to $500 for an incorporation. In like manner, attorney fees in these states vary from $300 to $1,000. The cost of incorporation should be viewed as a one-time insurance premium. Once the business is incorporated, the shareholders are protected from individual liability caused by the actions of the corporation or its employees. After incorporation, shareholders no longer have everything they own at risk. Peace of mind is an important consideration when deciding to incorporate. After a corporation is formed, the yearly requirements for meetings and record keeping are not much more than required for any non-corporate business.

A. STEPS FOR INCORPORATION

I. INTRODUCTION

There is no mystery to forming a corporation nor is it difficult. In its simplest sense, a corporation is merely a license to do business in a particular manner. In that sense, the articles of incorporation are the application for the license, and, when accepted for filing by the secretary of state, become the license. In fact, a corporation is said to be "licensed to do business" once the articles are filed.

The act of incorporating a business is simple. All it entails is the filing of the articles of incorporation and the subsequent issuance of stock. The actual act of incorporating is no more than standing in line before a clerk in the secretary of state's office and having the articles filed and stamped. It can also be accomplished by mail.

There are many companies that provide corporate kits which include basic articles, minutes and by-laws specifically designed for use in just one state. The usual cost is between $50 and $100. The corporate kit, however, does not address the many issues or provide the information contained in this book. This book, traveling beyond the mere corporate kit, provides guidance and advice on the considerations that arise in forming any corporation. Before filing any articles a person should decide what additional provisions he may want in the articles. In addition, a person should read those provisions in the state's corporation code (available in most public libraries) to assure that the state law has not changed in content.

There are many choices that an incorporator faces in forming a corporation. Many of these choices can be difficult given the many options available and the particular concerns of each business. One example of a choice that must be made is whether or not to become a "CLOSE CORPORATION" which requires the shareholders to agree to operate the business pursuant to a shareholder's agreement rather than under the formalized procedures of the state's corporate law. Another choice to be made is whether a Subchapter S tax treatment is desired. If it is, should the election be made at the first directors meeting. Nothing can replace the cold, practical consideration of the person forming the corporation. That person knows the business purpose and how it will be operated. The most any book can do is steer the incorporator to those provisions and issues of concern and practical use.

There is no set definition of a small business. The definition varies among the states and is different under federal law. Simply, it means a corporation with a limited number of shareholders. When a business qualifies as a small corporation it has the opportunity of availing itself of special advantages. Under federal tax law a small business (less than 35 shareholders) may elect subchapter S tax treatment, which allows the corporation to be treated as a partnership for tax purposes. Many states have similar subchapter S laws for small corporations. Several states also permit small corporations (in Delaware it is 30 shareholders; in Ohio it is unlimited provided there has never been a public offering) to elect to become closely held corporations.

II. PROCEDURE

The steps for incorporating a business are simple. They can be summed up as simply filing the articles of incorporation and issuing the stock. In arriving at this result, the corporation will go through these steps:

A. CHOOSE A CORPORATE NAME

A corporation must have a name that denotes that it is a corporation and not a partnership or sole proprietorship. The name usually must contain the word "Incorporated", "Corporation" or "Limited." The name must not mislead the public into believing it is an agent of the federal or state government. The name of the corporation must not mention or suggest involvement in a regulated or licensed field unless the corporation has that license. For example, selecting the name Dr. Peter Jones Medical Corporation for a corporation would not be valid unless Peter Jones, as the principal shareholder, actually had a medical license.

In practice, the main concern is that the proposed name may be so similar to an existing corporation's name that it misleads the public. No state will permit two corporations to have the same name or one so similar that they are confusing. To avoid the possibility of having the articles rejected because of similarity to the name of an existing corporation, the incorporator should conduct a name search with the secretary of state's office. If the name is not taken, it can be reserved for a period of 60 days or longer. The reservation fee is nominal. The search can be done by mailing a request with the name and a check for the search to the secretary of state. The amount of the check and where to send it can be obtained by telephoning the secretary of state's office. A search through the secretary of state's office will take about 30 days. There are attorney service firms (in the phone book for the state capitol) that will search the name and reserve it within two days for about $30. These firms also usually sell, for under $100, corporate kits for the state. If the corporation will be doing business in other states, it may have to operate under a fictitious name if the corporate name is substantially similar to an existing business in any of those states.

B. PREPARE AND FILE ARTICLES

After the corporate name is reserved, the incorporator prepares and files the articles of incorporation. Each state has it own requirements for the contents of the articles. There are sold in every state, corporate kits that contain the basic articles, stock and filing materials needed to become a corporation under that state's law. Such kits cost between $50 and $100. In addition, there has also been written a companion book to this series on incorporation which contains the Articles, Bylaws, stock certificates and minutes in more detail than any corporate kit and, yet, at a cheaper price. Most attorneys charge between $800 and $2,000 to, in essence, tailor make a set of Articles for filing which usually are not necessary.

After the articles are prepared, they are filed with the secretary of state's office. Most states require the articles to be filed in triplicate originals, all signed by the incorporator. Four or more originals should be filed and a conformed, file-stamped copy requested and received from the secretary of state. Filing can be done by mail. It will take thirty 30 to 60 days to get a return. The alternative is to use an attorney service to file the articles. Such a firm usually takes a week to get the articles returned and charges about $50 for the service. The advantage of the attorney service is that any problem can be corrected faster. When the articles are filed, the incorporator must pay the filing fee and the yearly franchise fee for the corporation. The fees vary from state to state. For example, in California the total fee is $917 ($117 filing and $800 franchise tax). The correct amount of the fees can be obtained by calling the secretary of state's office. If an attorney service is used, they will know the fees.

C. ISSUE STOCK

After the articles are filed, the corporation exists in a de facto mode which means that it exists on paper. It is not until stock in the corporation is actually issued that it will exist at law (de jure). Outstanding shares in the hands of shareholders is the defining characteristic of a corporation.

Once the articles are filed, the incorporator calls a special meeting of the directors. In most states the initial directors are named in the articles. In other states the incorporator appoints the first directors at the meeting.

At the meeting the bylaws are adopted by the corporation. This is an important step because it is the adoption of the bylaws that creates the officer positions of the corporation and governs daily operations. The officers of the corporation are then appointed.

The most important matter of business at the first meeting of directors is the issuance of the stock. It is this step wherein the corporation sells its stock in exchange for money, property or labor furnished or to be furnished to the corporation. When the stock is issued, the incorporation is complete.

II. S CORPORATIONS

A. INTRODUCTION

The federal tax code calls a regular corporation a C corporation because it appears in chapter C of the Internal Revenue Code. A C corporation is subject to a different taxing structure than either a partnership or a sole proprietorship. A special corporation called a Subchapter S corporation, often referred to simply as a S corporation, is taxed quite differently from a regular corporation (a C corporation). Normally, the federal government taxes C corporate income twice. Corporate income is taxed when the C corporation first earns it and is taxed a second time when it is distributed to the shareholders.

The federal corporate tax rate is:

1. 15% of the first $50,000 of taxable income.
2. 25% of the next $25,000 of taxable income.
3. 34% of the remainder over $75,000 of taxable income.

Corporations having income between $100,000 and $335,000 are taxed at a 39% rate. When the after-tax income is distributed to the shareholders as dividends, the shareholders must include it on their tax returns as income. The shareholder has to pay income tax on the income he receives that has already been taxed as corporate income.

One alternative to this double taxation for a small regular C corporation is to pay most of the income as legitimate salaries to the shareholders for work done. A salary is deductible by the corporation whereas a dividend payment is not deductible. Thus if the income can be paid as salaries, corporate taxes are reduced.

A second alternative is for the C corporation to retain in its treasury a reasonable amount of income called "accumulated earnings." A corporation is permitted to accumulate reasonable amounts of earnings for future use of the corporation. Since the earnings are not distributed as dividends, they are not taxed to the shareholders. These retained earnings are not available for use by the shareholders.

The income tax of a C Corporation is subject to double taxation. It is taxed first when the corporation files its corporate tax return. The C corporation is taxed again when the corporation pays dividends to its shareholders. The dividends that a shareholder of a C corporation receives are includible in the shareholders income on his Schedule B of Form 1040. For example assume that a C corporation had $1,000,000 in net profit. As such, it will pay approximately $340,000 in taxes. After it distributes the remaining $640,000 to the shareholders, they will have to pay taxes on it again. Assuming the shareholders' tax rate is 28%, the shareholders will pay an additional $179,200 in taxes. The total tax on the corporate income is $519,200 which means that the joint tax exceeds 51%.

B. DEFINITION

Subchapter S of Chapter 1 of the Internal Revenue Code (hence the name "S corporation") permits qualifying C corporations to receive special tax treatment. Qualifying C corporations may elect to be taxed in a manner similar to that of a partnership at the federal level. Upon election by a C corporation, it becomes an S corporation (a pass-through entity whereby all of its income and deductions are passed through to the shareholders). The shareholders then claim their share of the corporation's income and deductions on their individual tax returns.

The S corporation is not subject to corporate income tax, accumulated earnings tax or the personal holding company tax at the federal level. The S corporation may be subjected to a special tax on its passive net income. Such tax arises where the S corporation has (1) earnings and profits and (2) gross receipts made up of passive investment income.

When an existing C corporation elects subchapter S status, there is a gains tax when any old C corporation assets are sold. The gain is attributable to the appreciation in value of any asset in the period after its conversion date to its sale date.

The requirements to become an S corporation are statutorily set. The moment that the requirements are no longer met, the S status of the corporation terminates. Only a small business corporation can elect S status. In order to be a small business corporation, the corporation must meet the following requirements:

1. It must not have more than 35 shareholders (married couples are treated as one shareholder).
2. It must be a U.S. corporation.
3. No shareholder can be a non-resident alien.
4. The corporation can have only one class of stock.
5. All shareholders must be individuals, estates or trusts.
6. The corporation cannot be part of an affiliated group of corporations.
7. The corporation cannot be a bank or insurance company.
8. The corporation has elected to be treated as a subchapter S corporation.

A corporation electing S corporation treatment will have its profits and losses passed to the shareholders. Passing through the profits and losses results in the shareholders, not the corporation, being taxed on them. S corporation income is taxed as though the corporation was a partnership or sole-proprietorship.

The S corporation must use a calendar year as its taxable year unless a legitimate business purpose is proven to the satisfaction of the IRS.

C. TAX TREATMENT

1. FEDERAL LAW

An S Corporation is a corporation given special tax treatment under federal law. The effect of the S corporation election is to have the corporation treated for general tax purposes as if it were a partnership. In an S corporation the income is attributed to shareholders in proportion to their stock ownership. The S corporation itself pays no income tax on the federal level.

Once a valid S election is made, the S corporation will no longer be subject to corporate income tax, accumulated earnings tax or the personal holding company tax at the federal level. An S corporation may be subjected to a special tax on its passive net income. Such tax arises where the S corporation has (1) earnings and profits and (2) gross receipts for income from passive investments. For example, assume that an S corporation earns $1,000,000. As a S corporation, it will pay no taxes. Instead, the shareholders of the S corporation will include their proportionate shares of the $1,000,000 on their individual tax returns. Assuming a 28% federal individual tax rate, the shareholders will pay $280,000, not the total $519,200 that a C corporation and its shareholders must pay in combined taxes.

Because of its tax advantages, successful small corporations have considered the tax effects of making an election to become an S corporation.

2. STATE TAX TREATMENT OF A FEDERAL S CORPORATION

A federal S corporation election does not mean that the corporation will be treated as a partnership for state taxes. Not all states permit similar S corporation treatment for corporations doing business in their states. For most states the corporation will continue to be taxed as though the federal election had never been made despite a federal tax election. The reason for non-partnership treatment is obvious: states retain the double taxation on the corporate income by denying S status to the corporations.

Unless a corporation does business in a state which has no income tax on corporations (some do not tax corporations), it will have to file a state return also and pay taxes. Only a few states, such as California, permit S corporation tax treatment. In these states, the profits and losses of the corporation are passed through to the shareholders. In California an election to be treated as a federal S corporation automatically operates as a state election as well. A federal S corporation not wishing to be taxed as an S corporation in California must specifically inform the state that it elects not to be an S corporation for state tax purposes. Unlike federal law, California continues to impose a regular C type corporate tax on S corporations, but it is at a lesser tax rate than the federal: 2½%. This is still higher than the state's minimum tax on net income. California, however, does not impose a tax on excessive passive income; the federal government does.

Most of the states which permit S corporations generally require an affirmative selection by the corporation for that tax treatment.

D. METHOD OF MAKING THE S STATUS ELECTION

A corporation wishing to become an S corporation must have the written consent of all its shareholders for the S status. Where the stock is owned jointly by a married couple, both spouses must consent to the S status. Likewise, where the stock is owned jointly, all joint owners must also consent to the S treatment. The consent must be signed by each shareholder of record when the election was made at any time during that portion of the year before the election is made. A C corporation preparing to elect S corporation status must give detailed attention to ensure that there is a consensus of all required shareholders. Every shareholder, whether still a shareholder or not, is required to consent to the election.

The corporation is required to file its Form 2553 with the IRS along with the shareholders' consent to S status. The S election must be made on or before the 15th day of the third month of a corporation's tax year for the election to become effective for that tax year. A late filing of the S election will be ineffective for the current tax year but will be effective for subsequent tax years. New corporations must file the election within two and one-half months of incorporation to be effective for the first tax year.

Once the election is made, it is valid and in force for as long the corporation meets the qualification requirements. The shareholders can revoke their S election. Once an S election is revoked or terminated, the corporation must wait five years before it can re-apply for S corporate status.

Each state has its own laws as to whether the corporation can be treated as an S corporation under state law. MAKING A FEDERAL ELECTION FOR SUBCHAPTER S TREATMENT DOES NOT MEAN THAT THE CORPORATION WILL SUBCHAPTER S TREATMENT FOR STATE INCOME TAXES. In states with neither corporate nor individual tax there is no problem because there is nothing to tax. In states that have a corporate tax, both the corporation and shareholders will be taxed at the state rates unless the state permits S treatment. If it does and shareholders elect S treatment, only the shareholders will be taxed on corporate profits. California, for example, automatically grants S treatment to any California corporation that receives federal S status. California requires the S corporation to file Form 3560 with the California Franchise Tax Board.

Whether or not a state permits S corporation treatment, the most tax savings will be from the federal election. Therefore, if the corporation wishes to be an S corporation, it can be so under federal law for federal taxes regardless of whether it is for state taxes. The tax consultant for the corporation can advise whether it is possible to make a state S election.

E. TERMINATION AND REVOCATION OF S STATUS

A corporation can revoke its S status simply by filing with the IRS Service Center handling its return. The revocation statement must state that the corporation is revoking its S election. The revocation statement must also state the number of shares that are issued and outstanding stock (both voting and nonvoting). In addition, the revocation statement must be accompanied with a shareholder consent to the revocation signed by shareholders owning more than half of the outstanding stock (both voting and non-voting) at the time the revocation election was made.

Because the requirements to be an S corporation are statutorily set, status is automatically terminated prospectively when any of the following events occur:

1. The corporation's shareholders exceed 35 (a married couple counts as one shareholder).
2. The corporation issues more than one class of stock.
3. The corporation becomes part of an affiliated group.
4. The corporation begins to operate as a bank or insurance company.
5. Ineligible shareholders acquire stock (foreign aliens, corporations, etc.).
6. The passive investment income (a) exceeds 25% of the corporation's gross receipts for three consecutive years, and (b) the corporation had earnings and profits at the close of the three consecutive years.

Once the S status is terminated, the corporation must wait five taxable years before it can reapply for S status. The IRS can give special consent sooner if requested.

F. TAX RETURNS FOR S CORPORATIONS

Because an S Corporation is treated differently than a regular C corporation, it must file different tax returns. Profits and losses of an S corporation are passed through to the shareholders. Income, losses and other K-1 items are allocated to the shareholders on a per share per day basis. Each shareholder is allocated a percentage portion (based on the shareholder's ownership interest) of the pass-through items of each day in the taxable year. For example, assume that a S corporation has $750,000 income. George and Harry, as the sole-shareholders, each owned 25 shares for a full year. Mark owned 50 shares for half a year and then sold them to Marcie for the other half. The allocation is made as follows:

1. The $750,000 is divided by the sum of the number of shares (100) divided by the days of the taxable year (366) for a full year: $750,000 ÷ 100 ÷ 366 = $20.4918 per day.
2. Each shareholder allocation is the number of days times shares owned times the daily allocation per share:

   George: 25 shares x 366 days x $20.4918 = $187,500
   Harry: 25 shares x 366 days x $20.4918 = $187,500
   Mark: 50 shares x 183 days x $20.4918 = $187,500
   Marcie: 50 shares x 183 days x $20.4918 = <u>$187,500</u>
   $750,000

Even though income from an S Corporation is not taxed at federal level, an annual U.S. Small Business Corporation Income Tax Return (Form 1120-S) must be filed within two months and 15 days of the end of the corporation's tax year. Form 1120-S is an information return. The IRS uses the corporate return to cross-check the shareholders' returns to make sure they are actually reporting their share of the S Corporation income.

G. SHAREHOLDERS

1. RESIDENT

A S corporation is a pass-through vehicle for the income and deductions of its shareholders. The shareholder's tax at state level depends on whether the corporation is an S or C corporation and if the shareholder is resident or non-resident in the corporation's state of domicile. The United States Supreme Court in a 1920 decision (Shaffer vs. Carter 252 U.S. 37) made clear that a state is permitted to tax all the income of a resident from any source. Income from stock (dividends) is generally taxed at the residence of the stock owner.

If a state exempts S corporations from state corporate income tax, the state derives no income unless it can tax the shareholders on the pass through of the corporate income. This is no problem whatsoever when the shareholder is a state resident because the state can tax all income of its residents. The corporate income of residents of the state where the S corporation is located will be passed through to the shareholder and taxed as personal income.

States tax a C corporation on its income from all activities carried on in the state. Dividends of C corporations are usually taxed to the individual shareholders at the tax rate of their state of residence, which may not be the state where the corporation does business.

2. NON-RESIDENT

(a). GENERAL

The United States Supreme Court in a 1920 decision (Shaffer vs. Carter 252 U.S. 37) made clear that a state is permitted to tax all income of a non-resident to the extent it arises from property or activity located in the state. If a state exempts S corporations from state corporate income tax, the state derives no income unless it can tax the shareholders on the pass through of the corporate income. This is no problem when the shareholder is a state resident because the state can tax all income of its residents from all sources. The problems arise when the shareholder of an S corporation is a non-resident. Jurisdiction of the corporation's home state to tax the pass through of the corporate income to the shareholders is open to question.

Each state addresses the issue of corporate income distributed to non-resident S corporation shareholders in its own fashion. Some states (like Delaware and Vermont) require the S corporation to pay the tax attributable to its out-of-state shareholders. Some states (such as Indiana and Maryland) require the S corporation to withhold taxes for its out-of- state shareholders. California and a number of other states require non-residents to file a written consent to be taxed under the state's personal income tax law on pass-through income. Several states (Mississippi, Nebraska, Oklahoma and Rhode Island) require the corporation to pay the taxes on non-resident shareholders if they do not file consent affidavits.

(b). DISADVANTAGE WHEN SHAREHOLDER'S HOME STATE HAS NO INCOME TAX

A distinct disadvantage can arise if the non-resident shareholder lives in a state that does not have an individual income tax. The following states do not have an income tax: Florida, Washington, Texas, Nevada, Alaska, South Dakota and Wyoming.

In some instance, the stockholder of a S corporation may be a resident of a state that (I) has no individual income tax or (ii) does not permit S corporation income from out-of-state sources to be treated as personal income (Connecticut, New Hampshire, Tennessee, Michigan and Oklahoma). The stockholders of a S corporation will owe income tax to the state where the corporation was formed if that state imposes an income tax. A non-resident subchapter S shareholder in these states, while owing no taxes to his home state, will nevertheless have to pay a personal income tax to the corporation's home state.

If the S election is not made, the income tax is paid in the C corporation's home state at the corporate level and there is no additional personal state tax to these shareholders in either state.

If the shareholder is resident of a state that taxes personal income including out-of-state S corporation pass-through income, his net state tax cost may be reduced by an S election.

(c). STATE TAX CREDITS

Because all states have jurisdiction to tax the income of their residents plus all sources of income for non-residents, all income that has a source in another state has the potential of double taxation.

To avoid having the income from an S corporation taxed to the shareholder both in the corporation's state and the shareholder's state, most states allow their residents to claim a credit for taxes paid to another state as long as the other state does not allow a credit. This credit allowed by the shareholder's state usually cannot exceed the taxes that would be paid in the shareholder's state. For example, California permits its residents to claim a credit for taxes paid in the following states:

> Alabama, Arkansas, Colorado, Delaware, Georgia, Hawaii, Idaho, Illinois, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Mississippi, Montana, Nebraska, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Utah, Vermont, Virginia, West Virginia and Wisconsin.

The state giving the credit usually requires that the income have its source in the taxing state. Out-of-state tangible income (such as dividends) taxed by a state on its residents usually will not qualify for a credit. Moreover, most states will not give a credit for a dividend distribution that is treated as an S corporation distribution by one state but a C corporation distribution by the other.

H. FRINGE BENEFITS

How fringe benefits in an S corporation are treated depends on the amount of stock in the corporation the recipient owns. If an employee owns more than 2% of the stock, the employee will be treated as a partner. Amounts paid for benefits for a shareholder who owns more than 2% of the stock will not be deductible by the corporation.

A shareholder owning more than 2% of the stock in an S corporation is required to include the receipt of fringe benefits (such as medical reimbursement payments) in gross income. The shareholder is entitled to deduct fringe benefits only to the extent that a partner in a partnership could do so.

I. BASIS OF STOCK

The basis of the stock in an S corporation is treated very much as the basis in a partnership interest. Both taxable and nontaxable income and both deductible and nondeductible expenses will serve either to increase or decrease the shareholders' bases in their stock. Basis is adjusted for income and loss before applying the rules relating to distributions for the year.

To the extent that property distributions are treated as a return of basis, the stock basis will be reduced by the fair market value of the property. Income passed through to a shareholder will first increase shareholder basis in loans to the corporation to the extent pass-through losses previously reduced basis.

J. CONCLUSION

There are a myriad of tax consequences that can result if a shareholder is a non-resident of the state of incorporation. Before an S election is made, the shareholders should consult with a tax professional to determine the tax effect on the non-resident shareholder. Normally an S election is advantageous for a resident shareholder.

CHAPTER 3

THE LIMITED LIABILITY COMPANY

I. DEFINITION

The most recent development in business law is the creation of the Limited Liability Company (LLC). The first LLC was created in the 1970's. For many years LLC's were not popular because the tax laws subjected them to more taxation than either a corporation or a limited partnership. In 1977, the first LLC was created in Wyoming for an oil company. The company was granted a private tax ruling stating that it would be treated as a partnership. In 1980, the U. S. Treasury issued proposed regulations that stated an LLC would be taxed as a corporation because its members did not have a partner's liability for the company's debts. In 1988, the Internal Revenue Service finally issued Revenue Ruling 88-76, 19882 CB 360, stating that an LLC could be taxed as a partnership. This revenue ruling calmed concerns about forming LLC's. As a result, the number of states permitting LLC's has increased dramatically. In April 1997, Hawaii, as the last holdout, implemented a limited liability company act. Now, all fifty states along with the District of Columbia, have enacted a limited liability company act permitting limited liability companies to be formed under their laws and also permit foreign limited liability companies to conduct business within their borders.

An LLC is a cross between a corporation and a partnership.

The characteristics shared with a corporation or a partnership are:

1. It bestows limited liability on its members just as a corporation does on its shareholders and a limited partnership does on its limited partners.
2. It can provide for the free transferability of its membership interests the same as a corporation or partnership.
3. It can provide for continuity of life after the death, resignation, expulsion or bankruptcy of a member the same as a corporation or a partnership.

In addition, an LLC may give full management and control to just a few managing members, which is the same treatment that is available in a partnership and similar to that of the board of directors of a corporation.

The following, however, are the major differences between LLC's and corporations or partnerships:

1. Unlike a corporation, which can have perpetual existence, an LLC can only exist for a stated period of time (30 years in many states) before it is terminated.
2. Unlike the partners of a general partnership, the members of the LLC are not personally liable for the debts of the company, which is the same basic treatment as that of shareholders of a corporation or limited partners of a limited partnership.
3. Unlike a corporation, the company does not have the corporate restrictions on financing. Example: The company does not need to create a special surplus account for distributions.
4. Unlike a corporation, in the majority of states, absent an agreement among the members to the contrary, profits and losses of an LLC are allocated in accordance with

> each member's percentage of capital contributions. A few states have adopted the per capita partnership rule: if there is no agreement on decision, profits and losses will be allocated equally among members. Either method s different from that of a corporation. Division of corporate profits and losses must be based upon the number of corporate shares that a shareholder owns.

These characteristics are important because they bear a direct relationship to the rights and obligations of each member in addition how each member’s interest is treated for tax purposes.

The main advantage of an LLC is the limited liability that it provides its owners, who are called members. In an LLC, the most that its members can lose in a lawsuit against the company are the assets they contributed to the LLC. The limitation of liability would naturally not extend to any personal guarantees of company debts by a member. If a member personally guarantees a company loan of $100,000, the member is personally liable for the repayment. The member's liability arises not because the person is a member of the company but because the member guaranteed that he personally would repay the loan. It is immaterial that the money may have gone directly to the company. The limited liability for members is quite different from that of a general partnership where the partners are totally liable for all debts of the business. The creditors of a general partnership can seek and
attach every dollar and piece of property that a partner owns in order to settle a judgement against the partnership. Such personal attachment to satisfy company debts cannot be taken against the

assets of a member. People either incorporate or form an LLC to eliminate this unlimited business liability exposure. Few people will invest in a business that risks everything they have or will earn.

LLC's are relatively new and has taken time for them to catch on. As of April 1997, all fifty states along with the District of Columbia, now permit limited liability companies to be formed under their laws and also permit foreign limited liability companies to conduct business within their borders.

An LLC is considered to be separate and apart from all of the people who own, control and operate it. An LLC holds most of the rights of a legal person. An LLC is able to validly execute contracts, incur debts, hold title to both real and personal property and pay taxes. The attractiveness of LLC's is that they are held to be separate legal entities from owners, the members, which gives them unique advantages over both corporations and partnerships.

II. FORMATION

A. General

An LLC is a statutory creation. It can only be formed by strict compliance with the state law under which it is being created. An LLC just as with a corporation or a limited partnership requires a public filing of its formation documents. The filing of the articles of organization is required:

1. To give public notice that the company is formed in a way

that bestows limited liability on the members for the debts of the company, and

2. To give the public notice where the company is located and who can act in its behalf.

Some states require an LLC to have more than one member (owner). This is a different requirement than imposed on corporations, which are permitted to legally have only one shareholder. Several states which include Arizona, Colorado, Delaware, Illinois, Iowa, Kansas, Louisiana, Maryland, Minnesota, and Virginia, for example, permit only one person to form an LLC, but the company is not given legal effect until it has more than one member. The states requiring the LLC to have two or more members also usually require that the organizers sign the Articles of Organization or, alternatively, a subscription agreement prior to filing the articles. If a company falls below the minimum number of members for an LLC, it will not only be dissolved but it will lose the limited liability shield for its members to the extent necessary to dissolve the company. A company will be treated harshly if it continues to do business for an undue period after ceasing to have the minimum number of members. Those states which have the two member requirement use it to insure the availability of the partnership classification for tax purposes. A partnership requires, by definition, two or more persons engaged in business.

B. ARTICLES OF ORGANIZATION

Articles of organization is an application by a group of individuals or entities for a license to do business as an LLC.

Once the articles are accepted and filed, the LLC is thereafter formed. Each state sets its own requirements for the contents of the articles, however, they all require:

1. A name for the company which does not mislead the public but does disclose that it is an LLC.
2. The address of the company's principal place of business.
3. The name and address of the company's registered agent in the state.

The requirement for listing both the resident agent and the registered office is also imposed upon a company which is incorporating. Listing of registered agent ensures that someone is authorized to receive legal process against the company. The resident agent is the person who is served any legal notices or summons and complaint on behalf of the company. A company maintains a resident agent in the state, or by default agrees to let the secretary of state serve as the resident agent. The registered office is the location where the company's authority is kept in the state. The registered office's address gives notice to the world where any complaint against the company can be served.

Several states also require additional provisions to be included in the articles, such as:

1. How capital contributions will be made to the company.
2. Whether the company will be treated as a corporation or partnership for tax purposes.
3. Name and address of each organizer.
4. Whether all the members or a centralized management will manage the company.

Some states, such as Colorado, Florida, Minnesota, Nevada, West

Virginia and Wyoming, require the articles to state if the company will continue in effect upon the death, bankruptcy or withdrawal of a member. This is a good provision which is recommended to be in every operating agreement, if not the Articles, especially if partnership tax status is sought because continuity of life is a determining factor.

This book attempts to provide a general set of articles sufficient for most states and has provided specific articles when necessary. The reader should, nonetheless, familiarize himself with the particular LLC law of the state where the LLC will be formed. There are possibly current changes not reflected in this text. The provisions contained in the articles of organization for an LLC can only be altered or changed by the filing of an amendment to the articles. Members frequently place important management provisions in the articles because it is difficult to amend them. The articles contained in this book are all that are needed to meet minimum requirements under state law. In practice, the entire operating agreement or any of its provisions can be included in the articles. Remember, once something is listed in the articles, it can only be changed by filing an amendment.

Before the articles are filed they must be approved and adopted. The person who will file the articles calls a meeting of potential members where they decide what provisions will be contained in the articles. They also decide another important detail: whether all the members or a centralized panel of selected managers will manage the business. Once the articles are adopted, they must be signed either by all the selected managing members, or by all of the members (if no managing members are selected. Usually, the operating agreement for the company is also created and adopted at this meeting.

C. OPERATING AGREEMENTS

After the LLC files its articles, it exists on paper; it does not exist at law (de jure) until membership certificates are actually issued. It is the fact that the company has outstanding membership certificates in the hands of members that is the defining characteristic behind the existence of an LLC. Similarly, a corporation is not deemed to be in effect until it has sold and issued stock. Following the filing of the articles, the potential members of the LLC meet to purchase their membership certificates and adopt the operating agreement for the business. After the membership certificates have been issued, the company is fully formed.

Operating agreements are the rules for the general day-to-day management and operation of the LLC. Contained in the operating agreement are the terms of the company concerning:

1. Capitalization of the business,
2. Distributions made from the business,
3. Admission and withdrawal of members,
4. Management of the business,
5. Fiduciary duties owed to and by the members, and
6. Dissolution of the company.

The operating agreement is adopted by the members and thereafter can be amended only by a majority vote of the members. An operating agreement is an attempt to resolve the many areas of potential conflict within an LLC and to delegate duties and assign responsibilities. A proposed form for a basic operating agreement for use in those jurisdictions that permit LLC's is included in the LIMITED LIABILITY COMPANIES book of this legal series.

Operating agreements can be general in nature or tailored to the needs and desires of the members. Most operating agreements contain or mention most of the issues covered in the Operating Agreements chapter. A few states do not require the operating agreement to be in writing. Only if the agreement is in writing can the actual intent of the members be ascertained with confidence.

Operating agreements are not set in concrete and, in fact, quite flexible. Members can change the operating agreements by simple amendments. The purpose of operating agreements is to establish procedures for daily administration and management of the company. As the company develops the operating agreement must be amended to meet new requirements.

As can be seen from the foregoing discussions, the steps for forming a business as an LLC are simple:

1. File the articles of organization,
2. Adopt the operating agreement, and
3. Issue the membership certificates.

Once these steps have been accomplished the LLC is formed and can commence operations. An LLC is easier and less expensive to create than a corporation or a limited partnership provided ordinary caution and care are undertaken.

D. MEMBERS

Members are the owners of the LLC. Usually an LLC only needs one member but some states require that the LLC have two or more members. Members own the membership certificates of the LLC and have the right to vote in the election of managing members. The extent of ownership interest a member has in the company is usually based either:

1. Upon a member's percentage of contribution to the total contribution of all the members,
2. Upon an equal division among all the members irrespective of contribution (per capita), or
3. Upon some other agreement between the members.

Members are not personally liable for the debts of the LLC beyond the extent of their investment in the LLC. Exception: A member is personally liable for a company debt or obligation if he personally guarantees repayment.

Members may agree for all members to manage the company or agree to elect a few members to manage, who will be called "managing members." In addition to electing any managing members, the members are required to vote on the following:

1. Amendment of the articles of organization,
2. Sale, option or lease of substantially all of the LLC's assets,
3. Merger or consolidation of the LLC with another LLC,
4. Amendment of the operating agreement,
5. Removal and replacement of managing members, and

6. Dissolution of the LLC.

The term "managing member" refers to all of the managing members. Managing members must be elected if the operating agreement does not reserve the management to all of the members. If managing members are elected, they alone are responsible for running the day-to-day business of the LLC. When the LLC is taxed as a corporation, the managing members are permitted reasonable compensation for their services. In small LLC's, the managing members usually serve for free to protect their investments.

Caveat: The decision to have the LLC managed by elected managing members is an element of corporate existence. If the company also has free transferability of its shares or continuity of life, it will be taxed as a corporation and not as a partnership.

Most operating agreements for an LLC require an annual members' meeting to review business affairs and conduct. The members also will elect or re-elect the managing members for another year. Members are usually given votes proportional to their percentage of ownership in the company. A majority of those membership interests voting is needed to carry a resolution or any other matter brought to the floor.

A member has a duty of loyalty to the LLC. A member cannot usurp a company benefit that could go to the LLC. A member owes the LLC the right of first refusal on any business opportunity he discovers that could affect the company. For example, if the company is in the paving business, a member could not form a competing paving business and solicit business from the LLC's existing clients. When a member has a personal interest on a matter before the board, the member is only allowed to vote on it when:

1. The member's interests has been fully disclosed to the board, and
2. The contract is just and reasonable.

A member cannot be sued by other members for losses incurred as a result of the member's actions or decisions provided they were reasonable and prudent. As agents of the LLC, members have the authority to bind the company by their actions. Members can execute contracts for the company and can subject the company to liability for damages arising from negligent or intentional acts they may commit on behalf of the company.

All of the states which permit LLC's hold that an assignment of a member's interest only passes financial right unless the operating agreement states otherwise. The assignee (person who acquired a member's interest in the company) only acquires the right to participate in the management of the company through a majority vote of the other members. Usually, a consensus is required.

This is important enough to repeat. The non-assigning members must agree to let the new member participate in the management unless the operating agreement states otherwise. This lack of full transferability of interest means interests do not have "free transferability." As a result, the value of the company is lessened and the company is assisted in obtaining tax treatment as a partnership.

E. MEMBERSHIP CERTIFICATES

Membership certificates should be thought of as the ownership interests in an LLC. The membership certificate is little more than a record that a person is a member of the company. The degree of interest that the member has in the company is determined by the terms of the operating agreement. Every LLC is authorized to sell only a certain amount of membership certificates in accordance with the security laws of the state where the company is formed. The purchasers of the membership certificates acquire an ownership interest in the common equal to their percentage of membership certificates to the total number of membership certificates outstanding. Membership certificates may be sold by an LLC for money, labor, services, canceled debts or property contributed to the LLC. Membership certificates can also be purchased with promissory notes. Although not required, membership certificates acquired with notes are usually secured by tangible property.

Membership certificates can be voting or non-voting. Non-voting membership certificates are usually issued by an LLC to raise money without giving the certificate owner the right to participate in the business. To attract purchasers for non-voting membership certificates, an LLC may guarantee a fixed distribution payment or the right to convert the non-voting interests into voting interest based upon a fixed formula at a later date.

F. SECURITY LAWS

A membership interest in an LLC is a security just like stock in a corporation or interest in a limited partnership. Thus a membership certificate cannot be sold unless it is either registered or exempt from registration under both federal and state law. Registration for sale of a security under federal law costs thousands of dollars and takes months. Fortunately, there are several specific exemptions that a qualified LLC can use to avoid the federal registration requirement. Most small LLC's have at least one exemption available to avoid registration. The exemptions are:

1. The company is exempt under section 3(a)(1) of the Securities and Exchange Act. This is the most popular exemption for small companies. It is available where all the members reside in the same state where the LLC is incorporated and doing business.
2. The sale of the membership certificates is a non-public offering under section 4(2) to sophisticated investors and there was no public advertisement or solicitation for the membership certificates sale.
3. The sale complied with SEC Regulation D requirements by adhering to strict SEC disclosure regulations.

Once the requirements for claiming an exemption have been satisfied, then the LLC can issue its membership certificates without fear of violating federal security laws.

In addition to the federal registration requirement, all states have registration requirements for securities sold in their jurisdictions. Just as there are exemptions from the federal registration requirement, each state and the District of Columbia has its exemptions. Usually, an LLC of less than 15 members can simply sell membership certificates and notify the secretary of state of the sale. An LLC using this exemption is generally not required to identify the members who purchased.

If a membership certificate is sold without complying with both federal and state exemption procedure, the sale is voidable at any time by the purchaser. If the company fails, the members could use the fact that no exemption was ever obtained to sue the organizer for their money. A California case provides an actual example of how security laws are applied. A limited partnership was sold to fund the drilling of an oil and gas well. At the time the legal exemption was for a maximum of five persons (it has since been increased to 35). The interests were sold to nine members. The well was drilled and was dry. Two of the investors sued to get their money claiming the sale was not exempt because more than five persons bought interests. The general partner faced criminal charges for selling an unlicensed security and had to refund the full investment money to all of the investors. If the sale had been to only five persons, there would not have been a problem. The lesson to borne in mind is that it is not only necessary but critical to open both the state and federal security laws.

G. TAXATION

How an LLC will be taxed is the second most important concern, the first being the limited liability of members. Because an LLC has elements of both a corporation and partnership, it can, depending on the facts, be treated for tax purposes as either a corporation or a partnership. When the LLC is taxed as a partnership, its income is passed to its members and double taxation is avoided. On the other hand, when an LLC is taxed as a corporation, its income is taxed twice, first upon being earned and second when distributed to its members as dividends. It is almost always better for an LLC to be taxed as a partnership so as to avoid the double taxation.

Regardless of how a LLC is treated for tax purposes, be it as a partnership or as a corporation, the members of the LLC will not have personal liability for the debts of the company.

Federal Tax law changed dramatically in 1997. As of January 1, 1997 all newly formed LLC's with two or more members will be treated as a partnership for tax purposes unless the LLC elects corporate tax treatment either as a C corporation or S corporation. A single member LLC will be treated as a sole-proprietorship for federal tax purposes. This is a complete reversal of prior federal tax law. Prior to 1997, an LLC was taxed as a corporation unless it could prove to the IRS that is should be a partnership. In order to prove that a pre-1997 LLC should be taxed as a partnership it had pass a special four-prong test created by the IRS.

As of January 1997, LLC are automatically given partnership tax treatment unless they specially opt out of it. To opt for corporate tax treatment, the LLC will file a new IRS Form 8832. The election is effective on the date specified in Form 8832 or the date filed if no date is specified. An effective date can even be chosen that precedes the filing by up to 75 days. See IRS. Regulation sec. 301.7701-3(c)(1)(I).

While LLC’s no longer have to pass the IRS’s four prong test for federal tax purposes, many states still apply that test in order to determine if the LLC will get state partnership tax treatment. These states had patterned their tax laws after the federal tax law and have not, as yet, changed their tax law to coincide with the new federal laws. In addition, some states have written the four-prong test into their LLC Acts so that the Articles of Organization filed in those states must address the issues raised in the four prong test.

Because some states still use the IRS four-prong test to determine if an LLC will be treated as a partnership for state tax purposes, this chapter will discuss the four-prong test. The IRS Revenue Rulings on the four-prong test are still persuasive authority for determining whether an LLC will get partnership taxation in a state which still employs the test. If it is not known whether a particular state uses the IRS four prong test in deciding whether to give an LLC partnership treatment, the organizer can go ahead and assume that it does and meet the test, thereby assuring partnership tax treatment for both federal and state purposes. Later if it is determined that the state does not use the four prong test or if state law is changed to do away with it, the company can change the articles or operating agreement any way that it wishes without fear of losing the state partnership tax treatment.

THE FORMER IRS FOUR-PRONG TEST STILL USED IN MANY STATES

The IRS utilized until January 1, 1997, a four-prong test for determining whether an LLC will be taxed as a corporation or a partnership. If an LLC possesses any three of the four following corporate characteristics, it will be taxed as a corporation and not as a partnership:

1. Limited Liability For Its Members. All LLC's will have this characteristic. It is to obtain limited liability for the members and the members elected to conduct business as an LLC.
2. Centralized Management. The states which permit LLC's allow the members to vest the management of the business in certain managing members. When this is done, the management of an LLC assumes the corporate characteristic of a board of directors.
3. Free Transferability of Interests. The right to sell, transfer or convey an interest in a business freely and without restrictions is a corporate characteristic. Such a right is similar to a person being able to sell his stock in a company. If the non-selling members must consent before the new member can participate in the management, then there is no free transferability, and this corporate characteristic would not be present.
4. Continuity of Life. The most important aspect of a corporation is its continuance after the death or withdrawal of one of its shareholders. A corporation,

unlike a partnership, does not terminate upon the death of its shareholders. If an LLC is required under the terms of the operating agreement to remain in full effect until its termination date, and even after the death of a member, it will be considered to have the continuity-of-life characteristic of a corporation. If the remaining members must vote to continue the company life, this corporate characteristic does not exist.

When three of the four characteristics listed above were present, the LLC was taxed as though it is a corporation. It does not make good sense to do business as an LLC unless the company will be treated as a partnership for federal tax purposes. In states which still utilize the IRS test for determining whether the LLC will be treated as a partnership for state tax purposes, if an LLC has any three of the above characteristics, it will be taxed as a corporation. Such taxation would be detrimental to members so care must be taken in deciding which common characteristics the company should share with a corporation.

Another tax concern of an LLC is how its property will be treated for tax purposes. Property which is titled in the LLC name is owned by the LLC, not the individual members. The same is true for property contributed to a corporation or a partnership. A member who contributes property to an LLC relinquishes ownership in the property, and property purchased with LLC funds is owned by the LLC. This company ownership of the property means that creditors of members cannot attach the property. They are limited to attaching the member's interest in the LLC. The property held by an LLC can be legally sold, transferred or conveyed only by the company. The LLC's basis in the contributed property is the basis that the member had before it was contributed.

H. DEBTS OF THE PRIOR BUSINESS

Many new businesses are really reformations of existing businesses. Frequently general or limited partnerships are changed to LLC's. At times a sole proprietor will contribute assets of an existing business into the LLC being formed. Question: How are debts from an existing business treated when the business assets are transferred to a new LLC? The general rule is that a newly formed LLC is not liable for the debts of a prior business whose assets were transferred into it unless all of the members (or all of the managing members) agreed to have the LLC so bound. Still, assured by the new LLC or not, the owners of the prior business still remain personally liable for the debts of the prior business. If the transfer of assets into the LLC is intended to defraud creditors or is in violation of a state's Bulk Transfer Act (which governs the transfer of assets of a business), creditors can sue the company to the extent of the value of the property transferred.

Every state has adopted the Uniform Commercial Code, which contains the Bulk Transfer Act. Under the Bulk Transfer Act, notice must be given to creditors of a business whenever the majority of a business's assets are transferred. The Bulk Transfer Act also applies to transfers into a new LLC. The transfer is usually required to give at least 10 days notice to creditors and the local tax assessor before the transfer. The tax assessor will impose a property tax on the transaction. Notice to creditors is usually given by publishing a Notice of Bulk Transfer in the newspapers of general circulation. If no creditor objects, the transfer occurs and the creditors lose their right to seek return of the transferred assets from the LLC.

III. DISSOLUTION OF AN LLC

Dissolution of an LLC is the termination of the company and is, in fact, its legal death. Dissolution occurs under the terms of the operating agreement when any of the following acts occur:

1. Members holding more than 50% of the voting rights in the LLC vote to dissolve.
2. Managing members dissolve the LLC because:
   - (a) The LLC did not issue any shares and thus was never really an LLC, or
   - (b) The LLC has filed a chapter 7 bankruptcy petition, or
   - © The LLC has disposed of all of its assets and hasn't conducted business for some time (usually 5 years).
3. Creditors file a legal action and win involuntary dissolution of the LLC to liquidate company assets and pay the creditors.
4. The termination date listed in the articles of organization arrives.

The most common reason for the early termination of a company is the death, bankruptcy or expulsion of a member. Unless the operating agreement states otherwise, a company will automatically terminate upon the death, bankruptcy or expulsion of a member.

In the absence of a contrary provision in the operating agreement, the voluntary withdrawal of a member will automatically dissolve the company in most states. A few states, such as Delaware, Iowa, Maryland, Texas, Virginia and West Virginia for example, permit members to withdraw without dissolving the company unless the operating agreement states otherwise. The states of Arizona, Colorado, Illinois and Minnesota, for instance, permit a member to withdraw even though forbidden in the operating agreement. In a situation where a member withdraws and the company is not dissolved, the member is entitled to the return of his capital. Specifically, Florida, Kansas, Nevada, Utah, and Wyoming, for example, each require the return of a withdrawing member's capital within six months unless an earlier date is specified in the operating agreement.

Several states, Arizona, Colorado, Illinois and Minnesota, for example, provide for a reduction of the capital returned to a withdrawing member when the withdrawal was in violation of the operating agreement and caused the company to incur damages. In the absence of contrary intent expressed in the operating agreement, some states, such as Arizona, Colorado, Delaware, Illinois, Iowa, Louisiana, Minnesota, Nevada, Oklahoma, Rhode Island, Texas and Virginia, hold that a withdrawing member is to receive the fair market value of his interest in the company minus any damages caused by a wrongful withdrawal from the company.

After dissolution has been approved or ordered, the LLC must stop doing business except to the extent necessary to discharge the affairs of the company. When a resolution to dissolve is adopted or ordered, the LLC must file a certificate of dissolution with the secretary of state where it was formed.

The distribution of company assets, following dissolution, will be made as follows:

1. All federal and state taxes are paid.
2. All employee wages and benefits are paid.
3. All secured liabilities are paid.
4. All unsecured liabilities are paid.
5. Any remaining funds are distributed pro rata among the members in accordance with their percentage of ownership interest in the company.

The proceeds received by a member in the dissolution of an LLC are a return of the member's investment. Any gain or loss realized by a member as a result of the dissolution is treated as a capital gain or loss. For example, assume that a member paid $4,000 for the membership certificates. He received $3,000 at dissolution. He has a $1,000 capital loss. Likewise, if the member received $6,000, he would have a $2,000 capital gain.

All states require that LLC's formed under their laws file a statement of dissolution either before or after the dissolution is completed. Arizona, Florida, Kansas, Louisiana, Maryland, Minnesota, Nevada, Oklahoma, Utah and Wyoming, for example, require filing a statement of intent when the dissolution begins and a statement of conclusion when the dissolution is finished. Other states such as Delaware, Illinois, Iowa, Rhode Island, Texas, Utah, Virginia and West Virginia do not require the first filing stating the intent to dissolve. All states require the final filing when the dissolution is completed.

Some states require the creditors of the company to be given specific notice of the intent to dissolve the company. For instance, Kansas requires the company to mail each creditor a notice of the dissolution within 20 days after filing the intent to dissolve.

IV. LAWSUITS

An LLC is a legal entity, but because it is an artificial entity, it needs an individual to file any lawsuit on its behalf. When the company is managed by all the members, a suit can be brought by a member only after a majority vote of approval by the members. An exception to the majority vote approval requirement for filing a suit may exist where there is a conflict of interest among the members or members are breaching their fiduciary duties. The non-agreeing members would be excluded from the voting, and only the votes of the disinterested members would be considered. If the suit is commenced, and it is later found that the members whose votes were ignored were not in violation of their fiduciary duties and had no conflict of interest, the persons bringing the suit might be held personally responsible for any damages caused by virtue of the suit.

When a suit is brought by virtue of a majority vote of approval by all members, no member will be personally liable for any damages that might result to the company. When the company is being managed by managing members, it is the managing members who have the authority to file suit on behalf of the company. A manager is bound by the fiduciary standard of care of a reasonable and prudent manager in making a decision about commencement of a lawsuit.

Liability attaches to a member who brings unauthorized or improvident suit that violates the fiduciary standard of care. Should a member act without the approval of the other members to file suit, the company would nonetheless be bound by the decision or settlement. The company may sue a member for any damages which the company suffered by virtue of the member bringing an unauthorized suit or settling one improperly.

As part of the legal series, a book on limited liability companies has also been written.

CHAPTER 4

NORTH AMERICAN FREE TRADE AGREEMENT

(NAFTA)

INTRODUCTION

The North American Free Trade agreement (NAFTA) is the most important and expansive trade agreement ever created. The signatories of NAFTA are Canada, Mexico and The United States.

Several Central American countries have expressed interest in joining NAFTA as well. NAFTA is the largest free trade zone in the world. NAFTA creates a single $6.5 trillion market with 370 million persons. The primary aspect of NAFTA is its tariff elimination feature. Prior to the enactment of NAFTA Mexican import tariffs were 2.5 times greater on American and Canadian goods than the import tariffs charged by the U.S. or Canada on Mexican goods. Nearly all tariffs on Canadian, Mexican, and American goods are scheduled to be slowly eliminated within 10 years.

NAFTA is in many ways a continuation of the 1988 Canada-United States Free Trade Agreement (CFTA). As a result of the enactment of the CFTA, trade between Canada and the United States experienced unprecedented growth. Both Canada and the United States prospered as a result of the increased trade to an extent that exceeded expectations. Canadian trade in 1992 accounted for 1.5 million U.S. jobs. It was the success of CFTA that prompted Canada and the United States to approach Mexico with the idea of creating a similar program for all of North America.

Mexico, after decades of isolationism, was receptive to the idea of a North American free trade zone. Until 1986 Mexico's markets had essentially been closed to foreigners. As a result, the Mexican economy had stagnated. In 1986, Mexico had eased some of its restrictions to foreign investment and opened many of its markets. The result was an immediate success. The year Mexico opened its markets (1986) U.S. trade with Mexico was $17.8 billion.

In 1992, U.S. trade to Mexico had increased to $40.6 billion, an increase of 228%. Mexico is the U.S.'s second largest market for manufactured goods, much larger than Japan. U.S. trade to Mexico in 1986 supported nearly 700,000 jobs scattered throughout the United States. NAFTA is projected to create another 200,000 U.S. jobs in its first year. Mexico was the third largest trading partner of the United States even before NAFTA. The per capita income for the average Mexican is relatively low compared to a U.S. citizen, but there are over 90 million Mexicans. The purchasing power is impressive.

NAFTA coverage will extend to products and goods originating in North America (Canada, America or Mexico) or goods and products that contain nonregional materials that have been transformed to such an extent by the manufacturing process that they are now considered as originating in North America. There is a de minimis rule for many products that permits as much as 7% of a product to contain non-North American materials without substantial modification.

Special treatment under NAFTA is afforded automotive goods. Tariffs on passenger cars, light trucks and other vehicles and parts are to be slowly eliminated, usually in five years but not more than 10. Cars and trucks must have at least 62.5% North American content (be composed of North American originating materials). Other vehicles and parts must have a 60% content. Mexico has agreed to end its Auto and Auto-Transportation decrees that impose production and sales restrictions by 2004. In 2009 Mexico will begin a 10-year elimination of its imports of North American used vehicles. Estimates for the U.S. automobile industry predict that for the first year NAFTA sales will rise from less than 2,000 vehicles to over 60,000 vehicles.

Most tariffs on textiles and apparel were eliminated immediately upon enactment of NAFTA with the remainder to disappear by 2004. Most U.S. quotas on Mexican textiles and apparel were eliminated on those goods that meet NAFTA's rules of origin (met the required percentage of North American origin).

Broadly speaking, a free trade zone in North America will remove or gradually reduce barriers to trade and permit a more profitable growth of trade between all of the members. Established economic policies of free trade increase efficiency in trade and lead to increased trade and overall improvement in economic well-being. Most economists have predicted that NAFTA will generate a discernible increase in U.S. jobs. The Institute for International Economics predicted a net gain of 170,000 jobs by 1995 with 316,000 new jobs against a loss of 145,000 jobs.

The average Mexican purchases more U.S. imports than the average person in the European community or Japan. Seventy cents of every dollar a Mexican spends on foreign products is spent for a U.S. product. In 1992, the average Mexican spent $450 on U.S. produced products. In contrast, the average Japanese individual only spent $385 on U.S. products. Mexico is the second largest market for U.S. tele-communications exports in the world, which increased 20% between 1991 and 1992.

NAFTA will have both its good points and its bad points. Personal feeling on NAFTA will depend on how it affects the individual on a personal basis. The International Trade Commission has estimated that the U.S.'s horticultural, tuna, apparel, construction and household glassware industries are to be the most adversely affected by NAFTA. In contrast, the greatest gains are estimated in U.S. agricultural and capital goods. Capital goods are goods used in the production of other goods: industrial buildings, machinery, equipment, highways, office buildings, government installations. These goods form a nation's productive capacity.

Capital goods have been the slowest increasing export category of U.S. exports between 1988 and 1993. Capital goods remain the largest single export item to Mexico but the percentage has been dropping. In 1987, the percentage of total U.S. capital goods exported to Mexico was 40%. In 1992, this percentage reduced to 33%. The percentage is misleading to an extent because overall trade with Mexico during this period increased by 228%. So the net cash value of capital exports to Mexico was nearly twice what it had been in 1987. Capital goods account for 40% of all U.S. exports to developing countries and 39% of all U.S. exports in total. The exports of capital goods to Mexico support major employment in high paying U.S. jobs and will continue to do so for many years to come.

Prior to NAFTA, Canada had little trade with Mexico. Canada's reason for joining NAFTA was to assure that it did not lose benefits from its existing free trade agreement with the United States. Canada also recognized the possible advantage that might accrue from having the sizeable Mexican market opened to it. Generally, the tariff reduction schedule established under CFTA remains in force for trade between the U.S. and Canada at lower rates than most of the NAFTA schedules. The result is that most goods traded between Canada and the U.S. are very nearly tariff free whereas goods traded to and from Mexico will still in many cases be subject to tariffs for the next five or 10 years. Canada and the U.S. still have a slight incentive over the next few years to trade between themselves rather than with Mexico until all tariffs are eliminated.

It has been asserted that NAFTA is the best prospect for reducing illegal immigration from Mexico to the United States. A study on the economic impact of illegal immigration was performed in 1991 by Robinson and Hinojosa-Ojeda of the University of California. The report concluded that free trade coupled with internal reforms could reduce immigration (both legal and illegal) by 260,000 to 1.1 million people by the year 2000. Another study by William Spriggs of the Economic Policy Institute (an opponent to NAFTA) concluded that NAFTA would result in 1.4 million fewer Mexicans migrating to the U.S. by the year 2000. It has also been concluded that a reduction of illegal migration to the U.S. will result in the real wages of U.S. residents increasing as much as 6%. NAFTA does not interfere with a member's right to set its own environmental, health or safety standards. Nonetheless, NAFTA requires each country to make laws and set standards compatible with the other two. Supplemental agreements on environmental issues require that each country actively enforce its environmental laws equally and without discrimination against persons or entities from the other NAFTA members.

Commissions are to be established to settle disputes when a government does not enforce its laws with the result that investors, persons or businesses from the other NAFTA countries are placed in a competitive disadvantage. If for a period of time the nonenforcement of the law continues, trade sanctions may be imposed under NAFTA against the offending country. The United States reserves the right to enforce its own trade laws, and if NAFTA is not operating for the benefit of U.S. workers and businesses, the U.S. may withdraw from NAFTA at any time after six months notice.

An argument against NAFTA often heard is that U.S. companies will abandon the U.S. and relocate in Mexico. While this will undoubtedly occur in some glaring instances, it will not be the rule. Even before NAFTA, Mexico permitted regulated foreign investment. In addition, there is the maquiladora program that permits American companies to open plants directly across the border and have the finished products shipped to the U.S. tariff free. Despite this fact, only a few foreign companies have opened plants in Mexico and the U.S. is not being overcome with imports from such plants. In fact, the opposite has occurred: U.S. exports from highly paid U.S. workers have flooded Mexico. The economic message is that low wages alone do not guarantee success. Quality of the work and high productivity are more important than low wages alone. The text of NAFTA may be obtained by calling the U.S. Printing Office at (202) 783-3238 or by fax at (202) 512-2250. Payment for the order may be made by credit card using VISA or MasterCard. Documents can also be ordered by mail sent to:

Superintendent of Documents
U.S. Government Printing Office
Washington, D.C. 40402

The prices for the NAFTA publications are:

TEXT OF NAFTA (volumes 1 and 2)	041-001-00376-2	$41.00
TARIFF SCHEDULES (ANNEX 302.2):		
UNITED STATES	041-001-00377-1	$34.00
MEXICO	041-001-00391-6	$34.00
CANADA	041-001-00390-8	$30.00
SUPPLEMENTAL AGREEMENTS	041-001-00411-4	$6.50

The tariff schedules are the most important NAFTA books. These schedules list the tariff rate that each party imposes on the imported goods from each of the other members and the tariff elimination schedules.

CUSTOMS PROCEDURES

The greatest practical impediment to trade between countries is the paperwork which exporters must prepare in order to sell their product. The cumbersome nature of the paperwork and long delays in delivery that result from any small technical mistake has caused manufacturers to decide not to export their product. The main reason behind the paperwork is so that the importing country can collect tariffs. As tariffs are eliminated, the need for such paperwork is, itself, gradually eliminated. Towards this end, NAFTA has up customs procedures to reflect the gradually reducing tariffs and thus less paperwork as well.

NAFTA concerns increasing trade between Canada, Mexico and the United States. For that reason, it is important for a procedure to be adopted to determine what is the country of origin for products exported between the countries. Without a viable system to determine truth of origin, non-NAFTA countries can ship their product through one NAFTA country to another in order to avoid import duties.

NAFTA adopted the origin rule of the 1988 Canada-U.S. Free Trade Agreement (CFTA) as its standard. To be covered by NAFTA, exported goods must have undergone processing in North America. Many foreign corporations have significant investments in NAFTA countries. It is hoped these foreign corporations will increase their operations in Canada, Mexico and the United States to qualify for the NAFTA tariff reductions.

I. CERTIFICATE OF ORIGIN

NAFTA creates a uniform certificate of origin for use by NAFTA countries. The Certificate of Origin can be obtained from many stationary stores and from the U.S. Custom Service. The exporter of a product seeking NAFTA tariff reduction must state in the certificate of origin that the product qualifies as an "originating good." An originating good is one that qualifies under NAFTA as a product possessing the required North American content. NAFTA does not require certificates of origin when the value of the exported good does not exceed $1,000. Importers who seek to claim tariff reductions on imported goods under NAFTA must declare the imports qualify as originating goods. The importer's declaration must be based on the exporter's certificate of origin. An importer has one year to seek refund for any excess tariff that was erroneously paid on qualified original goods. For example, assume that a product qualifies for a 10% reduction in tariffs, but the importer mistakenly pays full tariff. The importer can seek a refund for the 10% overpayment within one year of the overpayment.

False statements on a certificate of origin will subject the exporter to the same civil and criminal penalties as an importer who makes false statements to avoid tariff duties. An exporter who voluntarily corrects a false certificate will not be subject to penalties for the false statement.

II. PRODUCT TRACING

NAFTA imposes upon both exporters and importers the burden of having to maintain records for five years on products that were issued certificates of origin and received reduced tariffs. NAFTA requires that the parties keep records on:

1. The cost of the product exported.
2. The value of the product exported (its finished price).
3. Materials used for the products construction (including the source of the materials and their cost).
4. The cost of assembly of non-NAFTA materials.
5. The payment for the product.

The purpose of requiring the maintenance of these records is to assure that goods for which tariff reductions were given did, in fact, qualify for the reductions. The documentation requirement imposes a greater burden on smaller companies than larger companies. Small companies do not usually maintain such detailed records. Revamping their records policy to maintain such comprehensive records will be difficult. When the tariff savings involved are relatively low, the expense in maintaining these records may exceed the amount actually saved. In such an event, the importer may simply decide to pay the full tariff rather than be bound by unprofitable record keeping.

The customs agency has the authority to determine if exported products actually qualify for NAFTA tariff reductions. NAFTA permits a customs agency to verify the contents of a certificate of origin by sending written questions to the exporter or visiting the exporter's premises in the exporter's country. Surprise inspections of an exporter's premises are not permitted, but should an exporter deny a request for an inspection, the exporting country can then deny preferential tariff treatment to the exporter.

NAFTA permits exporters and importers to obtain advance rulings from the customs agencies. The advance rulings state how the importing country will treat certain goods if imported from the other NAFTA participants. NAFTA requires each country to establish a program for processing advance rulings. Advance rulings can provide assurance to the exporter. Most exporters want to know how their product will be treated before actually commencing trade.

III. ADMINISTRATIVE OPERATION

NAFTA requires that each NAFTA member give to exporters the same rights of review and appeal it gives to importers in its own territory. NAFTA does not require that each country adopt the same system of review and appeal. Instead, NAFTA merely requires that each country give exporters the same rights of review and appeal it furnishes its own citizens (the importers).

Uniform regulations are required to be adopted by NAFTA countries for the interpretation, application and administration of "rules of origin." They provide a uniform standard for tariff comparison and NAFTA implementation. NAFTA requires each of the countries to cooperate among themselves in its implementation. Specifically, the countries are required to collect and exchange trade data and statistics. NAFTA also requires that a working group be established to process changes to rules of origin and uniform regulations. In 1989, the United States adopted a "harmonized system of tariff classification." This system has been adopted throughout the world. NAFTA adopted this system, thereby standardizing the origin rules for the NAFTA countries.

IV. COUNTRY OF ORIGIN RULE

NAFTA Article 401 determines what exports are covered by NAFTA. Article 401 states:

A good shall originate in the territory of a party where:

(a) The good is wholly obtained or produced entirely in the territory of one or more of the parties;

(b) Each of the nonoriginating materials used in the production of the good undergoes an applicable change in tariff classification set out in Annex 401 as a result of production occurring entirely in the territory of one or more of the parties, or the good otherwise satisfies the applicable requirements of that Annex where no change in tariff classification is required, and the good satisfies all other applicable requirements of this chapter;

(c) The good is produced entirely in the territory of one or more of the parties exclusively from originating materials; or

(d) The good is produced entirely in the territory of one or more of the parties but one or more of the nonoriginating materials provided for as parts under the Harmonized System that are used in the production of the good do not undergo a change in tariff classification because:

(I) The good was imported into the territory of a party in an unassembled or a disassembled form but was classified as an assembled good pursuant to General Rule of Interpretation 2(a) of the Harmonized System, or

(ii) The heading for the good provides for and specifically describes both the good itself and its parts and is not further subdivided into subheadings, or the subheading for the good provides for and specifically describes both the good itself and its parts, provided that the regional value content of the good, determined in accordance with Article 402, is not less than 60 percent where the transaction method is used or is not less than 50 percent where the new cost method is used.

Goods exported from a NAFTA country to another NAFTA country will be covered by the tariff elimination schedule of NAFTA if:

1. The goods were completely manufactured or produced in a NAFTA country from materials that derived entirely from a NAFTA country, or
2. The goods contain non-NAFTA derived parts which were significantly changed as a result of production in a NAFTA country, or
3. The goods contain non-NAFTA parts and their assembly into the final product accounted for 60% of the value of the finished product, or
4. The good contains non-NAFTA parts or materials the cost of which do not exceed 7% of the value of the finished products.

V. TARIFF CLASSIFICATION CHANGES

Annex 401.1 describes the tariff changes required to grant

North American origin to goods containing non-NAFTA components. Annex 401.1 tariff category listings also state what the manufacturer must do to meet the NAFTA tariff elimination requirement. NAFTA differs from previous tariff treaties in that it does not require a specific percentage of the product value to be derived from the country claiming the tariff reduction. Under the Generalized System of Preference (GSP), 35% of the value of the product must be derived from work or materials provided by the GSP country seeking the tariff reduction.

Article 402 of NAFTA establishes two methods for determining the North American content of the finished products exported between NAFTA countries. Article 402 reads in pertinent part:

> 1. Each party shall provide that an exporter or producer may calculate the regional value content of a good on the basis of the following transaction value method:
>
> $$RVC = \frac{TV-VNM}{TV x 100}$$
>
> where RVC is the regional value content expressed as a percentage.
>
> where TV is the transaction value of the good adjusted to a F.O.B. basis; and
>
> where VNM is the value of nonoriginating materials used by the producer in the production of the good.

Under the transaction value test, the North American content of exported goods between NAFTA countries is determined by subtracting the price paid for non-NAFTA materials used in the products construction from the price of the finished product.

Under the net cost test, the price paid for the non-NAFTA materials used in the product are subtracted from the net cost of manufacturer of the product. The manufacturer is entitled to use either of the above tests in determining whether the product meets the North American origin standard. If the product passes either test, it qualifies for coverage under NAFTA.

VI. AUTOMOTIVE RULES

The importance of the automobile industry to the economies of Canada, Mexico and the United States has resulted in special rules for automotive products. NAFTA Section 403 establishes special origin requirements. Under Article 403, the net cost test is used to determine if the North American origin requirement is satisfied. NAFTA requires that automobiles, light trucks and engines must have new cost basis of 56% starting in 1998 that increases to 62.5% in 2002. For other vehicles and automotive parts the percentages are 55% and 60% respectively. The percentage of North American content is higher than the percentage under CFTA. Under CFTA, the local content was only 50%. The higher limits under NAFTA will now control automotive imports between Canada and the U.S.

In order to spur the construction of new automotive manufacturing facilities, NAFTA reduced the North American origin requirement to 50% for the first five years of production. For plants refitted for the production of a new series or line of vehicles, the North American content requirement is reduced to 50% for the first two years of production.

VII. U.S. CUSTOMS SERVICE

The United States Customs Service will be primarily responsible for regulating customs matters under NAFTA. To administer and implement NAFTA's customs provisions, the U.S. Customs Service has assigned personnel to man the help desk in Washington D.C. from 8:00 a.m. to 5:00 p.m. EST. The Customs Service provides information service to U.S. importers and brokers and to Mexican and Canadian exporters or producers of goods for export to the United States. The help desk can be reached:

1. By Fax: (202) 927-0097
2. By phone: (202) 927-0066
3. By letter: U.S. Customs Service
   NAFTA Help Desk, Room 1325
   1301 Constitution Avenue, NW
   Washington, D.C. 20229

In addition to direct contact with its personnel, the Customs Service provides information through its "Flash Fax" system. The Customs Service's Flash Fax system will fax information to a caller's fax machine 24 hours per day. This system is automated and covers the areas of general interest to most importers and exporters. The menu of information available from Flash Fax is obtained by calling (202) 927-1692 or 927-1694.

Besides the help desk and Flash Fax, the information can be obtained from the Customs Service's Electronic Bulletin Board. Through the Bulletin Board, the Customs Service provides the entire trade community the latest information on its customs operations plus NAFTA information. The user, once he has accessed the Bulletin Board, can down load specific information into his personal computer. There is a small charge for accessing the system. To access the Bulletin Board the user must:

1. Set the user's communication package on his personal computer as an ANSI terminal,
2. Set the DATABITS field to 8,
3. Set the STOPBITS field to 1,
4. Set the PARITY to N,
5. Set the phone number to (202) 376-7100,
6. Set the terminal background color to black,
7. Disable any call waiting feature.

If problems are experienced regarding the use of this system, call (202) 376-7039 for assistance.

In addition to the general information available from the Customs Service through its help desk, Flash Fax or Bulletin Board, specific information on NAFTA can be obtained on:

1. Duty phaseouts.
2. Temporary admission.
3. Rules of origin.
4. Marking.
5. Drawback.
6. User fees.
7. Vessel repair.
8. Certificates of origin.
9. Verification procedures.
10. Advance ruling procedures.

VIII. EXPORT INFORMATION

To provide assistance to exporters, the government of Mexico, the United States Department of Commerce and the United States

Customs Service have instituted several phone services for the dispersement of information. These phone numbers are:

A. <u>UNITED STATES DEPARTMENT OF COMMERCE</u>

1.	Office of Mexico	(202) 482-0300
2.	Office of Mexico, "FLASH FACTS" Information Line	(202) 482-4464
3.	Office of Canada	(202) 482-3103
4.	Office of Canada, "FLASH FACTS" Information Line	(202) 482-3101
5.	Office of Textile and Apparel, Martin Walsh	(202) 482-3400
6.	Industrial Trade Staff	(202) 482-3703

B. <u>UNITED STATES CUSTOMS SERVICE</u>

1.	NAFTA HELP DESK	(202) 692-0066
2.	NAFTA HELP DESK, "FLASH DESK" Information Line	(202) 692-1692

C. <u>MEXICAN GOVERNMENT</u>

1.	NAFTA Hotline	(011-525) 211-3545
2.	FAXLINE	(011-525) 256-4737

CHAPTER 5

GUARDING AGAINST EMPLOYMENT PROBLEMS

From the moment a person in business decides to hire employees, life will never the same. The social engineers have succeeded in passing employment laws that impose onerous and often ridiculous hiring restrictions. The result is that employers can find themselves totally at the mercy of unscrupulous employees or prospective job applicants who file frivolous employment complaints. In addition, the regulatory agencies almost always side with the employees or prospective employees regarding such complaints.

A national television news show devoted an entire program to an example of this plight during the 1992 Presidential campaign. A small employer in Illinois with about 50 employees was charged by the federal government's Equal Employment Opportunity Commission with discrimination against a black woman because she had not been hired. The employer's business was located in a primarily Hispanic part of town. All of the employees were minorities. The only Caucasian was the boss. The number of employees had varied in the past. Many employees would come and go. The employer had other black employees. The Equal Employment Opportunity Commission concluded that, given the demographics of the area, the employer should have had more black employees and ordered him to pay a fine of nearly $100,000. There was no proof of discrimination: only the imposition of the demographic study that the agency claimed was not a quota requirement. The show interviewed former black employees who all stated that they had never in any way felt discrimination or been treated unfairly. The employer offered the woman a job, but she refused, choosing instead to receive the agency's award of lost pay for not being hired. This highlights the concern that an employer should have when hiring employees.

In our society a terminated employee or an unsuccessful job applicant has nothing to lose by filing a false complaint alleging discrimination. Most complaints are not required to be verified. Outlandish claims can be made. In fact, there are some people who deliberately apply for a job with the hope of being rejected so they can file a discrimination suit. After the suit is filed, the person offers to settle for an amount considerably less than the employer would have to spend defending himself against the worthless complaint.

Employment law is not and has never been settled. Each state and the federal government has its own laws regulating employment relations. A corporation operating plants in several states will have unique problems. Such corporations must be careful to obey all state laws. They must be careful not to give unequal treatment to their employees in the different states because of differing state laws. An example of this is that in 1997, American Airlines challenged in Federal Court a City of San Francisco law that required employers doing business with the City give all the rights to the partners of gay employees that it gives to spouses of married employees. American Airlines objected because it would have to give those rights to gay partners outside of San Francisco as well or be in violation of the Federal law of equal pay for equal work.

The penalties for violating labor laws can be astounding. In a case involving sex discrimination, an insurance carrier recently paid more than $250,000,000 in settlements. Given the fact that courts can go back years and make awards for hundreds of people regarding past conduct, it becomes absolutely imperative that an employer know, understand and follow the law. Ignorance and good faith mistakes are just not sufficient defenses to violations of employment laws.

This chapter is designed to help instruct an individual in how best to hire competent, professional and decent employees without violating state or federal law. This chapter touches upon the major considerations of employment law. An employer should have, at the least, cursory knowledge of them.

I. NON-DISCRIMINATORY QUESTIONS THAT AN EMPLOYER MAY ASK

An employer has the right to establish job-related requirements and to seek the most qualified person for a job. The employer is permitted to ask questions and obtain certain personal information to be used in making the employment selection and the job assignment decisions. The tests for the appropriateness of a certain question are whether they will result in the disproportionate elimination of members of a protected group, or are they a valid predictor of successful job performance.

Despite the above, an employer is prohibited from making any non-job related inquiry which may directly or indirectly limit a person's employment opportunities because of race, color, religion, national ancestry, physical handicap, marital status, sex or (for adults) age.

An employer is not permitted to ask a woman her maiden name.

Such information is considered irrelevant to job performance and an unnecessary intrusion into her privacy. Asking such questions may tend to stigmatize an unmarried woman or perpetuate stereotypes that a single woman may get married and quit while a married woman is a more stable employee. Appropriate questions that can be asked instead are, "Have you ever used another name?" or "Is any additional information relative to a change of name, use of an assumed name, or nickname necessary to enable a check on your work or educational record? If so, please explain."

The employer is permitted to ask the applicant for his place of residence. Such information is necessary for the ordinary operation of the business. The employer has a legitimate reason for wanting that information so he can contact the individual when necessary. He also needs it to maintain required tax and governmental records.

The employer has no valid business reason for asking whether an applicant owns or rents a home. Such a question may have the effect of discriminating against a job applicant who is a renter because the employer may feel that a person owning a home would be less willing or able to relocate if a better job comes along. An employer may incorrectly view a person owning a home as being more stable and reliable than a renting employee.

There are conflicting laws regarding the questions that an employer may ask a job applicant regarding citizenship and birthplace. It is illegal to discriminate against a person because of citizenship or national origin; yet it is equally illegal to hire an illegal alien. The problems facing an employer hiring aliens and the necessary compliance provisions are such that an employer doing so should be careful to assure the applicant is legally permitted to work in America. An employer should never ask an employee the following questions or ask him to provide proof of the following:

1. Are you a citizen?
2. What is the citizenship of your spouse, parents, brothers, sisters, uncles or aunts?
3. Where were you, your parents and spouse born?

An employer may not require the applicant to provide proof of naturalization, a green card or work permit prior to the decision to offer the person a job. An employer may ask the following question, "Can you, after employment, submit verification of your legal right to work in the U.S.?" An employer may make a statement that proof of the right to work in the United States may be required after a decision is made to hire the applicant.

It is against the law to ask questions that are designed to discover an applicant's national origin. Questions that have been held to be illegal are:

1. Questions concerning nationality, lineage, ancestry, national origin, descent, or parentage of the applicant, parents or spouse.
2. What is your mother tongue?

3. What is the language that you most commonly use?

4. How did the applicant learn the ability to read or write the foreign language?

If a foreign language is necessary or relevant for the job, an applicant can be asked if he reads, writes or speaks a language other than English.

Most states make it illegal for an employer to ask an applicant about any arrests that the applicant may have suffered. Such information is considered irrelevant and an intrusion into the job applicant's right of privacy. Arrests that did not lead to criminal charges being filed are usually not public records and thus not discoverable by the general public.

People can be arrested by mistake or in violation of their civil rights or as a material witness. There is no relevance between an applicant's arrest where no prosecution occurred and job performance. Therefore, questions regarding any arrests of an applicant should not be asked.

Questions regarding criminal convictions depend upon whether the conviction is a felony or a misdemeanor and if it relates to job performance. Most states, such as California, permit an employer to ask an applicant the general question, "Have you ever been convicted of a felony?" California and a few other states require a statement to follow this question to the effect that a conviction will not necessarily disqualify an applicant from employment.

A few states require the questions to be tailored directly to the job, such as for a druggist: "Have you ever been convicted of a felony regarding drugs?" or for a job requiring a driving license, "Have you ever been convicted of a felony regarding a motor vehicle?"

Many states, such as California, do not permit an applicant to be questioned about misdemeanor convictions. In California, for instance, many offenses are misdemeanors which would be infractions in most other states such as fishing without a separate license for each fishing pole used or removing a sign without a permit. In any event most states do not consider questions about misdemeanor convictions legal.

Questions regarding the refusal or cancellation of a bond are illegal in California unless related to the job. Most states would permit such questioning if they were tailored to a job that required bonding. Example: If bonding is required for a job such as a cash register operator, the employer might be able to ask, "Have you ever had a bond canceled for a cash register job?" Probably the better thing to do is for the employer to state that bonding is a condition for hire. The bonding company would then probably discover any past rejection or cancellation without involving the employer in any illegal invasion of the applicant's right of privacy.

An employer should be careful when asking an applicant about military service. The information sought could lead to charges of age discrimination or national origin discrimination. Questions that should not be asked are:

1. General questions about military service such as date and type of discharge. It might be possible to calculate the applicant's age from this information and thus expose the employer to possible age discrimination claims. Such questions are against California law. Some states may permit them, but the risk outweighs the benefits.
2. Questions regarding service in a foreign military are against California law. Such questions may lead to discovery of an applicant's national origin and expose an employer to a discrimination lawsuit.

In California the safe employer should ask the applicant only questions concerning relevant skills acquired during the military service. This is a good practice, even in states not as liberal as California. It avoids challenges or potential lawsuits for past practices if the law should happen to change.

It is illegal in California to ask an applicant to list all organizations, clubs, societies and lodges to which he belongs. The reason for this is that the questions are so general as to elicit and obtain irrelevant information. Moreover, the answers could disclose information that might cause discrimination based on age, religion, sexual or national origins. The theory is that if the employer does not know of the information, the employer cannot use it to discriminate. An employer may ask an applicant the following question, "Please list job-related organizations, clubs, professional societies, or other associations to which you belong. You may omit those that indicate your race, religious creed, color, national origin, ancestry, sex, or age."

An employer must be careful when speaking with a person offered as a reference by an applicant. In questioning the reference, the employer may ask only those questions that could be asked of the applicant. The employer may not ask an applicant's references questions whose answers would elicit prohibited information regarding the applicant's race, color, national origin, ancestry, physical handicap, medical condition, marital condition, age or sex. An employment discrimination complaint can be filed by a job applicant against any employer who asks such improper questions.

The employer is permitted to ask an applicant the name of the person who referred the applicant for the position. The employer may also request the names of persons willing to provide professional or character references on the applicant. An employer may ask an applicant to furnish the name and address of a person to be notified in the case of an accident or emergency. Such information serves a legitimate business purpose. The employer is not permitted in California to ask the name, address and relationship of a relative to be notified in case of an accident or emergency. From this information may be inferred other information of marital status or national origin that is otherwise improper and irrelevant for job performance. For example, if a parent is listed as the relative to be contacted, the applicant's ethnic background might be determined from that parent's name.

II. AGE DISCRIMINATION

Age discrimination is the firing or hiring of employees based solely upon age. In 1967 Congress passed the American Discrimination in Employment Act (ADEA) to fight age discrimination. Under this Act an employer cannot discriminate in the hiring, firing or promotion of employees between 40 and 65 years of age. In 1978 ADEA was extended to most employees up to 70 years of age with the following exceptions:

1. Executive or high-policy making employees.
2. College or university employees.
3. Bona fide occupational qualifications, such as airline pilots retiring at 60 years of age.

There have been significant and well publicized cases in the last few years whereby employees who were discharged because of their age have recovered huge awards in court.

Age discrimination is against both state and federal law. Yet some jobs may legally have age limitations. Examples: Airline pilots who must retire at age 60 or a bartender in a state where the legal age to drink is 21. Age questions that are illegal or dubious and should be avoided are as follows:

1. What is your age?

2. What is your birthdate?
3. What are the dates of attendance or completion of elementary or high school?
4. General questions that are designed or tend to identify applicants as being over 40 years of age.

Questions that have been held not to promote age discrimination are:

1. If hired can you show proof of age?
2. Are you over eighteen years of age?
3. If under eighteen, can you, after employment, submit a work permit?

An employer may make a statement that employment is subject to verification that applicant meets legal age requirement. Age discrimination for a job is permitted when the type of job requires exceptionally good health. Where the risk to the public increases as the employee ages, the validity for an age limit for employment or for mandatory retirement also increases. Federal courts have upheld the mandatory retirement of airline pilots at 60 years of age by recognizing that pilots of that age have more strokes and heart attacks than younger pilots. A pilot having a heart attack may result in a plane crash.

III. EQUAL PAY FOR EQUAL WORK

The Federal Equal Pay Act (FEPA) applies to nearly all employers in the United States (Congress exempted itself). Under this act, employers must pay the same amount to men and women working under similar conditions doing jobs that require similar skill, effort and responsibility. Under FEPA salary differentials based upon non-sex reasons such as seniority or work performance are still permissible. Job titles are not dispositive in determining if the work done by men and women are similar. The actual duties need not be identical but they must be substantially equal in order for FEPA to apply.

FEPA is administered by the Equal Employment Opportunity Commission (EEOC) at 2401 E. Street, N.W., Washington, D.C. 20506. If the EEOC decides not to act upon a complaint filed against an employer, the employee will have two years to file a lawsuit for the equal-pay violation. He has three years to file for intentional discrimination. The court can award back pay, court costs and attorney fees.

IV. INDEMNIFICATION

In most states an employer cannot require an employee to indemnify (reimburse) the employer for torts committed during the normal course of employment. Some employers, as a condition of employment, require employees to agree to indemnify (pay) all claims and judgments that other persons may have against the employer as a result of the employee's actions. Example: An employee has a car accident while running a job errand. The employer is sued because the accident occurred while the employee was performing his job. An indemnification requirement for employment would force the employee to pay any judgment against the employer. Employment contracts requiring employee indemnification usually violate both the state's Labor Code and public policy. An employee is an agent for the employer and the employer is responsible for what the employee does in the course of employment. An exception that might permit indemnification is the situation where the employee commits an intentional tort. Most states will permit the employer to sue the employee for indemnification (reimbursement) for the damages that the employee caused. Example: An employee attacks and beats a person on the job. The employer is liable for damages, but, since this is an intentional tort, the employee may be required under state law to reimburse the employer.

V. DISMISSAL FOR ALCOHOLISM

Alcoholism is not considered a handicap under the Federal Rehabilitation Act or in most states. Therefore, in most states it is permissible to fire an alcoholic employee. The reason used for the firing, although work product is not affected, is the anticipated future medical expenses expected to be caused by the alcoholism.

However, recent court decisions have held that under the Americans With Disabilities Act (ADA) alcoholism is considered a disability. As such, under recent case law, am employer can not fire an alcoholic employee without first making a reasonable attempt to accommodate the employee. This means establishing or paying for a treatment program for the employee. If the employee fails to attend or complete the program in addition to remaining sober on the job, he can be fired without fear of being in violation of the ADA.

A few states, such as New York, have laws that prevent an employee from being fired for alcoholism unless the employee is unable to safely and properly perform his duties. A person fired or adversely treated by an employer because of alcoholism can get information about his rights from the National Council of Alcoholism at 733 Third Avenue, New York, New York 10017.

VI. SEXUAL HARASSMENT

The Equal Employment Opportunity Commission states that sexual harassment pertains to either physical or verbal conduct and exists when:

1. Submission to the conduct is made either explicitly or implicitly a condition of employment.
2. Submission to or rejection of the condition is used as a basis for employment decisions affecting the individual.
3. The conduct substantially interferes with an individual's work or creates an offensive work environment.

If an employer is informed of sexual harassment and does not take sufficient corrective action, he can be sued in federal court or a complaint can be filed with the EEOC. The employer is responsible for the elimination of sexual harassment of employees at work under both state and federal law.

A woman or man can sexually harass, and the harassment does not require overt contact. There are many lawsuits in which women have sued other women for creating a hostile work environment. Women have claimed that the harassing women have caused them severe emotional distress by explicit sexual or profane language. The Ninth Circuit Court of Appeals (West Coast, U.S.A.) has held that the test to determine if conduct is harassment is the "reasonable woman" standard: if a "reasonable woman" would be offended, it is harassment even if the average reasonable man would not consider it harassment.

VII. WORKERS' COMPENSATION

Workers' Compensation is a state-sponsored program involving employer participation (usually mandatory) that ensures all employees against injuries on the job. The program provides cash benefits and medical care for workers who become disabled through injury or sickness related to their job. If death results from the job related injury, benefits are paid to the surviving spouse and dependents. The program has a "down side": injured employees are barred from suing their employers for the injuries suffered on the job. An injured worker is not precluded from suing third parties, only from suing the employer.

Upon hiring an employee the employer becomes responsible for the payment of all workers' compensation, disability and social security payments. Regulatory penalties are available to ensure every employer complies, and there are other punishments for failure to comply. Example: The Zoe Baird case. Ms. Baird was nominated by President Clinton to be the U.S. Attorney General. It was then subsequently discovered that she had employed undocumented aliens and had not made the required social security and other withholding payments for the employees. The hue and cry from the public regarding this breach of the law by someone who was to be the top law enforcement officer of the nation resulted in her name being withdrawn from consideration.

VIII. OSHA

OSHA is short for the Occupational Safety and Health Administration. It was created by the 1970 Occupational Safety and Health Act. An employer may be subject to civil fines of $10,000 with $1,000 per day and criminal fines of $20,000 with criminal sentences of one year per violation of OSHA regulations.

OSHA exists to assure that the workplace is run in a safe manner. Most states have their own state OSHA, and both work together to assure workplace safety. Complaints about OSHA violations are kept confidential upon request. Federal complaints can be filed at the United States Department of Labor, OSHA, 200 Constitution Avenue, N.W., Washington D.C. 20120. An employer should contact OSHA and get handouts regarding information that all employers are required to post at the job site.

IX. OVERTIME

The Fair Labor Standards Act (FLSA) requires that employees be paid overtime pay of at least one and one-half times their regular pay when they work in excess of 40 hours per week. Employers are not permitted to average an employee's hours over two or more weeks to avoid paying overtime. Not all employees are covered by the FLSA. Executive, professional and administrative personnel are not covered by FLSA, nor are some employees of small businesses.

The Act is administered by the Wage and Hour Division of the U.S. Department of Labor. Complaints should be filed in the nearest office listed in the phone book. Upon request, the division will mail a copy of its pamphlet: Handy Reference to the Fair Labor Standards Act.

X. AT-WILL EMPLOYMENT

Most employment in the United States is done without executing a written contract. Termination of such employment is therefore "at the will" of the employer. Unless state law requires grounds for discharge of an employee, an employer may fire an employee who does not have an employment contract. The employer may fire him at any time and without reason. Exception: illegal discrimination.

The only limitation on an at-will employer is that the employer may not fire an "at will" employee for an illegal discriminatory reason such as age, sex, religion or natural origin.

California is one of a minority of states that will find an implied contract that prohibits firing an employee without just cause. The implied contract theory used in California is not followed in most states. The implied contract is found to exist if the company acts in such a way as to create the belief among employees that they will only be fired for good cause.

XI. CIVIL RIGHTS ACT OF 1991

The Civil Rights Act of 1991 pertains to discrimination in employment. The key provisions of the act permit:

1. Compensatory and punitive damages against an employer for victims of intentional discrimination based on sex, religion, disability, race or natural origin. Damages are capped based on the size of the employer.
2. Jury trials in cases involving compensatory and punitive damages.
3. An easier burden of proof for the plaintiff.
4. An expansion of existing law to cover racial harassment on the job and discharge based on discrimination.

Under the Civil Rights Act of 1991 the Rehabilitation Act and the American with Disabilities Act were amended to permit victims of intentional discrimination on the basis of sex, disability or religion to sue for compensatory or punitive damages. Victims of racial discrimination were already permitted to sue for such damages under Title 42 U.S.C. Section 1981. Recovery of damages is not permitted in cases of unintentional discrimination caused by the impact of neutral employment practices.

Plaintiffs may recover both compensatory and punitive damages for violations of the Civil Rights Act of 1991. Punitive damages, however, are not recoverable from a government agency or political subdivision. It must be proven that the employer acted with malice or reckless disregard of the employee's civil rights to win punitive damages. Recovery for both compensatory (future pecuniary losses, pain and suffering, etc.) and punitive damages is limited by the size of the employer:

MAXIMUM RECOVERY	NUMBER OF EMPLOYEES
$ 50,000	15-100
$100,000	101-200
$200,000	201-500
$300,000	501 or more

There is no limit on compensatory damages for past pecuniary losses, nor are damages suffered as a result of racial discrimination limited under Title 42 U.S.C. 1981.

As strange as it seems, prior to the Civil Rights Act of 1991, while it was unlawful to discriminate on the basis of race in hiring and promotions, it was not unlawful to harass an employee based on race. The United States Supreme Court had held that previous civil rights laws did not protect workers from racial discrimination on the job.

The 1991 Civil Rights Act now permits claims for racial discrimination in preparation, performance, modification and termination of employment contracts as well as discrimination in the enjoyment of all benefits, privileges, terms and conditions of the contractual relationship. In short, an employer is no longer permitted to harass employees because of their race.

The 1991 Civil Rights Act makes it easier for an employee to maintain a legal action for an alleged civil rights violation in employment. Once an employee demonstrates that a particular practice by an employer causes a disparate impact on minorities and women, the burden of proof shifts to the employer to justify the practice. The employer is required to show that the challenged practice is job related for the position in question and consistent with business necessity. The employee may also prove unlawful disparate impact by showing that a less discriminatory alternative is available and the employer refuses to adopt it.

Prior to the 1991 Civil Rights Act, many employers, specifically governmental agencies, routinely adjusted upward the employment test scores for minorities. This procedure was called gender or race norming. Supposedly these practices were intended to adjust for the fact that women and minorities were not exposed to the educational system to the extent of white males. Had they been, according to the theory, they would have actually achieved these higher scores. The Civil Rights Act now prohibits race and gender norming. In December 1991 the federal government prohibited state employment agencies from increasing the scores of minority applicants on federally sanctioned aptitude tests.

Mixed motive discrimination exists when an employer acts, at least in part, for a discriminatory reason but proves that it would have reached the same decision based on non-discriminatory reasons. When the employer shows he would have done the same for non-discriminatory reasons, the court may prohibit the employer from considering the discrimination motive in the future and award declaratory relief, attorney fees and costs. The employee still may not recover damages, reinstatement or promotion.

Prior to the 1991 Civil Rights Act, plaintiffs alleging age discrimination had two years from the alleged discriminatory act (three years for willful discrimination) to file a lawsuit. The time was tolled for one year if the EEOC attempted to get voluntary compliance. Previously persons claiming racial discrimination under the 1964 Civil Rights Act had 90 days to file a lawsuit after receiving a letter from the EEOC notifying of a "right to sue." The Act amends the Age Discrimination in Employment Act (ADEA). The EEOC is now required to notify the complainant upon termination of the complaint proceedings. Then the complainant has 90 days to file suit.

Prior to the 1991 Civil Rights Act, plaintiffs could not recover the fees expended for expert witnesses over $40. This made getting a recovery in many cases worthless because it was expended on expert witness fees. Cases went to trial without experts because of the costs involved. The 1991 Civil Rights Act now awards the plaintiff expert witness fees if the plaintiff prevails.

XII. PREGNANCY

It is against the law to discriminate against a pregnant worker. Most states require an employer to provide unpaid leave for a pregnant woman for a maximum of three months. The federal government requires that employers with over 25 employees offer parental leave for a maximum of three months after the child is born. It is also against the law for an employer to reduce or remove a woman's seniority while she is on pregnancy leave. Pregnancy is not a disability: the employer is not required to furnish disability benefits. A pregnant woman is entitled to sick leave during the pregnancy.

The United States Supreme Court recently held that employers cannot deny women the opportunity to work in an environment that might cause genetically deformed children. The case: The employer was a battery manufacturer who excluded women from working in areas where they would be exposed to chemicals or materials known to cause birth defects. The employer was concerned with the possibility of having to pay higher insurance premiums to cover the anticipated medical treatment of children born with defects as a result of their mothers' exposure. The court found the argument irrelevant. Since the fathers were exposed to the hazards, the mothers had a right to demand exposure if they wanted it. Regardless of personal feelings in the matter, the Supreme Court has ruled that the employer cannot discriminate even with the best of intentions and legitimate business motives.

XIII. MANDATORY DRUG TESTING

The United States Supreme Court has upheld mandatory drug testing by employers in two cases. In Skinner vs. Railway Exec. (1989) 489 U.S. 602 the court upheld mandatory drug testing for railroad engineers. In National Treasury Employees Union vs. Von Raab (1989) the court upheld the mandatory drug testing for U.S. Customs employees who search for drugs or who handle firearms. The court's decisions made it clear that mandatory drug testing is permissible when done for legitimate business and safety necessity. The court's test: Is the sought prevention of harm accomplished by the drug test. If not, the testing is denied as an invasion of the worker's privacy. In American Federation of Governmental Employees vs. Thornburgh 720 F.2d 789 the U.S. District Court for the Northern District of California denied mandatory drug testing for all prison employees as overly broad for security purposes.

The Drug-Free Workplace Act of 1988 requires every employer receiving federal grants or contracts to create and implement drug-free policies at work. The act does not require or authorize an employer to conduct drug testing of employees. Most states have implemented laws that dictate when an employer can require drug tests.

XIV. HANDICAP DISCRIMINATION

The Federal Rehabilitation Act states:

> "No otherwise qualified handicapped individual shall, solely by reason of his handicap, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any activity receiving federal financial assistance."

Under this Act, a handicapped person is any person who has or has had a physical or mental impairment that substantially limits major life activity. Persons with serious illnesses or diseases, such as heart disease and cancer, are considered handicapped. The act applies to any employer receiving federal financial assistance or any employer having federal contracts of over $2,500. Most states also have laws similar to the Federal Rehabilitation Act that preclude discrimination based solely upon a person's handicap.

A handicapped person is any person who was born with or has acquired a physical or mental impairment, has a record of such impairment, or is regarded as having such an impairment, which limits one or more major life activities, such as self-care, performing manual tasks, seeing, hearing, speaking, breathing, and working on a temporary or permanent basis. A physical or mental impairment is any physical disorder, disfigurement, or anatomical loss or limitation of movement, or any mental or psychological disorder acquired as a result of illness, accident or birth.

Under both federal and California law, AIDS is classified as a physical handicap. It is unlawful for an employer to discriminate in employment regarding persons afflicted with AIDS. An employer may not ask an applicant questions that may disclose the AIDS affliction. A physical examination for the job may be required which may disclose the AIDS infection. The law is still being developed in AIDS discrimination. In California as long as the person can perform the job, and the job does not involve food preparation or handling, the employer is not permitted to discriminate because of the presence of the HIV virus. If the applicant has already begun to have medical problems associated with AIDS, the employer may refuse to hire him. It is still legal to refuse to hire a sick person who may not reasonably be able to do the job or will immediately incur substantial medical treatment.

The Rehabilitation Act was implemented under Title VII of the Civil Rights Act. The Rehabilitation Act contains three main provisions in Title VII which apply to recipients of federal financial assistance, federal contractors and the federal government, sections 501, 503 and 504 respectively. Under section 504 an employer involved with the federal government by virtue of a contract or grant must not discriminate. Regulations promulgated under section 504 prohibit an employer who receives federal funds from discriminating against handicapped individuals while the employer is involved in recruiting, advertising, processing applications, hiring, tenure, promotion, transfer, layoffs, fringe benefits, or any other aspect of employment. Coverage under this act pertains only to employers with 15 or more employees.

In order to determine whether an employer has met the requirements to accommodate a handicapped person's disability reasonably, the following elements should be examined:

1. Whether or not the requirements for all positions in which the handicapped person may be hired, promoted, etc. are legitimate, necessary, equitable and reasonable.
2. Whether or not the requirements are equally applied.
3. What specific accommodations would be necessary to enable the handicapped person to perform the tasks.
4. What the impact is on the organization in terms of cost or business necessity.

Reasonable accommodation is determined on a case-by-case basis after giving consideration to all of the above factors. The United States Supreme Court has held that an employer is not required under federal law to make substantial or major adjustments to its employment programs in order to allow a handicapped person to participate. If the handicapped person could not reasonably be expected to perform the tasks required to be performed by a typical graduate of the program, the employer is not required to let the handicapped person participate in the program. An "otherwise qualified handicapped person" is someone who is able to meet the program requirements including relevant physical qualifications despite the handicap. While meaningful access to the program must be available to all handicapped persons, the employer is not required to make such substantial changes in the program that the fundamental purpose of the program will be significantly altered or defeated.

XV. THE AMERICANS WITH DISABILITIES ACT

The Americans With Disabilities Act (AMDA) was a new federal law enacted in 1992. As of July 26,1992 it applies to all employers with 25 or more employees. In 1994 this act will cover all employers with over 15 employees. The Act requires employers to make reasonable accommodations for disabled employees, both in the hiring process and the workplace.

Under the Americans With Disabilities Act a person who has a substantial physical or mental impairment is disabled. Under AMDA a substantial impairment is one that significantly impairs or restricts a major life activity such as hearing, seeing, speaking, breathing, walking, performing manual tasks, caring for oneself or learning. An individual with a disability still must be qualified to perform the essential function of the job with or without reasonable accommodation in order to be covered by this act and protected from discrimination.

Under the Americans With Disabilities Act the employer is liable for discrimination if no reasonable attempt is made to accommodate a disabled person in hiring or in performing the job in the workplace. Reasonable accommodation is not defined in the act. Compliance is intended to be determined on a case-by-case basis. The requirement to accommodate a disabled person reasonably is satisfied when the future accommodation poses an undue hardship on the employer. There will be numerous administrative hearings and court cases needed to determine what constitutes undue hardship on the employer. This is a developing area of law, and it will take specific court decisions to define everyone's rights and duties.

Deaf persons pose their own unique difficulties. The main problems are how to keep the deaf person involved in the business and to be able to communicate with him reasonably. Some companies have addressed these problems by hiring interpreters. Through the interpreters the deaf employees are able to participate in meetings and interact with other staff. A small company might not have the money or ability to hire such interpreters. Sign language might be a substitute, or communication might be through a computer if the cost is not prohibitive.

XVI. PERMISSIBLE QUESTIONS FOR HANDICAPPED JOB APPLICANTS

Some sample questions that are proper to be asked by a potential employer of a prospective handicapped employee are:

1. Is there any reason that you cannot perform the job or any other position for which you are being considered?
2. How does stress or deadline pressure affect your job performance?
3. Do you have a driver license? (If necessary for the job)
4. How is your health in general?
5. In an emergency who should be contacted?
6. What are your personal and professional goals?
7. Who referred you to this job?
8. How did you learn of this job?
9. Where do you go to school?
10. Do you have any physical or mental handicaps which might affect job performance in the position you are seeking or in which you might later want placement?

XVII. IMPERMISSIBLE QUESTIONS TO HANDICAPPED JOB APPLICANTS

Unless the following questions relate to a bona-fide occupational qualification, they should not be asked:

1. Do you have a mental or physical handicap?
2. How did you become disabled?
3. What special needs or accommodations do you require in order to work?

4. What genetic disorders (epilepsy, multiple sclerosis, etc.) do you suffer?
5. What medication do you regularly take?
6. Do you have a restricted diet?
7. Do you get tired in the afternoon?
8. Can you travel without assistance?
9. Have you ever had a heart attack or seizure of any type?
10. Are there any restrictions stated on your driver's license?

The significance of the above questions should be obvious. If any of the above questions are asked, and the job applicant is not hired, the job applicant has a prima facie case that the employer illegally discriminated against him. The employer may face a discrimination lawsuit. If the employer does business with the federal government, then all federal contracts may be terminated. It simply is not worth the risk for an employer to ask questions which a rejected job applicant can use as a basis for a complaint of invidious discrimination.

XVIII. STATE ANTI-HANDICAP DISCRIMINATION ACTS

In addition to the federal laws discussed above, all employers must comply with state handicap laws. For example, there was a private law school in a building that had only two floors. The school had no handicapped students or teachers. Nevertheless, California law required that the school install an elevator between the first and second floors. Apparently the rationale was that disabled students were discouraged from attending the school because they could not get to the second floor. No handicapped students ever applied to the school. Regardless, the school installed the elevator. The installation was a useless expense because the school did not experience a rush of handicapped students at its doors even after it was installed. The money could have been better spent improving the library to produce better educated students. State law required the elevator and therefore it was installed.

Generally, for every federal anti-discriminatory law, there is a corresponding state which also must be obeyed. As such, whenever a federal law is cited, the employer should look for the state version as well. An employer must comply with both state and federal laws or face the consequences.

PART II

AFTER RETIREMENT OR DISABILITY

Part II of this book pertains to the problems and concerns faced by a person approaching retirement or becoming unable to work as a result of a disability. Part II is divided into four chapters:

1. Social Security. This chapter covers the history of Social Security, its purpose, the basic coverage and application procedure.
2. Supplemental Security Income. This chapter, as with the Social Security chapter, covers the procedure in which an eligible person (usually of retirement age or disabled) may apply for additional income from the Social Security Administration.
3. Disability. This chapter discusses the Social Security disability benefits available to a worker. It is important that a disabled worker be aware of the existence of such disability benefits in addition to any benefits under a state's Workers' Compensation.
4. Medicare. This chapter deals with the benefits available under the Medicare program. This program is one of the largest and most important social programs run by the government. It provides the basic medical coverage for most of the elderly and retired persons in America. It is important to have an understanding of such an important program when engaged in financial planning.

CHAPTER 6

SOCIAL SECURITY

Social Security is one of the first universal social programs implemented in the United States. It was created during the depression to provide for old and disabled workers who could no longer care for themselves. Social Security has developed from a supplemental source of income to the sole source of income for many retired persons. Social Security is funded by taxes on workers. The Social Security taxes collected are used to pay the benefits for those receiving Social Security payments. When Social Security was first created, the average life expectancy was 65 years of age. Today the average life expectancy is 72 years of age for men and 77 years of age for women. When Social Security was first implemented, it was never envisioned that huge numbers of workers would be receiving benefits into their seventies and later. Typically in the 1930's, only one of all four grandparents lived long enough to collect Social Security and he collected for only a few months before dying. This was really how the program was intended to work.

There is a great deal of concern today that the Social Security fund is insolvent. Certainly it was never intended to run the way it is now. When established, Social Security was to invest its funds in income- generating sources. Instead of investing in the private sector and helping to develop the nation's economy, the

Social Security administration simply buys federal bonds and thereby increases the federal deficits. In fact, the federal deficit does not even reflect the money owed to the Social Security program. Creative bookkeeping has been employed by Congress to hide the truly disastrous state of the Social Security fund.

Congress has repeatedly raised Social Security taxes and the retirement age in a futile attempt to save the program. Now workers younger than age 40 must work until age 66 before retiring. There are proposals before Congress that call for raising the age to receive Social Security benefits to 70 years. For people currently receiving benefits, Social Security will still exist. Given the dismal state of Social Security predicted for the future, it appears that it will have to undergo massive changes in order to survive.

A congressional report issued in March 1993 concluded that the Social Security fund will bankrupt in 1995. A Democrat proposal to raise revenue for the fund is to raise the limit on wages which are taxed for Social Security. All wages, not just the first $54,400, would be taxed for Social Security. At first blush this seems a fair proposal. Everyone would pay Social Security taxes for the benefits they will receive in the future. If that is done, however, to be fair, the government should also impose income taxes on Social Security benefits received now by individuals who work and earn income over a certain amount. This, however, would be unfair to the individuals who would be paying for Social Security benefits in the future that will then be taxed a second time when received. The reason such benefits are taxed now from high income workers (over $30,000 per year) is that these people may not have paid the same percentage of Social Security taxes for the benefits received as others did. All of this shows how Social Security has become a sacred cow for politicians, and how it is used by politicians to purchase votes. Reliance on Social Security as the sole source of support upon retirement is foolish. Even Franklin Roosevelt, when he created Social Security, intended it to be only a supplement to other sources of income for an individual, such as pensions, savings, individual retirement accounts, etc.

This chapter is written to reflect the current problems, concerns, and benefits available. It is written to give the reader a concise and accurate depiction of the questions and answers to be faced in participating in the Social Security program.

I. HISTORY

In 1935, Congress enacted the Social Security Act during the depression to provide a measure of economic support for retired workers, disabled workers and their dependents. The rules governing Social Security are complex and highly formalized. This act created the Old Age, Survivors and Disability Program (OASDI) which is administered by the Social Security Administration (SSA). It is the OASDI program that is commonly called "Social Security." The types of programs covered by Social Security have expanded substantially over the years. Nearly all workers participate in Social Security although they may not all be covered for all benefits.

Social Security is a universal program; everyone is required to participate. Every worker is required to have a Social Security number in order to determine a worker's eligibility and benefits. When Social Security was first created, it was specifically stated in the law that a Social Security number was not to be used for identification purposes. Today it is impossible to deal with any governmental agency without furnishing a Social Security number. To insure participation in the Social Security program, Congress requires that children have Social Security numbers in order for parents to claim a dependency income tax exemption for them. Social Security numbers are obtained by applying for a Social Security card from the Social Security Administration (SSA). In applying for a Social Security card, the applicant or child's parent must provide evidence of age, identity and alien status. The SSA will inform the applicant of the types of proof that are acceptable.

Social Security is funded by special taxes on both workers and employers. The Social Security taxes are partitioned as follows:

1. Social Security Hospital Insurance: There is a combined tax rate of 7.65%: 6.2% for old age, survivors and disability insurance (OASDI) imposed on both employee and employer on wages up to $57,600 and an additional 1.45% tax for hospital insurance (Medicare) on wages up to $135,000.

2. Unemployment Compensation: There is a tax of 6.2% on the first $7,000 of wages. Employers are allowed credits against the tax for participation in state unemployment programs to the extent that most employers pay only .8% except when credit reductions are in effect in a state.

Self-employed individuals must pay a self-employment tax which is 15.3% on the net self-employment income. This rate consists of 12.4% for OASDI and 2.9% for Medicare. The OASDI earnings base is $57,600 and the Medicare earnings base is $135,000.

Social Security is a tax program. There is no absolute right to receive Social Security. The United States Supreme Court has held that Congress can change Social Security laws and benefit requirements without violating any contractual rights with taxpayers. For example, Congress raised the age to receive Social Security benefits from 65 years of age to 66 years of age. There is currently a proposal to raise the requirement age again to receive Social Security benefits at 67 years of age starting in the next century.

This chapter is intended to apprise the reader of the workings of the SSA and the benefits available under the Social Security Act. After reading this chapter, a person should have a good understanding of Social Security and be able to seek more specific information from the SSA in a knowledgeable manner.

II. TYPES OF BENEFITS

Social Security benefits fall into four categories:

1. Old age benefits that are payable to the retired worker.
2. Disability benefits that are payable to the worker.
3. Support benefits for dependents of retired or disabled workers.
4. Survivor benefits for a surviving family of a deceased worker, including a lump sum death benefit payable to the survivors.

In order to receive Social Security benefits, a person must apply for them. The government will not search for an eligible person to inform him of the right to receive Social Security benefits. Since it is up to each individual to apply for benefits, it becomes vital that everyone know their entitlements.

III. CALCULATION OF BENEFITS

The benefits received under Social Security depend on the following factors:

1. How much the worker contributed into the program.
2. Whether the worker has dependents.
3. How long the dependents survive.

As a result of these factors, the amounts of entitlements will vary from person to person. A single person without dependents will receive less benefits than a married person or a person with dependents even though they both worked the same number of years. Since benefits to a worker continue until death, it is possible for a person to receive more in benefits than the taxes paid into the system.

Eligibility for Social Security depends on two main elements:

1. The worker from whom the coverage is derived must have engaged in employment covered by the Social Security program, and
2. The worker must have worked in the covered employment long enough to have acquired insured status.

Everyone who meets these requirements is protected by the Social Security system. Eligibility is not related to need but to work and is available to rich and poor alike. A dependent (such as a child or a spouse) may receive benefits based upon the work of a family member (such as a parent or spouse).

A. COVERED EMPLOYMENT

Nearly all paid work in the United States constitutes "covered employment." According to the Social Security Administration more than nine out of 10 employees are covered by the system. Federal civilian employees and employees of some state and local governments are not covered by Social Security because they have their own retirement plans. Employees of non-profit organizations may not be covered because such organizations must elect to participate in the Social Security program.

In 1951, Congress extended Social Security coverage to domestic workers. Domestic workers include maids, housekeepers, cooks, gardeners and others performing similar duties in the home of another for pay. A domestic worker earns credit towards Social Security coverage for each calendar quarter in which he earns at least $50 from a single employer. There is no coverage if the worker earns less than $50 per quarter from a single employer. The employer has the responsibility of withholding and paying the Social Security tax. Failure of an employer to make the Social Security payment is a crime. It was an extreme embarrassment when it became public knowledge that President Clinton's nominee for Attorney General Zoe Baird failed to pay Social Security benefits for undocumented aliens. It was viewed as hypocritical by the American public for the top enforcement officer of the United States to be violating American laws. Besides not paying the Social Security payments, it may have also been illegal for her to have hired aliens without proper documentation. This issue was not even addressed.

Farm work is covered employment for the purposes of the Social Security provided that:

1. The farmworker receives over $150 per year from one employer, or
2. The farmworker works for one employer more than 20 days per year and is paid on the basis of time rather than piecework.

A worker hired and paid by a crew leader works for the crew leader, not the farmer. The crew leader is thus responsible for the withholding and payment of the Social Security taxes. When the farmer does the hiring, the farmer is required to undertake withholding and payment of Social Security taxes. A sharecropper is considered a self-employed farmer and is responsible for paying his own Social Security taxes.

B. NUMBER OF QUARTERS NEEDED FOR COVERAGE

To be eligible for benefits, a worker must have engaged in covered employment for a required number of quarters that vary, depending on the type of benefit sought. A covered year of employment is broken into the following four quarters:

1. January through March.
2. April through June.
3. July through September.
4. October through December.

From 1936 to 1978 an employee was credited with coverage for every calendar quarter in which the worker received cash wages of $50 or more. A self-employed individual was credited from 1950 to 1978 for every calendar quarter the individual earned $100 as self-employed. From 1978 a worker is credited with a quarter of coverage for every $250 earned during the year with a maximum of four quarters available. Once the worker has met the required number of quarters for coverage, he has acquired insured status for certain benefits.

C. INSURED STATUS

Insured status is the second requirement for Social Security coverage. It requires that the worker be engaged in covered employment for a fixed number of quarters. There are four types of insured coverage:

1. Fully insured.
2. Currently insured.
3. Specifically insured for disability benefits.
4. Transitionally insured.

The number of quarters a person must work to be covered in each status varies according to age. A worker must have attained fully insured status to receive most of the benefits under the Social Security program. For anyone born after January 2, 1929, 40 quarters of coverage are needed to be fully insured. All quarters of coverage are counted including quarters worked before 1951 and after retirement age.

For persons born prior to January 1929, the number of quarters needed for fully insured status are equal to the number of years between 1950 (or the year in which the worker reached 21 years of age after 1950) and the year the worker reached 62 years of age. Example: A person reaching 62 in 1989 needed 38 quarters for fully insured status (1989-1951 = 38).

Some survivor benefits require that the deceased worker have been currently insured. This means that the deceased worker must have acquired six quarters of coverage during the previous 13-quarter period in which:

1. The worker died,
2. The worker became disabled and entitled to disability benefits, or
3. The worker became entitled to retirement benefits.

The coverage requirements are absolute. A person who does not meet the eligibility requirements is not covered regardless of how close the person is to satisfying the requirement. A person who lacks a few quarters of coverage can obtain those quarters by working in covered employment. There are several public employment programs financed by the federal government that encourage senior citizens to work in public service programs. Participation in the Foster Grandparent Program, Senior Aide Program, Peace Corps, VISTA, Retired Senior Volunteer, and Greenthumb usually will gain the needed Social Security credit.

IV. RETIREMENT BENEFITS

A worker is eligible for retirement benefits when all of the following requirements are met:

1. The worker has reached 62 years of age.
2. The worker is fully insured (has 40 quarters of coverage).
3. The worker has retired.

A worker who retires at age 62 will receive lower benefits than a person who defers retirement until later in life. Retirement at 62 years of age rather than 65 years of age will result in the benefits received being permanently reduced by 20%. Retiring at age 62 can actually result in a financial benefit to a worker. A person retiring at age 62 will have received 36 checks by age 65. So even though the check that the person receives at age 65 is less than it would have been if retirement had been delayed until age 65, it will still take about 12 years to equal the amounts previously paid as a result of the earlier retirement.

When a worker delays retirement after age 65, the Delayed Retirement Benefit is ¼ of 1% of the monthly benefit times the number of months, beginning with the month the worker became 65 and ending with the month the worker became 70 (for the months that the worker was fully insured and did not receive benefits). Under the Social Security Act of 1983, for workers reaching 65 in 1990 or later, the ¼ of 1% will be increased by 1/24 of 1% for each even year until the rate reaches 2/3 of 1% for persons reaching 66 in 2009 and later. If a deceased worker earned a delayed retirement credit, the surviving spouse's benefit will be based on the primary insurance amount plus the amount of the delayed retirement credit.

A surviving spouse who is age 62 (or is younger and supporting dependent children) is eligible for retirement benefits based upon the deceased spouse's eligibility. Usually, the surviving spouse will receive one-half of the deceased spouse's benefits, but it may be less depending on other factors.

A divorced spouse may also be eligible for Social Security benefits, despite a remarriage of the deceased worker if:

1. The divorced spouse is at least 62 years of age.
2. The divorced spouse was married at least ten years before the divorce.
3. The divorced spouse is unmarried.

In the past Congress required that a surviving husband had to prove that he had received one-half of his support from his wife in order to receive the benefits. In 1977 the U.S. Supreme Court, in Califano vs. Goldfarb 430 U.S. 199, held that requirement unconstitutional. Any surviving husband who was denied these benefits prior to this decision and has never received them should reapply for the benefits.

A child can be eligible for retirement benefits upon the death of a parent if all of the following are met:

1. The child is unmarried,
2. The child is under the age of 18 years or under the age of 22 if a full time student, and
3. The child is dependent upon a retired worked for support.

The term "child" is broadly defined to include adopted children, step-children and, in some cases, even grandchildren. The benefit given to such children is usually one-half the worker's retirement benefit.

V. DISABILITY BENEFITS

Under the Social Security Act, disability is defined as follows:

> "(the) inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months."

The SSA has accepted some diseases as automatically rendering the afflicted person disabled. These diseases are compiled in a list entitled "Listing of Impairments." Some of the diseases on the list are epilepsy in acute form, arthritis in major joints, and advanced tuberculosis. A person not suffering from a listed disease (or one found to be medically equivalent to it) may still be found to be disabled. The worker is disabled if the physical or mental impairments are so great as to render the worker unable to do his previous work or engage in other substantial gainful work. The applicant for disability benefits has the burden of proving the existence of the disability.

Often the SSA will have the matter reviewed by their own experts. A hearing on the denial of disability benefits may be scheduled and an appeal taken as a result of the denial of those benefits. To receive disability benefits, a worker must meet the following requirements:

1. A disabled worker younger than 24 years of age needs 1½ years of covered work, which is six quarters earned within three years of the disability.
2. A disabled worked between 24 and 31 years of age needs to have earned coverage for at least half of the time from age 21 to the time of the disability. Example: A person 30 years of age must have 4½ years (18 quarters) of coverage; a person 25 years of age must have two years (8 quarters) of coverage.
3. A disabled worker older than 31 years of age must be fully insured and have five years of covered work (20 quarters) within the 10-year period preceding the

disability.

As with retirement benefits, a disabled worker's family is entitled to disability benefits when a parent or spouse is disabled. Disability is discussed in greater detail in a later chapter.

VI. SURVIVING SPOUSE BENEFITS

A surviving spouse who is 50 to 60 years old and disabled or who is 60 years of age or older will receive monthly survivor benefits upon the death of a fully insured spouse. A surviving divorced spouse who meets the above requirements, is unmarried and was married to the deceased person for at last 10 years is also eligible for survivor benefits. To be a surviving spouse, the person must have been married to the decedent worker for at least nine months or have adopted a child with the deceased worker. The survivor benefit is between 82½% and 100% of the deceased spouse's retirement benefit.

For a husband or wife to receive survivor benefits, there must be a valid marriage. The existence of the marriage is usually not difficult to prove. A marriage certificate, an affidavit by the person performing the marriage or an affidavit from the witnesses to it will be accepted by the SSA as proof. A more difficult scenario exists when there is a common law marriage.

A common law marriage is one in which the man and woman live together for a fixed amount of time and hold themselves out as husband and wife. Only 14 states permit common law marriages. Most states, like California, do not recognize common law marriages. A common law marriage is accepted by the SSA if it is valid in the state where it occurred.

A common law marriage may be proven in two ways:

1. If both spouses are alive, by a joint affidavit that they are married.
2. If one spouse is dead, an affidavit by the surviving spouse and two blood relatives (preferably of the deceased spouse) that there was a marriage as evidenced by the conduct of the parties.

Even if the surviving spouse is too young to receive survivor benefits, the surviving spouse may be entitled to some other benefits. If the deceased spouse died fully insured, and the surviving spouse is caring for the deceased spouse's dependent children, the surviving spouse is eligible for a parent's insurance benefit. This parent's benefit is about 75% of the deceased spouse's basic monthly benefit. Prior to 1975, a surviving husband could not receive this benefit unless he proved that he received half of his support from the deceased wife. The law has since changed, and either parent can now receive these benefits provided the eligibility requirements are met.

VII. PARENTS' ELIGIBILITY FOR SURVIVOR'S BENEFITS

The parents of a deceased worked are eligible for survivor benefits upon the death of a child if all of the following requirements are met:

1. The deceased child was currently eligible for

benefits at the time of death,

2. The parent was at least 62 years of age at the death, and

3. The parent was dependent on the deceased child for at least 50% of the surviving parent's support.

The parent's benefit will be 82.5% of the deceased child's worker's benefit.

VIII. APPLICATION FOR BENEFITS

The process of obtaining Social Security benefits requires that the person submit an application for benefits to the Social Security Administration. The applicant must simultaneously submit the necessary proof of the statements in the application (such as age, identity and work history).

An application for one type of Social Security benefit also serves as an application for any other Social Security benefits which the applicant may entitled. Application forms for Social Security benefits can be obtained from any Social Security office. If a person is unable to go to the SSA office, the SSA can send a representative to the applicant's home. A person should begin considering whether to apply for Social Security benefits before reaching 62 years of age. The worker should discuss both the advantages and disadvantages with a Social Security worker about retiring at age 62 or waiting longer.

The SSA attempts to move as quickly as it can in ruling upon an application for benefits. Given the huge number of claims and files processed, some types of claims take longer to process than others. According to SSA statistics, applications for retirement or survivor's benefits take between 60 and 90 days for processing. It can take substantially longer if the applicant fails to provide complete or necessary information for verification purposes. Disability applications take substantially longer because of the higher level of proof needed. The SSA estimates the disability application will take between three and six months to process. To speed things along, an applicant should supply all necessary information and be available to answer questions that may arise. If the SSA does not act within 90 days, the applicant can demand in writing to be paid. The SSA must pay the applicant within 15 days even though final determination has not been made. If the claim is rejected, the applicant must repay the money.

The SSA has the authority and discretion to make advance payments of benefits to a person. The SSA may grant advance payments if it appears that the person will probably qualify even though the final determination has not yet been made. The advance payments are made independently of the 90-day waiting period necessary for an expedited payment.

If the worker decides not to retire at age 62, the worker should contact the SSA again three months before actual retirement or upon reaching age 65, whichever comes first. It is important to file an application promptly. Retroactive benefits are only paid for one year. In other words, if a worker waits and files at age 68 instead of 65, he has lost two years of back benefits.

IX. PROOF OF SUPPORT

It is necessary to prove that half of the applicant's support was provided by the deceased or disabled worker to obtain some survivor benefits. As proof of support, the SSA wants the applicant to show that the worker supported the applicant for the year preceding the application. If support cannot be proven for the 12 months because of illness, unemployment or death the applicant must prove that the worker provided support for at least three months and that no other person contributed substantial support during that period.

Children's dependency can be shown by proving the dependent and worker lived together in the same household. A financial statement is usually required to divide the income available to the applicant and the income supplied by the worker.

X. THE SSA DECISION ON THE APPLICATION

The SSA sends letters to applicants informing them of acceptance or rejection of their applications for benefits. When applications are accepted, the reply letters will state the amount of benefits the SSA will pay to the applicant. When the application is denied, the SSA letter usually will give a brief statement as to why it was rejected and inform the applicant of the right to appeal the denial.

If the SSA pays less than the amount a recipient feels it is supposed to pay, the SSA should be notified immediately. If the SSA agrees that it made a mistake, the underpayment can be recovered by issuing a check for that amount or paying it during the next seven payments. If the SSA insists that the amount was correct, the recipient should ask for an immediate reconsideration by the SSA. If the SSA does not change its position during reconsideration, a hearing before an administrative law judge of the SSA's Office of Hearing and Appeals should be requested.

When the SSA decides to reduce or terminate benefits previously awarded, it must give written notice of that decision to the recipient. The notice is given before the benefits are reduced or terminated. After the required notice is given, the Social Security benefits are reduced or terminated unless reversed on appeal.

XI. APPEALING A SSA DENIAL OF BENEFITS

An appeal is an administrative review of an SSA decision to deny, reduce or terminate Social Security benefits. No decision of the SSA is final until the time to file and appeal has run or all appeals have been exhausted. The SSA has prepared a complex procedure for processing appeals. After each administrative step, an individual upset with the decision may seek review of a still higher review group. Until the entire course of administrative review is run, an individual cannot seek court review of the SSA decision.

Unless an appeal is made within 60 days the decision becomes final and thereafter can no longer be challenged. A request for an appeal should be in writing. The SSA has a special form for this purpose, but a letter specifically asking for an appeal will suffice. The notice of appeal must be filed within 60 days of receipt of SSA's notice of their decision. An appeal should be filed within 60 days of the date of the denial of the SSA's decision, not of its receipt. This reduces the possibility of delay in the mail affecting the timeliness of the appeal. If the notice of appeal arrives late at the SSA office, the applicant must prove that the letter was mailed in time: a tough prospect. It can be proven if the notice of appeal is sent by certified mail.

After the appeal is filed, the SSA will conduct an internal reconsideration of its decision. The applicant may be requested to furnish additional information, but he will not be asked to testify or produce witnesses. If the SSA's reconsideration upholds the original decision (it usually does), the applicant may file a request for hearing before an administrative law judge within 60 days of the decision. The applicant may be represented by an attorney, call witnesses and present evidence at the hearing.

The administrative law judge serves as a representative of the SSA. The SSA does not have its own representative at the hearing. The judge tries the case based on the file, the written determination of the SSA and the evidence produced at the hearing.

An administrative law judge rarely rules against the SSA. A few years ago, administrative law judges for the SSA filed a federal lawsuit to enjoin the SSA from continually pressuring them to deny appeals. An applicant can file an appeal of an administrative law judge's decision within 60 days of its issuance. The appeal is made to the Appeals Council of the SSA in Arlington, Virginia.

The appeal is conducted through written briefs submitted by the parties. These briefs discuss the evidence produced and considered at the hearing. Oral arguments may be requested before the Appeals Council, but witnesses or new evidence cannot be produced. Less than 10% of all decisions appealed to the Appeals Council are reversed. There is no fee charged by the SSA for appeals. If the appellant wants an attorney to represent him at the hearing, he must pay for the attorney. The SSA may pay an appellant's attorney fees for representation during the administrative hearings. If the case goes to trial and the appellant prevails, the court can award attorney fees of 25% or less of the back benefits awarded. Moreover, if the judge finds that the SSA's opposition was unjustified, he can order the SSA to pay all of the attorney fees. The attorney fee agreement between the attorney and the applicant should require the attorney to settle for only the award ordered by the court.

As a final step in the appellate process, an applicant can sue the SSA in federal court for a denial of benefits, but only after the individual has first completed all of the above administrative procedures. That means that before a lawsuit can be file in federal court, the individual must appeal the SSA's denial of benefits all the way through the Appeals Council. After the administrative procedures have been exhausted, the individual must file the lawsuit challenging the SSA denial within 60 days of the Appeals Council decision. The suit is filed in the federal district court for the state where the individual lives. The federal court will look at the SSA record to determine if the SSA acted arbitrarily, capriciously or in disregard of the law. The court will not grant a new trial but will review the facts of the case to determine if the applicant was given a fair hearing. About 40% of all SSA decisions are reversed in federal courts; so it can be worthwhile to contest a questionable denial of benefits.

XII. RECEIPT OF BENEFITS WHILE WORKING

Social Security retirement benefits were not intended to be paid to persons who were working. It was intended to replace income lost or reduced because of retirement. Given today's economic reality, many retired people are being forced to return to the job market to survive. This causes a conflict with the seniors' need to survive and the Social Security program that was intended to help the senior worker.

A person is only permitted to earn a limited amount of money and still retain full Social Security benefits. If more than the allowable limit is earned, Social Security benefits are reduced one dollar for every two dollars earned over an annual ceiling of $7,680 if the beneficiary is less than 65 years of age. If the beneficiary is between 65 and 69 years of age, the annual ceiling is $10,560, and the reduction of benefits is one dollar for every three dollars earned. This is known as the "Retirement Test" and applies to all workers receiving retirement benefits below 70 years of age. After 70 years of age, the worker can earn any amount of money without loss of benefits. Before any retired person goes back to work, the following factors should be carefully considered:

1. If the person is receiving a pension from his job, pension benefits may stop if he returns to work with the former employer.
2. Social Security, federal income taxes and state income taxes must be paid on the wages even though Social Security benefits are being received.
3. Medical expenses are not deductible until they exceed 7.5% of the adjusted gross income, which increases because of work.
4. The Retirement Test will reduce Social Security benefits one dollar for every three over the annual ceiling until age 70. After age 70, there is no reduction for work.

   For example, a person receiving $8,000 per year in benefits who earns $12,000 working will net about $16,100 after deducting for taxes and lost benefits. The net amount received after all adjustments may not be enough to make working worthwhile.

Besides reducing benefits for a person while working, the receipt of such benefits may also be subject to income taxes. This is simply double taxation. The taxes to pay for these benefits were collected from the worker's earnings, and now the benefits are taxed again when received. Social Security retirement benefits that will be included in recipient's gross income are the lesser of:

1. One-half of the net benefits received, or
2. One-half of the excess of the combined income over a base amount ($25,000 for an individual, $32,000 for a couple filing jointly, $0 for a couple filing separately).

For example, assume a couple has an adjusted gross income of $30,000. They receive $7,000 in Social Security benefits and $4,000 in tax-exempt interest.

1.	Adjusted gross income	$30,000
2.	Plus tax-exempt interest	$4,000
3.	Modified adjusted gross income	$34,000
4.	Plus one-half Social Security benefits	$3,500
5.	Combined income	$37,500
6.	Less base amount	$32,000
7.	Excess above base amount	$5,500
8.	One-half over base amount	$2,750
9.	One-half of social security benefits	$3,500
10.	Amount included in tax return (lesser of 8 and 9)	$2,750

A recent government report estimates that people in their 40's will receive only about $.82 in benefits for every dollar paid in Social Security taxes. Again, they will pay income taxes on this $.82 that is a return of money on which they have already paid income taxes. Remember, taxpayers pay taxes on their earnings before the Social Security taxes are paid. So these $.82 of benefits have already been totally taxed. This was not a tax-free contribution like a tax-deferred pension. The closest analysis is the purchase of an annuity with after-tax money. No one would purchase an annuity that would only pay $.82 for every dollar invested and then be taxed on the $.82 per dollar which is received.

Congress views the Social Security fund as another source of government income. The only reason that the Social Security fund is in jeopardy of bankruptcy by 1995 is that the fund has never operated as it was intended. Originally, the monies in the fund were to be invested like any normal retirement plan. Instead, Congress uses the Social Security fund for general government spending. The federal government borrows the taxes paid into the Social Security fund and pays a lower interest rate than the fund would get if it loaned the money to private borrowers. Because the money is taken by the government, no funds are available for investment in appreciating property. There are no Social Security owned or financed hotels, shopping centers or industries that are increasing the value of the fund. As the fund now stands, it is owed large amounts of money by the federal government, which is itself insolvent. In the private sector no one would continue to loan money to a borrower who for 20 years has had a growing deficit. To make the Social Security fund solvent again (rather than stop loans to the federal government and let the fund be administered as first intended), Congress will once again raise the earnings limits for Social Security taxes. Congress has proposed taxing all income earned prior to retirement for Social Security purposes and raising the upper age limit for which there will be no taxes on Social Security benefits from 70 years to 75 years.

XIII. VERIFYING A WORKER'S SOCIAL SECURITY RECORDS

It is vital that everyone verify his SSA records. The SSA will only correct errors within three years, three months and 15 days of the time it makes the mistake, not when the mistake is discovered. After that, the error will not be changed. For a person to obtain a copy of his Social Security record, he must go to the local SSA office and fill out Form SSA-7004 requesting it or telephone 1-800-772-1213. The burden is upon the worker to provide the information necessary to correct an error. This may require copies of tax returns, pay stubs or other requested information.

A person accompanied by an authorized agent is permitted by law to see all of the non-medical information in the person's Social Security file. Medical information in the file must also be disclosed if it is reasonably necessary to process a claim for benefits. A refusal of the SSA to permit inspection of the file is grounds to sue the SSA under the Freedom of Information Act.

XIV. SOCIAL SECURITY BENEFITS CANNOT BE ATTACHED BY CREDITORS

The Social Security Act specifically states that Social Security benefits cannot be attached (garnished) by creditors. This extends to money in a bank account that has accrued from the deposit of Social Security checks. The only exceptions to the attachment prohibition are attachment to pay back federal taxes and attachment for court-ordered child support or alimony.

While the benefits are not attachable, the property purchased with them is attachable by creditors. Example: If the recipient purchased a membership in a golf course with the benefits, the creditors can sell the membership even though they could not have taken the cash used to buy it.

XV. DEMOCRATIC PROPOSED SOCIAL SECURITY BENEFITS TAX INCREASE

In May 1993 President Clinton proposed a major increase in the tax on Social Security benefits. The proposed tax increase would force millions of Americans to pay an average of $1,000 per year. President Clinton's proposal is aimed at senior citizens receiving Social Security benefits and who have income of over $25,000 for a single person and $32,000 for a married couple. Currently, 50% of the Social Security benefits received by persons earning more than the above limits are taxable. President Clinton proposed raising the amount of Social Security benefits that are taxable to recipients to 85%.

The Clinton proposal would adversely affect over a quarter of all persons receiving Social Security benefits. The tax on such benefits would increase an average of $720 to $1,270 per year. The Treasury Department estimates that under the Clinton proposal 790,000 households with income below $40,000 would have to pay an average of $276 dollars per year more in additional taxes. The purpose of the tax increase is to raise an additional $23.3 billion dollars over five years. This is money taken directly from people who have worked and paid the taxes to earn these benefits. The money collected from these additional taxes does not return to the Social Security fund, but is spent by the federal government as ordinary income.

The American Association of Retired Persons (AARP) has vehemently attacked the proposed tax plan. AARP has pointed out that senior households with income between $30,000 and $50,000 could be paying $1,000 per year in additional taxes. AARP has correctly emphasized that the income power of older Americans decreases with time because of inflation along with the ability to replace income taken by increased taxes.

Senator Daniel Patrick Moynihan, D-N.Y., Chairman of the Senate Finance Committee has assailed another Clinton Social Security tax increase on the Medicare payroll tax. Currently the annual earnings subject to Medicare payroll tax are $135,000. The Clinton administration proposes taxing all income. Under this proposal, the high earners pay more than the low earners, but they would all receive the same benefits when they retire. Senator Moynihan correctly summed up the issue facing Social Security reform when he stated, "We are at risk of losing the connection between a contributory social-insurance program...and moving toward a needs-based, welfare-conditioned system." This is the real issue. The Social Security Act was not passed or intended to be a welfare program. The social contract has been changed by the government. Retirement income is being decimated, and it now is necessary to consider carefully the proposed tax increases by the Clinton Administration and the Democratically controlled Congress when planning for retirement. Every dollar taken in taxes is one less dollar available for the taxpayer's own security. It is important that people desiring to keep their money work with groups that oppose these Social Security tax increases.

Given the inability of our government to cut government spending in order to reduce the deficit, a person planning for retirement should assume that all Social Security benefits will ultimately be heavily taxed.

XVI. SOCIAL SECURITY ADMINISTRATION'S TOLL FREE NUMBER

The best way to receive information is to go the nearest Social Security Administration office and speak with a representative. In many instances that is not possible, especially for one disabled. The Social Security Administration has addressed this problem by installing a toll-free number staffed by Social Security representatives to answer question from the public.

The SSA's toll-free number is 1-800-772-1213 and is available 7 a.m. through 7 p.m. Monday through Friday for all time zones. The representatives will answer the questions from the public to the best of their abilities and send the caller SSA publications that address the caller's concerns. The SSA also has a web site at http://www.ssa.com.

The caller should never rely totally on information provided by the SSA representative over the phone. If the information is wrong, the SSA is not bound by bad advice given over the phone by its representatives (just like the IRS says it is not bound by wrong advice given by its agents over the phone). This telephone service should only be used as an information gathering source. The only real way that a person will know if he qualifies for benefits and the extent of those benefits is to apply for the benefits and let the SSA make a formal determination.

The important thing to remember is that this information is free and readily available. For that reason, everyone having questions regarding their Social Security benefits or eligibility should use this service if unable to go to the local SSA in person. It would a be shame for a person not to receive benefits to which he is entitled because of a lack of information that could have been obtained by a simple phone call.

XVII. SOCIAL SECURITY TAXES OVER THE YEARS

The amount of money collected as taxes has steadily increased from the inception of the Social Security program. Self-employed persons were not covered until 1951. Self-employed individuals can deduct half of the tax as a business expense to equalize themselves with employed taxpayers. The maximum earnings taxed was $125,000 in 1991, $130,200 in 1992 and $135,000 in 1993. The rates and ceilings will continue to rise in the future. The maximum annual tax includes the 1.45% Medicare tax.

Years	Tax Rate Employee	Tax Rate Self-employed	Maximum Earnings Taxed	Maximum Taxes
1937-1949	1.000%	0.00%	$3,000	$30.00
1950	1.500%	0.00%	$3,000	$45.00
1955	2.000%	3.00%	$4,200	$84.00
1960	3.000%	4.50%	$4,800	$144.00
1965	3.680%	5.00%	$4,800	$174.00
1970	4.800%	6.90%	$7,800	$374.40
1975	5.850%	7.90%	$14,100	$824.85
1980	6.130%	8.10%	$25,900	$1,587.67
1985	7.050%	11.80%	$39,600	$2,791.80
1990	7.650%	15.30%	$51,300	$3,924.45
1991	7.650%	15.30%	$53,400	$5,123.30
1992	7.650%	15.30%	$55,500	$5,328.90
1993	7.650%	15.30%	$57,600	$5,528.70

XVIII. COST-OF-LIVING INCREASES

Social Security benefits for a beneficiary over 62 years of age are increased each December to reflect increases in the cost of living. Such increases become payable the following January. The cost-of-living increase for 1993, made payable as of December 31, 1992, was 3.0%. Cost-of-living increases are made regardless of whether or not the worker retires.

XIX. AVERAGE BENEFITS

According to the Social Security Administration, in January 1993 the following were the average benefits which it paid:

a. For a retired worker: $653

b. For a retired couple: $1,106

c. For a widow with two eligible children: $1,288

d. For a widow(er) without eligible children: $608

XX. TABLE OF RETIREMENT BENEFITS

The following is a table of estimated monthly retirement benefits for a worker. Also included is the benefit for the spouse if at or below age 65 with a child under 16 years of age. This is an estimated table of benefits that assumes a steady-level increase of wages on par with the general population until retirement. Benefits are expressed in present-day cash value. Included in the estimated calculation of benefits is the fact that younger workers' retirement ages are higher, resulting in a reduced monthly benefit upon early retirement (for them) at age 65.

Age in 1993	Recipient	Annual Earnings $12,000	$30,000	$42,000	Maximum
65	Worker	$529	$970	$1,066	$1,128
	Spouse/child	264	485	533	564
64	Worker	522	956	1,053	1,118
	Spouse/child	261	478	526	559
63	Worker	525	960	1,060	1,136
	Spouse/child	260	480	530	560
62	Worker	530	965	1,070	1,150
	Spouse/child	262	485	540	575
61	Worker	525	960	1,080	1,160
	Spouse/child	260	490	535	570
55	Worker	520	965	1,100	1,200
	Spouse/child	265	490	550	600
50	Worker	500	950	1,050	1,150
	Spouse/child	250	470	525	550
45	Worker	490	925	1,075	1,175
	Spouse/child	260	480	535	575
40	Worker	510	960	1,080	1,200
	Spouse/child	265	490	540	590

XXII. BENEFITS ON EARLY RETIREMENT

A person can retire anytime after reaching the age of 62 years and begin receiving Social Security benefits. The monthly benefit received as a result of an early retirement will be less than if the person waited until reaching full retirement age. The reason for the lower monthly check is that the person will have paid less than a person of comparable age who worked until full retirement. For persons born between 1943 and 1954, the retirement age will increase to 66. For persons born after 1959, the retirement age will increase to 67.

The amount that a person's retirement benefit will be reduced because of early retirement depends on the age of the person when the benefits begin. The reduction of benefits is 5/9ths of 1% multiplied by the number of months that the person will receive benefits before attaining the full retirement age (65 years of age for most people). Once a benefit is reduced because of early retirement, it will not be increased to the full amount when the person reaches full retirement age: the reduction in the benefit amount is permanent.

AGE AT	% OF	ANNUAL EARNINGS			
RETIREMENT	BENEFIT	$12,000	$30,000	$42,000	MAXIMUM
65	100.00%	$500	$750	$1,000	$1,250
64½	96.66%	483	725	967	1,208
64	93.33%	466	700	933	1,167
63½	90.00%	450	675	900	1,125
63	86.33%	433	647	867	1,079
62½	83.33%	416	625	833	1,041
62	80.00%	400	600	800	1,000

The reduction factors for the spouse of a worker electing early retirement benefits are different:

a. For a spouse between 62 and 64 years of age, the reduction in benefits is 25/36 of 1% for the number of months benefits will be received before reaching full retirement age.

b. For a surviving spouse between 60 and 64 years of age, the reduction percentage is 19/40 of 1% for the number of months before attaining full retirement age.

c. For a disabled spouse between the ages of 50 and 59 years, the reduction of the monthly benefit is 28½%.

XXIII. FAMILY BENEFITS

Social Security covers not only the worker but the worker's family as well. When a worker retires, other members in the family may also become entitled to benefits based upon the worker's earnings record. These benefits, payable to the worker's family, are calculated as a percentage of the worker's benefit. There is a maximum family benefit that will be paid to the worker and the worker's family.

BENEFITS	PERCENTAGE OF WORKER'S BENEFIT
SPOUSE at full retirement age	50.0%
SPOUSE at age 62	37.5%
SPOUSE with disabled child or child below 16 years of age	50.0%
EACH ELIGIBLE CHILD	50.0%

The worker must apply for his retirement benefits before the family members can apply for their benefits. The family benefits are in addition to the benefits received by the worker and do not diminish or reduce the worker's benefits.

XXIV. SURVIVOR BENEFITS

Social Security benefits are paid in some instances to the survivors of a deceased worker. Survivor benefits are adjusted yearly for the cost of living. For the survivors to receive benefits, the worker must have been either currently insured (which provides coverage for some but not all benefits) or fully insured (which provides coverage for all benefits).

A currently insured worker is one who has earned six quarters of coverage during the preceding 13 quarters before the death of the worker. For a currently insured worker, the following survivors will qualify for survivor's benefits:

a. A spouse or divorced spouse caring for an eligible child under the age of 16, or a child who had been disabled before the age of 22.

b. Any eligible child under the age of 18 (or under the age 19, if in high school), or disabled before the age of 22.

A "fully insured" worker has earned all of the required quarters to become fully insured in the program. The survivors of a fully insured worker include not only the spouse and children but dependent parents.

XXV. LUMP SUM SURVIVOR'S DEATH BENEFIT

Upon the death of a currently insured or fully insured worker, a lump sum of $255 will be paid by Social Security to the worker's surviving spouse. If there is no surviving spouse, the payment will be made to any children of the worker who are entitled to receive survivor benefits. If there is no spouse or children entitled to receive survivor benefits, the $255 will not be paid to anyone.

XXVI. SURVIVOR FAMILY BENEFITS

As with regular retirement benefits, survivor benefits are limited to a maximum family benefit amount based the deceased worker's retirement benefit.

SURVIVOR	PERCENTAGE OF DECEASED WORKER'S
Spouse at full retirement age	100.0%
Spouse at age 62	82.9%
Spouse at age 60	71.5%
Disabled Spouse at age 50-59	71.5%
Spouse under 61 with disabled child or child under age 16	75.0%
Each eligible child	75.0%
Dependent Parent	82.5%

Survivor benefits are non-duplicative of other Social Security benefits. This means that if the recipient is eligible to receive other Social Security benefits in addition to the survivor benefits, he will be awarded the largest of the eligible benefits. For example, assume that a surviving spouse is eligible to receive benefits based on her own work record and also based on her deceased husband's survivor benefit. The surviving spouse may receive the benefit based on her work record but then will not receive any survivor benefit based upon her deceased husband's account.

Survivor benefits are subject to the earnings limitations the same as though the person was receiving the benefits as a result of a normal retirement. Thus, survivor benefits will begin to be lost and reduced for earnings that exceed the earning limitations.

XXVII. ESTIMATED MONTHLY SURVIVOR BENEFITS

The following is a table of the estimated survivor benefits for a worker dying in 1993. The table is based on the assumption that the worker is currently insured and has worked steadily throughout his career.

WORKER'S AGE AT DEATH	RECIPIENT	WORKER'S ANNUAL EARNINGS $12,000	$30,000	$57,600+
65	Spouse age 65	529	$970	$1,128
	Spouse age 60	378	693	807
	Spouse with child	397	727	846
	Dependent parent	436	800	930
	MAXIMUM FAMILY BENEFIT	816	1,696	1,974
60	Spouse age 65	525	960	1,125
	Spouse age 60	375	686	804
	Spouse with child	393	720	844
	Dependent parent	433	792	928
	MAXIMUM FAMILY BENEFIT	810	1,675	1,975
55	Spouse age 65	530	975	1,150
	Spouse age 60	378	697	822
	Spouse with child	398	731	863
	Dependent parent	437	804	949
	MAXIMUM FAMILY BENEFIT	810	1,700	2,025
50	Spouse age 65	533	980	1,175
	Spouse age 60	381	700	840
	Spouse with child	400	735	881
	Dependent parent	440	809	969
	MAXIMUM FAMILY BENEFIT	815	1,710	2,050
45	Spouse age 65	540	1,000	1,200
	Spouse age 60	386	715	858
	Spouse with child	405	750	900
	Dependent parent	446	825	990
	MAXIMUM FAMILY BENEFIT	815	1,750	2,100
40	Spouse age 65	550	1,150	1,250
	Spouse age 60	393	822	893
	Spouse with child	412	863	938
	Dependent parent	454	949	1,031
	MAXIMUM FAMILY BENEFIT	820	1,800	2,175

CHAPTER 7

SUPPLEMENTAL SECURITY INCOME

Supplemental Security Income (SSI) is a specialized program implemented under Social Security to provide for aged or disabled workers in need. As with other Social Security programs, it has developed over the years from supplemental source of income to, in many cases, the sole source of income for many persons. To keep from becoming a general welfare program, Supplemental Security Income benefits are limited to needy persons who are blind, over 55 years of age or otherwise disabled. To be in need requires that the recipient be without assets over a certain value and not receive monthly income over a certain amount. Supplemental Security Income benefits are available only to citizens of the United States and lawful aliens in permanent residence in the United States.

The receipt of SSI benefits is not mutually exclusive nor a bar against participation with other federal and state welfare programs. In particular:

1. It is legal for an eligible person to receive both Social Security and SSI benefits. In fact, according to SSA figures, over one- half of all recipients of Social Security benefits also receive SSI benefits.
2. It is possible for an eligible person to receive both Medicaid and SSI benefits. Most states treat a person as eligible for SSI and automatically eligible for Medicaid.

An applicant for SSI benefits should apply for Medicaid.

3. In some states an eligible person can receive both Food Stamps and SSI benefits. The States of California, Wisconsin, Oregon, Utah, Vermont, Virginia, New York and some counties in both Minnesota and Ohio deny food stamps to persons receiving SSI benefits, although there are proposals to change the law. An applicant for SSI benefits should apply for food stamps. As long as the applicant tells the truth, there is nothing to lose. Even in California and Massachusetts, the law may change, and the applicant may become eligible.

This chapter is written to reflect the current problems, concerns, and benefits available. It is written to give the reader a concise and accurate depiction of the questions and answers to be faced in participating in the program.

I. DEFINITION

The Social Security Administration (SSA) administers the federal program which handles Supplemental Security Income (SSI). The program provides cash assistance to aged, blind or disabled individuals who have little income and few assets. Under the program, the qualified individual receives a monthly check based upon need, determined on a sliding scale from $354 per individual to $552 or more for a married couple. These figures are not absolute and are likely to change with the budget increases each year. The bottom line is that workers in need may be eligible for such SSI payments. A few states supplement SSI by paying an additional amount. Therefore, any individual receiving SSI should also check to determine if aid is also available through their state's welfare department.

The following persons are eligible to receive SSI benefits:

1. A person over 65 years of age.
2. A blind person.
3. A disabled person.

In addition, each of the above persons must be in need. This means that their income and total assets cannot exceed a certain level. To reach this minimum level, some applicants transfer their property to their children. Such transfers may be valid if performed in accordance with the law. For transfers after July 1988, there is no penalty for transferring assets to another person for less than fair market value in order to qualify for SSI. This must be a legitimate transfer with title actually passing free and clear with no conditions for future use or a life estate being retained by the applicant. While such a transfer may be permitted for SSI, it still does not apply for Medicaid. Medicaid will not pay the applicant's nursing home expenses for 30 months following the transfer.

SSI benefits are available only to citizens of the United States and aliens lawfully admitted to the United States for permanent residence. As a result, illegal and undocumented aliens cannot participate in the program despite the fact that they may pay Social Security taxes.

II. DETERMINATION OF NEED

To receive SSI payments, a worker must be in need. That need is determined by a comparison of the debts and obligations of the worker with his income and assets. Obviously, a person with millions in assets but no income will not be found in need and eligible for SSI payments.

In making its need determination, the SSA considers any assets which a person can convert into cash as equivalent to cash and available to pay for his support or maintenance. When the person is married, the SSA also considers the assets of an applicant's spouse as available for the applicant's care and support. By law the SSA looks for "cash or other liquid assets or any real or personal property that can be converted into cash" by or for the use of the applicant for SSI benefits.

To be eligible for SSI benefits, the applicant cannot have assets worth more than $2,000 if single or worth more than $3,000 if married. Not all assets are counted in determining an applicant's eligibility. Furthermore, an applicant may give $500 or less to children before filing for SSI benefits and still be eligible.

By law certain assets are exempt when determining a person's eligibility to receive SSI benefits. The exempt assets which an applicant can have and still receive SSI benefits are:

1. Life insurance policies. These are exempt altogether from

the calculation of an applicant's total assets. Other types of insurance policies are also excluded if their cash surrender value is less than $1,500.

2. One automobile with a value of $4,500 is exempt for SSI purposes. If the value exceeds $4,500, only the excess is counted in computing the SSI eligibility. If the vehicle is specially equipped for a handicapped driver or otherwise needed for transportation for specific medical treatment, it may be treated as fully exempt for SSI purposes.
3. Household goods up to $2,000 are exempt for SSI purposes. Not included in SSI eligibility calculations are wedding and engagement rings along with medically necessary medical devices such as wheelchairs, oxygen tanks, walkers, etc.
4. Insurance proceeds used to replace destroyed, lost or damaged exempt property are also exempt if the proceeds go to replace or repair the exempt property.
5. The family home is totally exempt for SSI purposes if the applicant lives in it as a residence. The house may be totally paid for and worth any amount of money and still be exempt.
6. Property essential for self-support is exempt up to $6,000. This property is determined on a case-by-case basis. The SSA decides if such property is necessary for

the applicant in producing income for support.

All of this exempt property is not included in determining the eligibility of an applicant for SSI. Any decision by the SSA to include such property in an applicant's list of available assets could be appealed.

Generally, property held by an applicant's spouse is attributed to the applicant for the purposes of determining eligibility to receive SSI. Therefore, if any property is held jointly with a spouse, that property will be attributed to the applicant. Property held jointly with persons other than the applicant's spouse may still be attributed to the applicant in determining eligibility to receive SSI benefits. It is considered the applicant's asset if the applicant's interest in the property can be sold without the consent of the other owners. If the property can be sold without the other owner's consent, then the applicant's interest in the property will be included in the applicant's list of assets for determining eligibility. If the applicant's interest in the property cannot be sold without the consent of the other owners, the applicant's interest is exempt from use in determining the applicant's eligibility to receive SSI benefits.

If an applicant for SSI benefits has a joint bank account with a spouse, the entire amount is attributed to the applicant for the purpose of determining SSI eligibility. The law is different when the joint bank account is with someone other than the applicant's spouse. Since 1982, the SSA will attribute to the applicant all of the funds in the bank account except those that can be proven to have been contributed by the other person on the account. The applicant is required to state in writing and under penalty of perjury the facts necessary to substantiate the amount of funds which belong to the other person in the joint account.

Just as common law marriages are recognized for SSI purposes, the SSA will recognize a de facto marriage, even though it might not be valid under state law. When the persons hold themselves out as married, the SSA will attribute to the applicant for SSI benefits the income and assets of the other person as though the other person was indeed a valid, legal spouse. Factors considered by the SSA to determine if the couple held themselves out as married are:

1. Their names which they use in public.
2. How they introduce each other to strangers.
3. How they receive mail.
4. How they sign leases and deeds.

If they both qualify for SSI benefits and are found to be holding themselves out as married, they will receive the married couple benefit (which is less than two single benefits). In 1989 the married couple benefit was $552, and the individual benefit was $354. The amounts increase a bit each year.

Generally, the only relative whose property will be attributed to an applicant is that of a spouse. All of the spouse's property will be attributed to the applicant for the purposes of determining eligibility to receive SSI benefits. Property held by children or other relatives is not included in the applicant's estate unless some of that property was transferred by the applicant solely to make the applicant eligible. Such property transferred to a child may be attributed to the applicant.

When an applicant is determined to have too many assets, the applicant is denied SSI benefits. The applicant is told that to receive SSI benefits he must reduce his estate to below the threshold amount. To do this, he may spend cash or sell assets until the estate is within the maximum amount allowed by law. An applicant can also purchase a home, or he can invest in improving a home rather than spending the cash in other nonproductive ways. There is no law against an applicant divesting himself of his assets in order to become eligible, provided the assets are truly given away. Special qualification rules exist when the total countable assets do not exceed $3,000 for an individual or $4,500 for a couple, and liquid resources (cash, stocks, bonds) do not exceed $533 for an individual or $800 for a couple.

In order for a couple to receive SSI benefits, there must be a valid marriage. The existence of the marriage is usually not difficult to prove. A marriage certificate or an affidavit by the person performing the marriage or the witnesses to it will suffice. Likewise, a valid marriage is needed before the SSA can attribute the assets and income from the person of the opposite sex to the applicant.

A more difficult scenario exists when there is a common law marriage. A common law marriage is one in which the man and woman live together for a fixed amount of time and hold themselves out as husband and wife. Only 14 states permit common law marriages. Most states, like California, do not recognize common law marriages. A common law marriage will be honored by the SSA if it is valid in the state where it occurred. A common law marriage may be proven in two ways:

1. If both spouse are alive: a joint affidavit that they are married.
2. If one spouse is dead: an affidavit by the surviving spouse and two blood relatives, preferably of the deceased spouse, that there was a marriage as evidenced by the conduct of the parties.

A valid common law marriage bestows upon the surviving spouse of the worker and the children born of the marriage all of the rights and protections that are afforded in a traditional marriage. A recipient of SSI benefits is required by law to keep the SSA informed concerning changes in income or living conditions. This reporting helps the SSA to redetermine the recipient's eligibility for SSI benefits and the appropriate amount of such benefits as the recipient's conditions change. The SSA can require a recipient to file forms each year stating the recipient's current assets and income. Failure to make the required reports can result in the recipient being overpaid and thus responsible for repayment of the overpayment of SSI benefits. The SSA also has the authority to fine the recipient $100 for failure to file the report.

A. EARNINGS BY AN APPLICANT

Income for the purposes of determining eligibility to receive SSI benefits is defined as:

> "the receipt by an individual of any property or services which he can apply, either directly or by sale or conversion, to meeting his needs for food, clothing and shelter."

This definition of income includes both earned and unearned income and personal property received in lieu of cash which is called "in-kind" income. The SSA has complex rules for determining an applicant's income. Some income is exempt altogether while other "in-kind" income is attributed to the applicant. For this reason, an applicant should appeal any finding on excessive income that he feels is erroneous. Generally, to be eligible for SSI benefits, an applicant cannot receive as income more than the monthly SSI benefits. In 1989, the monthly benefit was $250 for an individual and $400 for a couple, but as the benefit increases, so does the amount that can be earned without losing eligibility.

The SSA will look only at the income of a single person in determining eligibility to receive SSI benefits. A child's income will not be attributed to a parent for the purpose of determining a parent's eligibility to receive SSI benefits. If the applicant is married and living with his spouse, both incomes, including income exclusions available to each spouse, will be counted in determining the applicant's eligibility to receive SSI benefits.

Certain types of income received by an applicant are either totally or partially exempt from calculating the applicant's countable income for SSI eligibility. Example: The first $20 per month earned by an applicant is exempt whether it is from earned or unearned income. In addition, the following income is not counted when determining an applicant's countable income for SSI benefits:

1. Income tax refunds.
2. Property or sales tax refunds.
3. Insurance payments for replacement of damaged or destroyed property.
4. Welfare or AFDC payments.
5. Housing assistance payments.
6. Foster care payments.
7. Wages received from VISTA, Foster Grandparent Program, the Retired Senior Volunteer Program and the Senior Companion Program.
8. Proceeds received from the sale of assets.

Partially excluded income is the first $65 earned each month along with one-half of the income earned thereafter. With these exclusions on earned income, an applicant can earn over $100 per week and still qualify for SSI benefits. Since one-half of the applicant's earned income is used in determining eligibility, it is necessary to know what the SSA considers to be earned income. "Earned income" is any property, including cash, that the applicant receives in payment for the performance of a job. The SSA considers earned income to be gross wages that an applicant receives from a job and the net earnings from self-employment. In both cases, the SSA looks at the income before deductions for taxes and insurance.

There is an exclusion for one-half of earned income in determining if the applicant is earning too much money; however, there is no comparable deduction for unearned income. Therefore, all unearned income is counted against the applicant in determining the applicant's eligibility for SSI benefits. "Unearned income" is that income for which the applicant did not or no longer has to work in order to receive. Such unearned income includes but is not limited to Social Security benefits, Veteran benefits, Worker's Compensation, state unemployment benefits, insurance benefits, pensions, gifts, alimony, inheritances and lottery winnings and prizes.

B. TREATMENT OF IN-KIND INCOME IN DETERMINING ELIGIBILITY

Income, for the purposes of determining SSI benefits, includes both cash and property received by an applicant or spouse that can be used for the applicant's care and support. Non-cash property is considered in-kind income and the equivalent of cash if it can be converted to cash, or if it can replace property that could be used for the care and support of the applicant. Examples of in-kind income is food, clothing, shelter, or transportation. In-kind income may be either earned or unearned income depending on whether the applicant worked for it. Thus some, or none, of it may be excluded from the applicant's countable income depending on whether it is earned or unearned in-kind income.

The SSA has adopted two methods of valuing in-kind property, depending on whether the income is earned or unearned in nature. For earned in-kind income, the SSA uses the current market value of the property for inclusion in the applicant's countable income. For example, assume that an applicant receives $500 in produce for doing work. As such, $500 in earned income is attributed to him. For unearned in-kind income, the SSA uses a different method of determining the amount of income to be attributed to the applicant. In-kind unearned income is valued by the SSA by its presumed value. The SSA assigns a value to the in-kind property received based upon its presumed value to the average applicant. Example: The SSA presumes food for an applicant to be worth $80 for an individual and $109 per couple. It is the burden of the applicant to prove that the value of the food received is less than this amount.

The valuation rules governing in-kind property are complex, and if the applicant disagrees, he can appeal any denial of benefits.

III. APPLICATION FOR SSI BENEFITS

An applicant applies for SSI benefits by filing an application with the SSA. The application can be requested by mail from the SSA. The application is considered effective from the date that it is received by the SSA, or if mailed to the SSA, the date on the post mark of the envelope. It is the applicant's responsibility to prove eligibility to receive the benefits. The SSA is required by law to help an applicant establish eligibility for SSI benefits.

Detailed proof regarding the applicant's income and assets is necessary in order to determine eligibility. Even if it will take time to amass all of the information, the applicant should still file. If the applicant is eligible, SSI benefits will be paid from the date of application, not the date of final determination. So if it takes six months to prove eligibility, the applicant will receive 6 months of back benefits, if an official application has been filed.

Sometimes an applicant does not file an official application after being told unofficially that the applicant does not qualify. If the applicant was actually eligible, the failure to file the official application is a bar to recovery of the lost benefits. An applicant should always file an official application regardless of what the applicant is told unofficially.

There are several ways in which an applicant may receive benefits while awaiting a final determination on his application for SSI benefits:

1. If the SSA wants additional proof of age, the applicant may receive advance payments, pending final determination, by proving financial need and producing a written document at least three years old that shows that the applicant is at least 65 years of age.

2. If the applicant is considered "presumptively disabled," the applicant is entitled to benefits while the application is being processed.
3. If the applicant can prove a strong likelihood that he will qualify and a financial emergency exists which requires immediate emergency assistance, he may be eligible for temporary assistance.

In addition to SSI benefits, the applicant can apply for welfare benefits from the state. Normally it takes seven to 10 days to get a check. When there is an emergency situation, the SSA can issue a partial check for $200 of the benefit to which a recipient will be entitled when:

1. The person is eligible for SSI but has not received the check because it was lost or stolen, or
2. The person has been approved for SSI benefits, but the check has not yet been issued.

The SSA can only issue such a check once every 30 days under the immediate payment program.

IV. PRESUMPTIVE DISABILITY

A presumptively disabled person is one who is suffering so severely from a disability that a final determination of eligibility is very likely. In such an event, the applicant is entitled to receive benefits while the application is being processed. A presumptively disabled person is one who:

1. Had two limbs amputated.

2. Had a leg amputated at the hip.

3. Is totally deaf.

4. Is confined to bed or a wheel chair.

5. Suffered a stroke within four months of the application.

6. Suffers from cerebral palsy or muscular dystrophy.

A presumptively disabled person may receive advance payments for three months while the application is pending. If the applicant is ultimately found not to be eligible, he must repay the advance payments.

V. PAYMENTS OF SSI BENEFITS

SSI benefits are paid in the beginning of each month. The check usually includes both the federal SSI payment and the individual state's welfare supplement. A few states pay their SSI supplement separately. When a couple is receiving SSI benefits, each spouse will receive a separate check for one half of the monthly benefit for the couple. The recipient of the checks can designate other persons, called "representative payees," to receive the checks on the recipient's behalf.

If an applicant's check does not arrive on time, the applicant should notify the SSA immediately. If the SSA determines that no check was issued but should have been, it will issue a check within 15 days. If a check was issued and mailed to the applicant, the SSA will first determine if the check has been cashed. If it has, the SSA will check with the Treasury Department to determine if the check signature was forged. If the check was cashed, it will be a long time before a replacement is issued. While waiting for the replacement check, the applicant may apply for emergency assistance from the state welfare department.

VI. BENEFITS AFFECTED BY AN APPLICANT'S DOMICILE

A domicile is the permanent legal residence of a person. The domicile of an applicant for SSI benefits is important because there is a wide variation among the states as to whether they supplement federal SSI and to what extent.

SSI benefits are not available to persons living outside the United States. SSI benefits are not available in Puerto Rico, Guam and the Virgin Islands. The living arrangements of the applicant also affect the monthly benefit. If the applicant is living in the household of another and receiving support and maintenance, the monthly SSI benefit is reduced by one third.

Individuals living in public institutions such as prison or state hospitals are not eligible for SSI benefits. If the applicant lives in a nursing home where more than 50% of the cost is paid by Medicare, the monthly SSI benefit is reduced. If an individual lives in a retirement home, the monthly benefit may actually be increased because retirement homes are not paid by Medicare and cost a great deal.

VII. TERMINATION OF DISABILITY BENEFITS

If a person is receiving SSI benefits because of a disability and the SSA determines that he is no longer disabled, it will notify him of its intent to terminate SSI benefits. The only remedy a recipient has against a threatened SSA action to terminate benefits is to file a request for reconsideration within 60 days of the SSA notification. SSA benefits will be stopped 10 days after the SSA notification unless:

1. The recipient files a request for reconsideration, and
2. A written notice that he wants to continue to receive benefits while appealing the determination that he is no longer disabled.

Failure to file the requests in the allotted time usually bars any future challenges of the SSA decision. In certain cases, however, when good cause can be shown for the delay, the SSA will excuse it and permit a late filing.

VIII. OVERPAYMENTS

If the recipient loses all of his appeals, he may be required to pay to the SSA any overpayments of benefits that were erroneously received. For overpayments made after October 1984, the SSA is permitted to take from a recipient's SSI benefits the following amounts as repayments of previous SSI overpayments: the lesser of the monthly SSI benefit, or 10% of the recipient's countable monthly income.

The SSA can take more than the above amounts when the recipient was guilty of fraud, willful misrepresentation or concealment of assets in obtaining the overpayment or the recipient requests the higher rate.

When a recipient is found to have been overpaid by the SSA, the recipient must ordinarily repay those benefits, unless the SSA has granted that person a waiver for overpayment. A waiver may be granted from the SSA when the overpayment was not the result of the recipient's act and the overpayment would defeat the purpose of SSI to help eligible persons survive or be against equity and good conscience. In short, if the recipient was innocent in causing the overpayment and cannot afford to repay it, the SSA should grant a waiver.

Any recipient the SSA claims was overpaid may request, within 30 days of the SSA notification, that SSI benefits not be reduced until after a reconsideration of the SSA's determination. This permits the recipient to continue receiving the full amount of benefits while the SSA is reconsidering its decision.

IX. NURSING HOME BENEFIT UNDER SSI

When a recipient of SSI benefits enters a nursing home, his SSI benefits are redetermined to ensure Medicaid pays for the nursing home. When Medicaid does not pay for the nursing home, SSI benefits remain unchanged. When Medicaid pays for the nursing home, the SSI benefit is reduced to $30 per month, providing the recipient is otherwise eligible.

X. ATTACHMENT OF SSI BENEFITS

The Social Security Act specifically states that SSI benefits cannot be attached or garnished by creditors. This extends to money in a bank account that accrued from the deposit of Social Security checks. The only exceptions to the attachment prohibition of SSI benefits are attachments to pay back federal taxes and attachments to enforce court-ordered child support or alimony.

While the benefits are not attachable, the property purchased with them are attachable by creditors. Example: The recipient purchased a boat. Creditors can sell the boat, even though they could not have taken the cash used to buy it.

CHAPTER 8

MEDICARE

I. INTRODUCTION

The Medicare program was established by the federal government in 1965. As the name infers, Medicare provides medical care by covering some of an eligible person's health expenses. Medicare has been altered almost every year of its existence to keep pace with advances in medical science and the ballooning cost of medical expenses. Today it is estimated that an elderly person spends in excess of fifteen percent (15%) of his gross income on medical expenses. A recent medical study states that the average person spends more on health expenses in the last year of life than in all the other years together.

There are many misconceptions as to what expenses Medicare will pay. Medicare does not pay all of the expenses that a person may incur. For most services Medicare requires cost-sharing with the person being covered. The practice of cost-sharing has often caused severe financial problems on the elderly. Many retired couples have no retirement or receive retirement benefits below the poverty level. They often cannot afford their share of the cost and receive no treatment.

The fact that Medicare does not cover all medical expenses has resulted in many insurance companies offering supplemental insurance policies to pay what Medicare does not cover. Most people have seen advertisements for these policies on the television, and many retirement organizations also have such policies for their members. Extreme care is warranted in purchasing a Medicare supplement. While many of the policies do an adequate job in supplementing short-term care, few cover the person for long-term care. Yet the cost for long-term care poses the greater financial and medical risk for a person. Medicare pays for most of the cost of the usual hospital stay. Medicare statistics, however, show that 5% of the population over 65 years of age will need long-term care.

Medicare is divided into two parts: hospital insurance (called Part A) and supplementary medical insurance (called Part B). Part A benefits are used primarily for the payment of services rendered by hospitals and nursing homes and are funded through Social Security taxes. Part B coverage is optional and is purchased by monthly premiums paid by the recipient of the benefits.

Everyone over 65 years of age is eligible for Medicare. They should be aware of the coverage of the plan so they can plan their anticipated needs in the future. Congress has considered denying Medicare coverage or taxing the benefits received by those recipients earning over a certain amount. This effort has been thwarted in large part by the lobbying efforts of the elderly.

II. ELIGIBILITY

Medicare does not cover everyone. Only persons who fall within fixed classes will be covered by Medicare, regardless of need. The classes for coverage under Medicare are:

1. People who are 65 years of age or older and are also eligible to receive benefits under the Social Security Act or the Railroad Retirement Act. A person over 65 years of age can receive Medicare without retirement provided the person is eligible to receive Social Security or Railroad Retirement benefits.
2. A person who has reached 65 years of age but is not eligible for Social Security or Railroad Retirement benefits is eligible if he has amassed a minimum number of Social Security quarters.
3. A person 65 years of age who has not obtained the minimum number of Social Security quarters may enroll in the Medicare program by making premium payments. Voluntary enrollees must enroll in both Part A and Part B. In 1989 the combined premium was $189.10 per month.
4. A person under 65 years of age who is disabled and is eligible to receive Social Security or Railroad Retirement benefits for at least 24 consecutive months is also eligible for Medicare.
5. A person suffering from chronic kidney disease who is eligible for Social Security or Railroad Retirement disability benefits is also eligible for Medicare benefits.

When a person 65 years of age or older applies for Social Security or Railroad Retirement benefits, he automatically applies for Medicare coverage, both Part A and Part B. Since Part B is optional, the person must ask not to be included under it. A person who receives Social Security or Railroad Retirement benefits before reaching 65 years of age must specifically apply for Medicare benefits when reaching 65 years of age. Enrollment in Medicare is not automatic when Social Security or Railroad Retirement benefits have been received prior to reaching 65 years of age. If a person is over 65 years of age and not eligible for Medicare, he can voluntarily enroll in Medicare by applying at the local Social Security office.

III. PART A BENEFITS

Part A benefits for Medicare are available for the following three services:

1. Inpatient hospital services.
2. Inpatient care in a "skilled nursing facility."
3. Home health services.

Not all hospitals and nursing homes accept Medicare payments for the services which they render. Furthermore, Medicare only pays the amount for services which it considers reasonable. The extent of any bill which Medicare does not cover, along with any deductible, is to be paid by the individual.

There is a minimum yearly hospital deductible after the maximum deductible is paid, the covered person may have an unlimited hospital stay with full Medicaid coverage at Medicaid maximum level. The yearly deductible as of January 1, 1989, was $560.00. The deductible is expected to increase in order to help reduce Social Security insolvency. The current deductible figure can be obtained by calling the Social Security office or a hospital.

Medicare pays the following benefits for hospital services:

1. A semi-private room (a room with no more than two beds).
2. All meals and special diets.
3. Regular nursing services for the unit in which the person is hospitalized.
4. Intensive care when in special care units.
5. Drugs prescribed by physicians in the hospital.
6. Blood transfusions.
7. Hospital charges for lab tests, x-rays and radiotherapy.
8. Medical supplies used in treatment.
9. Use of medical equipment while hospitalized, such as wheelchairs, hospital beds and oxygen tanks.
10. Operating and post-operating room charges.
11. Rehabilitation charges incurred during the inpatient stay.

Medicare pays for an unlimited number of hospital stays after the once-per-year deductible is met, provided the stay is medically necessary. After the deductible is met, the person does not have to pay it again as long as he is in the hospital (even for years). If the person leaves the hospital and returns the following calendar year, a new deductible must be paid.

"Skilled nursing facility benefits" refer to care provided by registered and licensed practical nurses when ordered by attending physicians. Such care includes respiratory therapy, tube feedings, physical therapy, occupational therapy and speech therapy. Such care is covered for 100 days per year. No prior hospitalization is required. The first 20 days is covered entirely by Medicare, and for the next 80 days Medicare covers everything except a co-payment of $67.50 per day. Co-payments are expected to be increased further in response to Social Security insolvency. To be authorized by Medicare, a skilled nursing facility:

1. Must be certified to participate in the Medicare program.
2. Must have a physician certify that the recipient requires skilled care.
3. Must conduct ongoing utilization review to assure that the person is actually receiving skilled care.

When skilled care is no longer required, Medicare coverage ceases. Medicare does not pay for nursing home care just because the person can no longer take care of himself. It must be medically necessary

Hospice care for the terminally ill is unlimited, being medically necessary. Congress is expected to reduce this benefit because of Social Security's projected insolvency. The patient must elect to qualify for hospice care, and the election limits the patient's options for obtaining Medicare coverage for treatment of the terminal illness outside the hospice program. After January 1, 1990, hospice care can be given for more that 210 days provided the care is being given by a Medicare-approved participating hospice.

Since January 1, 1990, health care is paid by Medicare seven days per week for 38 consecutive days. After the 38 days there must be a lapse of at least one day before it can start again for another 38 days.

"Respite care" is in-home care for the chronically disabled. It provides a rest for the care giver. Care giving can be nursing, homemaking, and personal care. Since January 12, 1990, Medicare pays the first 80 hours per year.

Medicare is not a long-term solution to pay for nursing home care. Medicare does not cover intermediate or sheltered care: the two prevalent types of care the elderly need.

IV. PART B BENEFITS

Part B coverage requires paying a monthly premium. The amount of the monthly premium is adjusted July of each year. The premium s intended to cover 25% of the program costs. The remainder of the program costs are covered from the Medicare trust fund and general tax revenues. The Medicare Catastrophic Coverage Act of 1988 added an additional premium for catastrophic coverage and drug benefits of $10.20 per month beginning January 13, 1993. Premium charges are related to the recipient's federal tax liability and cannot exceed $1,050. This figure can be expected to be raised to get more money into the system. The premiums are deducted automatically from Social Security or Railroad Retirement benefits. Direct payments must be made to the Social Security Administration for Medicare coverage if a person covered by Medicare is not receiving Social Security or Railroad Retirement benefits. There is a yearly deductible before coverage begins. There is also a 20% co-insurance charge for most medical bills where the provider accepts the assignment. Even with Part B coverage, a recipient is expected to pay the deductible, co-insurance, non-covered items and all charges that exceed Medicare's determination of reasonable charges. All of which is called the "Medicare gap."

There is a yearly limit on out-of-pocket expenses for Part B services. Out-of-pocket expenses in 1993 were limited to $1,900, after which Medicare paid 100% of approved charges. Physician charges in excess of the approved charges are not considered as a Medicare out-of-pocket charge.

Medicare pays for most physician services provided in a hospital. In some instances the care provided by chiropractors, dentists, podiatrists and other medical professionals will be paid by Medicare. Physician services can be provided in the hospital, office, nursing home or patient's home. In addition, surgery and consultation services can also be covered. Moreover, most outpatient treatments such as electrocardiograms (EKG), X rays and physical therapy are covered. Outpatient psychiatric services are covered to a maximum of $1,000 per year as of January 1, 1989. In-patient psychiatric hospitalization is covered for 190 days.

Since January 12, 1990, Medicare covers at-home administration of intravenous antibiotics; additional intravenous drugs are expected to be added for at-home administration. There is a deductible for such drugs of $652 that will be increased in the future. Since January 1993, Medicare pays 80% of the cost minus the deductible. The deductible for the drugs does not apply if their use started in a hospital and was continued at home.

Outpatient prescription drugs are paid by Medicare after an initial deductible for $600. Medicare pays 80% of the approved cost of such drugs after January 1993.

Mammography screening is covered by Medicare screening. Since January 1990, Medicare pays 80% of the costs for the first year if less than $50.

Under Part B, Medicare also will pay for some of the outpatient hospital services. Some are those provided in an emergency room, an outpatient clinic, or a diagnostic laboratory. Except for outpatient laboratory tests, Medicare will pay 80% of the approved charge minus the appropriate deductible.

V. WHAT PART B DOES NOT COVER

What Part B does not cover is probably more important than what it does cover. Many people have the mistaken belief that anything related to a person's continued good health is covered by

Medicare as long as it is prescribed by a physician. This is not the case. Medicare pays only for what is considered to be medically necessary to treat a medical condition. The following services are usually excluded from coverage:

1. Routine physical check-ups.
2. Routine eye examinations.
3. Prescription eyeglasses or contact lenses for ordinary vision correction.
4. Hearing aids.
5. Routine foot care and orthopedic shoes.
6. Cosmetic surgery.
7. Routine dental exam and services.

This list demonstrates that the main impetus of Medicare is to treat serious medical conditions. It does not become involved with preventive medicine or care. Therefore, it is best that a person on Medicare determines if it is medically necessary or if it is preventive in nature before being treated. In one instance Medicare will pay for it, and in the other Medicare will not pay for it.

VI. KIDNEY DISEASE

Medicare has special treatment for those persons who are disabled as a result of kidney disease. The normal 24 month waiting period is reduced to three months for a person on dialysis. The three month period is even further reduced for persons entering into a training program for self-dialysis. A candidate for a transplant operation is eligible for coverage the month he enters a hospital provided the transplant takes place within three months. A person on dialysis does not have to be totally disabled. A person on dialysis may work without the work affecting his disability status for Medicare eligibility.

Once covered by Medicare, the person will remain covered for 12 months after the dialysis has been discontinued. If the person has received a kidney transplant, Medicare coverage will continue for three years after the transplant operation.

VII. PREVENTIVE TREATMENT

Medicare does not pay for preventive medicine or treatment. It probably should because "an ounce of prevention is worth a pound of cure." In the same vein it does not pay for well-patient care. A physical checkup is not covered by Medicare although recommended by all health-care providers to keep a person fit and discover problems early.

Not covering routine physical exams is not only short-sighted but imposes a great financial burden on the elderly. The average physical along with all of the routine blood tests now runs in excess of $200. If a person cannot afford the physical then he won't get one, and a problem that could be caught early will be missed until it explodes into a much more expensive or fatal condition.

VIII. AMBULANCE PAYMENTS

A concern to many persons on Medicare is whether ambulance payments will be paid. Part B covers ambulance payments under the following:

1. The ambulance is medically required, and the personnel are trained to Medicare standards.
2. The ambulance is for transportation from the scene of an accident to a hospital or from the person's home to a hospital or skilled nursing facility or between hospitals or from a hospital or skilled nursing facility and home.

When the ambulance does not take the person to the nearest facility, Medicare will pay only for the cost that would have been incurred if the ambulance had gone to the nearest facility.

IX. CATASTROPHIC ILLNESS AND NURSING HOME CARE

Medicare was amended in 1989 to expand Medicaid coverage to persons suffering catastrophic illness and needing nursing home care. An illness forcing a person into a nursing home for a long period of time is considered a catastrophe. Medicare pays only for skilled nursing services, not custodial care. In addition Medicare will only pay for skilled nursing care for 150 days. Any nursing care beyond that period must by paid by the recipient.

The following changes in Medicaid eligibility were enacted in 1989 to permit needy persons to receive Medicaid coverage for nursing-home care without requiring an at-home spouse to either divorce or become impoverished:

1. No income of an at-home spouse is to be considered available to a spouse in a nursing home in determining

eligibility.

2. Income is considered property to whom it is paid. Income paid to both spouses is attributed one-half to each spouse.

3. The home, household goods and personal effects of a couple are not counted in determining Medicaid eligibility.

4. Assets other than home, household goods and personal effects will be counted and divided by two. Assets belonging to the spouse in the nursing home are held to be available for payment of that spouse's nursing home care. If the at-home spouse has less than $12,000 in countable assets, the spouse in the nursing home may transfer assets to raise the figure to the $12,000. States are given the authority to raise the $12,000 limit to any figure below $60,000. All assets over $60,000 of the at-home spouse are attributed to the spouse in the nursing home and are considered available for nursing home care.

5. The at-home spouse must be allowed income from the spouse in the nursing home to have total household income of at lease 150 per cent of the federal poverty level. The 1989 federal monthly poverty level was $789.

X. PURCHASING SUPPLEMENTAL INSURANCE

Buying Medicare supplemental insurance to fill the Medicare gap may be a worthwhile investment. There are two general types of Medicare supplement policies: the service benefit policies and the indemnity benefit policies. Each type of policy has its own restrictions and type of coverage.

The service benefit policy correlates its coverage with that of Medicare. This type of policy usually claims to cover the difference between the actual costs of covered services such as hospitalization, surgery, outpatient care, drugs and skilled nursing care and the amounts that Medicare will actually pay. The best of this type of policy will leave the covered person with no out-of-pocket expenses. Warning: This type of policy does not cover anything that is not covered by Medicare. As a practical matter most people do not exhaust their hospital or skilled nursing home benefits; so there is little call for the insurance to reimburse. This type of policy generally comes into play for outpatient treatment and should pay the 20% co-payment. Many insurers use their own fee schedule (similar to the one used by SSA administrators of Medicare), and they may not cover the difference between what was charged and what Medicare actually paid for the service. It is important to know before such insurance is purchased how the insurance company determines what it will and will not pay. This type of Medigap Policy has all of the downside effects of Medicare except the deductible and co-payments. These plans do not provide full protection on the outpatient side, where they are needed most.

The second type of Medigap policy is an indemnity benefit policy. This policy provides a fixed amount per day or per service given to the covered person. The policy usually states that it will pay a certain amount per day or the actual cost of the service provided, whichever is lower. This policy should be carefully reviewed. It is possible with this type of policy to still have unpaid services when the unpaid Medicare portion exceeds the daily maximum. A good indemnity policy, however, is better than a service benefits policy.

A person considering purchasing a Medigap should do the following:

1. Should not purchase a limited purpose policy: a policy which covers only certain types of treatment such as accidents, heart attacks, kidney failure, etc. These policies all gamble that the purchaser will not fall into the coverage category and that coverage can be denied if there is overlapping cause for treatment. For example, a person with a heart attack policy may be denied coverage if the Medicare treatment also covers a cancer condition.
2. Should not purchase a policy which excludes coverage for pre-existing conditions. A policy which excludes pre-existing conditions for more than six months cannot be called a Medicare supplement. It is not illegal to exclude pre-existing conditions, but it is illegal to call the policy a Medicare supplement if the pre-existing

conditions are excluded for more than six months. Buying insurance when coverage is excluded is generally a waste of money because the insurance does not apply.

3. Should never buy a policy that can be canceled or non-renewed by the company at its option. That gives the company the right to cancel the policy once claims have been made. Companies would love the opportunity to cancel coverage once they have to start paying the claims.
4. Should not pay for duplicate Medicare coverage. The insurance company will always pay only what Medicare does not pay; so paying for coverage on what Medicare will pay is a wasted expense.
5. Should not purchase a policy which has an annual limit on the amount it will pay. As stated earlier, most people will spend more in their last year of life for health care than in all of their other years combined. Therefore, if there is a cap on the annual limit, it probably will not cover all the expenses in the final year of life and possibly not other years as well. The ideal policy should have no annual limits on coverage and a minimum life-time limit of $500,000.

The best Medigap policy should have all of these features and be based on a client's financial ability to pay for them:

1. The policy should contain a stop-loss provision which

places a cap on out-of-pocket expenses including those not covered by Medicare. If the policy does not have it, it can be added by a rider.

2. The policy should cover prescription charges for drugs which Medicare does not pay, including the deductible and the co-payments. Prescription drugs are a large part of the medical expenses incurred for health care by the elderly. The costs for such drugs have skyrocketed in the last few years and exceed the cost Medicare deems reasonable.

3. Every policy should be automatically adjusted to cover Medicare's yearly increase in co-payments and deductibles.

4. The policy should explain exactly what is covered and how the premium is being applied for the coverage. The benefits provided by the policy should be specifically stated. Special attention should be directed to the extent of coverage of doctor's bills. Many policies will only cover the 20% co-payment and do not cover the amount that Medicare deems to be excessive. Most companies only pay reasonable medical charges, and will not pay where Medicare determines fees are excessive. The only real protection is a written statement attached to the policy specifically stating the extent of the coverage.

If a person has Blue Cross or Blue Shield insurance at the time they turn 65 years of age and become eligible for Medicare, they should consider converting their coverage into a Medigap policy. Generally, such a conversion will offer lower premiums to reflect the change in protection under the new policy. Such a change, however, should be carefully considered in the instance where the prior policy also covered family members. Additional policies may be required on the other family members.

XI. ASSIGNMENT OF MEDICARE PAYMENT

Assignment is a term of art under Medicare which means that the health-care provider has agreed to accept as full payment for the services rendered what Medicare deems reasonable to pay for the service along with the 20% co-payment due from the patient. The provider also agrees to do all of the Medicare paperwork necessary to process the claim. Doctors previously could decide whether or not to accept assignments on a case-by-case basis. That has changed. Doctors must agree to take or not take all assignments on Medicare claims brought to them.

When a doctor agrees to take an assignment, he agrees to take as full payment the amount Medicare deems reasonable for the service provided. Medicare then pays 80% of that amount and the patient pays the remaining 20%. Example: A doctor performs open-heart surgery. The normal fee that the doctor would charge is $25,000. Medicare concluded that the reasonable fee is $20,000. The doctor has agreed to take an assignment. Medicare will pay $16,000 minus $1,900 (the 1993 Part B deductible of less than the out-of-pocket limit) and pay nothing thereafter.

In calculating the reasonableness of the doctor's charge for Medicare purposes (called the approved charge), Medicare uses the lowest of the following:

1. The amount that the doctor actually charged for the services which were provided.
2. The midpoint of all the charges which the doctor made for that service for the last two years (called the customary charge).
3. 75% of the bills submitted by the doctors in the area for this service (called the "prevailing charge").

When a person goes to a non-participating doctor (a doctor who has not agreed to accept assignments), the calculation of the Medicare payments becomes far more onerous on the recipient. The patient must pay all of the difference between what Medicare pays and what the doctor charged. Using the above example for a non-participating doctor, Medicare still would only pay 80% of the approved charge: $16,000 minus the outstanding Part B deductible. The patient pays the remaining $9,000 plus the outstanding Part B deductible, even though the $1,900 out-of-pocket limit for 1993 has been satisfied. The out-of-pocket limit applies only to approved Medicare charges. With a non-participating health care provider, the patient must pay everything Medicare does not cover.

To cloud the issue even more for non-participating doctors, there is the Maximum Allowable Actual Charge (MAAC) established by

Medicare. Neither the patient nor the patient's supplemental insurance company has to pay the excess where a doctor's charge exceeds this MAAC. An example of the application of this will use the above scenario. The doctor's fee of $25,000 exceeds the MAAC of $23,000. Medicare will still pay the 80% of the approved charge ($23,000) minus any outstanding deductible; the patient will pay the balance of $6,600 ($2,000 + $4,600) plus any outstanding deductible.

XII. CARE IN A NURSING HOME UNDER MEDICAID

As discussed above, Medicare does not pay for custodial nursing-home care merely because a person can no longer take care of himself. Medicaid, another federal program under social security, does provide nursing-home custodial for basically indigent persons. The average cost of nursing homes runs between $25,000 and $35,000 per year.

Current law requires that the assets of both the person seeking nursing-home care and the person's spouse be considered in determining eligibility for Medicaid coverage. The exact requirements for determining Medicaid eligibility vary from state to state because Medicaid operates in partnership with the individual states. A person is automatically eligible for Medicaid if the person is receiving or can receive Supplemental Security Income (SSI) payments for the aged, blind or disabled. If a person is not in one of these classes, he may still qualify for Medicaid coverage if he has low income (after subtracting certain deductions) and is medically needy. A person is permitted to spend his assets to a point where he can qualify for Medicaid assistance. Once eligible, Medicaid will pay for all the medical bills of the person as long as the person remains eligible for Medicaid assistance.

It is possible to transfer assets to someone other than a spouse or parent in order to become eligible for Medicaid; however, this transfer must be done more than two years before applying for Medicaid benefits. An exception to this rule is that before entering a nursing home, a spouse can transfer assets worth $12,000 (some states have a higher limit approaching or equal to $60,000) to the spouse who is staying at home. A person considering transferring assets to become eligible for Medicaid assistance should first consult with an attorney familiar with Medicaid law.

XIII. MEDICALLY NECESSARY TREATMENT

Medicare does not pay for treatment which it considers not medically or reasonably necessary. This issue comes into play when hospitalization or surgery is being recommended by a doctor. The reason is most of the cost for Medicare is generated in a hospital or nursing home. Decisions affecting these costs are reviewed in a very formalized procedure. The hospital will have a Utilization Review Committee (URC) or a Peer Review Organization study a patient's case to determine if the person should remain in a hospital or skilled nursing facility. They will decide if the doctor's recommended treatment should continue. If they deny the doctor's recommendation, the patient may appeal the denial.

If the patient wins the appeal, he stays and gets the treatment. If the patient loses, he must leave the hospital, and the treatment may be stopped.

XIV. FILING A MEDICARE CLAIM

To have Medicare pay the health-care provider, a claim has to be submitted. When the provider has accepted an assignment, the doctor or hospital will submit the claim on the patient's behalf. All the patient has to do is submit a claim to the Medigap insurance company for the coverage on the excess that Medicare will not pay. If the doctor or hospital is not participating in Medicare, the patient must submit the claim to Medicare. Claim forms can be obtained from the local Social Security office. It is important that claim forms be submitted immediately. A person has 15 months in which to submit claims to Medicare. After 15 months the claims will not be paid, no matter how meritorious! The patient will have to pay the entire amount.

The claimant must complete claim form HCFA - 1490S and include the bills that validate the reimbursement. Claims are processed by the year. Therefore, bills for different years must be submitted for their respective year of charge. Example: Bills for 1993 should be with claim forms for 1993, and bills for 1994 should be with claim forms 1994, etc. More than one bill can be submitted for each claim form provided the bills are for the same year.

CHAPTER 9

DISABILITY BENEFITS

The threat of permanent disability hangs over every person. Statistics from insurance companies show that one out of 10 people will be disabled at least temporarily at least one time in their lives. Disability always has a subdued terror for most people because they remember what it was like in the Great Depression, when a person could not work because of an injury. During the depression, when a person was disabled, he and his family starved unless they fell upon public charity. Congress created a disability program for workers to prevent this tragic scenario from continuing.

The Social Security Disability Insurance (SSDI) program was established under Title II of the Social Security Act. As with Supplemental Security Income (SSI), it was designed to provide benefits to disabled workers, widows, widowers and dependents. The main difference between SSI and SSDI is that the disabled worker must have been fully insured under SSDI at the time of disability if he wishes to qualify under SSDI. Disability benefits can be received by surviving spouses and surviving divorced spouses on the death of a disabled spouse. The decision to award SSDI benefits to disabled surviving spouses is based solely on individual medical factors regarding their disability and is not based on age, education or work experience.

A close relative was permanently disabled years ago in an industrial accident. The relative was not 55 at the time and so did not qualify for SSI coverage. If not for the disability coverage under this program, his family would have been forced onto welfare until he reached age 62 and could receive regular Social Security. The system works. Disabled persons should not be afraid to apply for the benefits. The system exists to help the disabled worker, and there is no shame in receiving benefits that the truly disabled worker has earned.

This chapter was written to make it as easy as possible for a disabled person to understand his rights and to remove the unnecessary fear and confusion in applying for benefits. It is necessary for people applying for benefits to understand their rights so that they can competently represent themselves and their family before the Social Security Administration in most areas.

There are two separate disability programs overseen and managed by the Social Security Administration in accordance with the Social Security Act. The first program is contained in the Supplemental Security Income (SSI) program. SSI will pay qualified disabled individuals monthly benefits provided their assets and countable income fall below a set cut- off point. The second program is the Social Security Disability Insurance (SSDI) program established under Title II of the Social Security Act. It was designed to provide benefits to disabled workers, widows, widowers and dependents. The disabled worker must have been fully insured at the time of disability to be covered under this program.

An interesting feature of the two disability programs is that they are not mutually exclusive. It is possible for a person to receive both SSI benefits and SSDI benefits provided the person qualifies separately under each program. If the Social Security benefits received by a disabled worker or dependent are below the income limit for SSI and other qualifications are met, the recipient of the benefits may also receive SSI benefits.

A disabled person 62 to 65 years of age has the option of applying for either disability or retirement benefits, but not both at the same time.

Usually, it is more beneficial financially to apply for disability benefits rather than retirement benefits when the rights overlap. The disability benefit is the same as if the person retired at age 65; the early retirement benefit, however, is reduced 5/9ths of one percent for each month of retirement before the person reaches age 65.

Many states have tied the SSDI program to the state's Medicaid program, and a person receiving SSDI benefits will receive Medicaid coverage automatically. So there is a bigger incentive to apply for SSDI benefits in these states because the monthly benefits are higher and the individual also receives Medicaid coverage. For surviving spouses and surviving divorced spouses, there is a reduction of disability benefits of a maximum of 28.5%, based on actuarial tables, if they seek the benefits prior to attaining 65 years of age.

I. DEFINITION OF DISABILITY

The Social Security Act defines a disability for both SSI and SSDI benefits as an inability by a worker to:

> "engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months..."

In addition the SSDI definition also states that:

> "An individual shall be determined to be under a disability only if his physical or mental impairment are of such severity that he is not only unable to do his previous work but cannot, considering his age, education, and work experience engage in any other substantial activity."

This requirement that "no other substantial gain activity can be possible" is the basis for nearly all rejections of disability claims and a multitude of litigation over wrongful denials of benefits.

Under the SSDI program disability benefits can be received by both surviving spouses and surviving divorced spouses. Eligibility requirements to receive SSDI benefits are much stricter and more tightly construed than under the SSI program. Eligibility is determined solely on medical factors pertaining to the disability. The Social Security Administration does not consider age, education or work experience of a surviving spouse or ex-spouse in determining eligibility to receive disability benefits under the

SSDI program.

II. ELIGIBILITY FOR SSDI BENEFITS

To receive SSDI benefits, a worker must meet the following requirements:

1. Be disabled, and
2. Have the requisite number of quarters of covered employment which are:
   a. A disabled worker younger than 24 years of age needs 1.5 years (six quarters) of covered work earned within three years of the disability.
   b. A disabled worker between 24 and 31 years of age needs to have earned coverage for at least half of the time from age 21 to the time of the disability. In other words, a person 30 years of age must have 4.5 years (18 quarters) of coverage. A person 25 years of age must have two years (eight quarters) of coverage.
   c. A disabled worker older than 31 years of age must be fully insured and have five years (20 quarters) of work within the ten-year period preceding the disability.

As with retirement benefits, a disabled worker's family is entitled to disability benefits when a parent or spouse is disabled.

A disabled person should file for benefits immediately upon becoming disabled in order to start the clock running. Under SSDI a person is entitled to 12 months retroactive benefits from the date of application for benefits; however, there is a five-month waiting period from the date of the disability. This means that a maximum of seven months benefits will be paid for the first year of disability.

SSI disability benefits do not have a special earning requirement as do SSDI benefits, and there is not a five-month waiting period for SSI payments to begin. On the other hand, there is no retroactive payment of SSI benefits which is another reason to file immediately.

Disability benefits are also dependent on the domicile (legal residence) of the applicant. The domicile of an applicant for SSDI benefits is important because there is a wide variation among the states concerning whether they supplement federal SSDI and to what extent. SSDI benefits are not available to persons living outside the United States. This includes Puerto Rico, Guam and the Virgin Islands.

An individual living in a public institution such as a prison or a state hospital is not eligible for SSDI benefits. If the applicant lives in a nursing home where more than 50% of the cost is paid by Medicare, the monthly SSDI benefit is also reduced. If an individual lives in a retirement home, the monthly benefit may actually be increased because retirement homes are not paid by Medicare, and retirement home cost is expensive.

III. DETERMINATION OF DISABILITY

The Social Security Administration uses a multi-step procedure to determine if a person is disabled. The SSA's test for determination of disability is as follows:

The first step is to determine if the person claiming disability benefits can engage in substantial gainful activity. The SSA defines "substantial gainful activity" as work for pay or profit that requires substantial physical or mental activity. To determine substantial gainful activity, the SSA looks at the following factors:

1. Pay or property received for the work.
2. The extent of education, skills and responsibility required.
3. How well the work is done, and how long it takes.

If the applicant earns less than $200 per month, the worker is not engaged in substantial gainful activity. If the applicant earns over $400 per month, the SSA considers the person to be engaged in substantial gainful activity. For amounts between $200 and $400, the SSA makes its determination on a case-by-case basis.

These limits can be expected to change as SSI benefits increase. Every disabled person should apply to determine if disability benefits are awardable under the current law. If the SSA determines that the applicant is able to perform substantial gainful work, benefits are denied. If the applicant is approved in step one, the SSA goes to step two.

The second step determines if the applicant has an impairment likely to last at least 12 months or result in death. If he does not, then benefits are denied. If he does, the SSA goes to step three.

The third step determines if the impairment significantly limits the ability to work. If it does not, benefits are denied. If it does limit his ability, the SSA goes to step four.

The fourth step determines if the applicant meets a listing of disabled impairments. The term "listing" refers to "Listing of Impairments" contained in Appendix 1 of the Social Security Regulations. Listings are divided into two sets. One set of listings, Part A, covers individuals over 18 years of age. The second set, Part B, covers individuals under the age of 18. Both sets divide the human body into 13 systems and list the disabilities by degree of impairment. The systems are musculoskeletal, senses and speech, respiratory, cardiovascular, digestive, genito-urinary, renal and lymphatic, skin, endocrine, multiple body, neurological, mental disorders, and malignant neoplastic diseases. Comparing the applicant's listing with the impairments is difficult and complex. A denial of benefits is appealable. If the SSA decides the applicant meets the degree of impairment required, benefits are immediately awarded. If the SSA decides he does not meet the requirements, the SSA goes to step five.

In step five the SSA decides if the applicant has a "residual functional capacity" to return to work: the ability to return and perform work for pay within 15 years of the disability. The ability to do current work is irrelevant. If the SSA believes the applicant can still do the same type of work he once did within 15 years of the disability, the applicant is not disabled under Social Security. Example: A doctor once washed dishes 15 years earlier and subsequently became unable to practice medicine. If he can still wash dishes, the SSA might not find him disabled. If the applicant is found to have a residual functional capacity to work, the benefits are denied. If the SSA finds he does not have a residual functional capacity, the SSA goes to step six.

Any denial of benefits based upon this test in step five should be appealed. The SSA often misapplies the test or is overly harsh. This is the greatest reason for denial of benefits; the test result is most often reversed on appeal.

In step six the SSA determines if the applicant is able to do "substantial gainful activity" in the national economy. When the SSA decides that a person cannot return to past work, the SSA determines what kind of work the applicant can do. In determining that a person can obtain gainful employment, the SSA must consider:

1. The applicant's age.
2. The applicant's education.
3. The applicant's prior work experience.
4. Exertion level in being able work.
5. General skills available.

The SSA uses grids to determine eligibility. These grids are charts used to rate an applicant's disability based on the above factors. The grids are three tables based upon the individual's residual functional capacity after consideration of the disability. Each table rates an applicant in accordance with set rules in order to make a decision on disability. Grids are used where the applicant has been found (in the first five steps) to be unable to return to his former employment, and the impairments are not one of the listings in step five. Instead the impairments are primarily exertional.

Grids are used only in cases where the impairments are exertional in nature, and in those cases they are strictly applied. An "exertional impairment" is generally one that does not involve mental problems, sensory or skin problems, postural or manipulative limitations, pain or environmental restrictions (special sensitivity to fumes or dust in the workplace). Disability will be found using the grids only if the applicant fits all of the grid requirements for disability completely.

Grids are used only where the applicant has established that a return to former work is impossible because of severe medically-determined impairments. There are 82 separate grid determinations, but only 16 grids lead to a finding of disability. As a rule the younger and more educated or skilled the applicant, the less likely he will be found disabled under the grids. The SSA does not always make correct determinations using the grids and a denial of benefits should be appealed. If the applicant is able to do substantial gainful activity in the national economy, benefits are denied. If the applicant is not so able, then benefits are awarded.

There is an important exception for the normal step-by-step determination process of the SSA. This exception exists for applicants who:

1. Have a marginal education of sixth grade or less,
2. Have worked more than 35 years in arduous, unskilled labor, and
3. Cannot return to their former employment because of a severe impairment.

The individuals who meet these exceptions are considered disabled without further analysis.

IV. DISABILITY OF A SURVIVING SPOUSE OR A SURVIVING DIVORCED SPOUSE

A surviving spouse who is disabled and between 50 and 60 years of age will receive monthly survivor benefits upon the death of a fully- insured spouse. A surviving divorced spouse who meets the above requirements, is unmarried and was married to the deceased for at least 10 years is also eligible for survivor benefits. To be a surviving spouse, the person must have been married to the decedent worker for at least nine months or have had (or adopted) a child with the person.

The SSA employs a special test for determining if disability benefits paid to a surviving spouse or surviving divorced spouse should continue. The benefits for surviving spouses or surviving divorced spouses are based on medical disability alone, and the following five-step process is used to determine if disability benefits should be terminated based on medical improvement:

1. The SSA determines if the person is engaged insubstantial gainful activity. If the applicant is gainfully active, the SSA will terminate benefits. If not, the SSA goes to step two.
2. The SSA determines if there has been medical improvement in the person since the last review. If there has been improvement, the SSA goes to step three. If no improvement is evident, it goes to step four.
3. The SSA decides if the medical improvement relates to the ability to perform work. If the improvement does relate, the SSA goes to step five. If it does not, the SSA goes to step four.
4. The SSA will continue the benefits unless it finds any of the following:
   a. The original determination was obtained by fraud.
   b. The person can not be located.
   c. The person fails to cooperate with the SSA.
   d. The person refuses, without good cause, to follow prescribed treatment.
5. The SSA must determine if the person's current impairments meet or equal the current Listing of Impairments. If they do meet, the benefits will continue; if not, the SSA will terminate benefits.

In order for a surviving spouse or surviving divorced spouse to receive SSDI benefits there must be a valid marriage to the covered worker for the requisite amount of time. The existence of the marriage is usually not difficult to prove. A marriage certificate or an affidavit by witnesses or by the person who performed the marriage will suffice.

Problems arise when there was a common law marriage. A common law marriage is one in which the couple lives together for a fixed amount of time, usually five years, and holds themselves out as husband and wife. Only 14 states permit common law marriages. Most states, including California and the District of Columbia, do not recognize common law marriages. A common law marriage may be proven in two ways:

1. If both spouses are alive, by a joint affidavit that they are married.
2. If one spouse is dead, by an affidavit by the surviving spouse and two blood relatives (preferably of the deceased spouse) that there was a marriage as evidenced by the conduct of the parties.

A common law marriage is accepted by the SSA only if it was valid in the state where it occurred.

V. EVIDENCE IN SUPPORT OF A DISABILITY CLAIM

The SSA's decision to grant or deny disability benefits is based on all of the medical information that it has on the health of the applicant. Therefore, it is vital for an applicant to provide complete, detailed and current information and a physician's statement or medical report in support of his position. The applicant's medical report should contain answers to most of the following questions:

1. For how long has the applicant been treated?
2. What impairments does the applicant have, and what are their symptoms?
3. What were the results of any lab test?
4. What medication is the applicant taking?
5. What is the prognosis for recover?
6. Would working worsen the condition?
7. How many hours per day can the applicant sit, stand or walk on a sustained basis?

Generally, the medical evidence is viewed to determine whether it supports a finding of disability. It is the only evidence that is really dispositive in and of itself. If the medical evidence does not support some form of disability, the matter ends immediately. If it supports a finding of disability, the SSA must decide the extent of the disability and if substantial gainful activity is still possible.

The applicant should give all information of whatever type and character in support of the application for benefits. In particular, the applicant should furnish all information relating to the following:

1. Any and all pain that the applicant feels.
2. Any limitation in daily activities caused by the

disability.

3. The actual functions and duties of the applicant's former work, and why it can no longer be done.
4. The effect of medication on the ability to work.
5. Any other effects that the disability has had on applicant's getting and keeping a job.

It must be remembered that information not furnished to the SSA at the administrative hearing usually will be disallowed for presentation after a denial of benefits. The exceptions for permitting newly discovered evidence at the appeal stage are rare. The applicant should do his best to make sure all information is presented to the SSA before the administrative hearing.

VI. APPLICATION FOR DISABILITY BENEFITS

A person may apply for SSDI benefits by filing an application with the SSA. The application can be requested by mail from the SSA. The application is considered effective from the date it is received by the SSA or the date on the postmark of the envelope if mailed to the SSA . It is the applicant's responsibility to prove to the SSA that he is eligible to receive the benefits. The SSA is required by law to help an applicant establish eligibility for SSDI benefits.

Detailed proof regarding the applicant's income, assets and health is necessary in order to determine eligibility. Even if it will take considerable time to amass all of the information, the applicant should still file.

If the applicant is eligible, SSDI benefits will be paid from the date of application, not the date of final determination. If it takes six months to prove eligibility, the applicant will receive six months of back benefits, but only if an official application was filed.

Occasionally an applicant may not file an official application because some worker for the SSA told the person that he was not eligible. Relying on oral statements of eligibility is dangerous. If the applicant was actually eligible, the failure to file the official application is a bar to recovery of the lost benefits. An applicant should always file an official application regardless of what an SSA employee may say unofficially.

There are several ways in which an applicant may receive benefits while awaiting a final determination on his application for SSDI benefits:

1. If the SSA wants additional proof of age, the applicant may receive advance payments pending final determination by proving financial need and producing a written document at least three years old that shows that the applicant is at least 65 years of age.
2. If the applicant is considered "presumptively disabled," the applicant is entitled to benefits while the application is being processed. A presumptively disabled person is one who is suffering so severely from a disability that a final determination of eligibility is

very likely. A presumptively disabled person is one who:

a. Had two limbs amputated,

b. Had a leg amputated at the hip,

c. Is totally deaf,

d. Is confined to bed or a wheel chair,

e. Suffered a stroke within four months of the application, or

f. Suffers from cerebral palsy or muscular dystrophy.

A presumptively disabled person may receive advance payments for three months while the application is pending. If the applicant is ultimately found not to be eligible, he must repay the advance payments.

3. An applicant may be eligible for temporary assistance if he can prove a strong likelihood that he will qualify and a financial emergency exists that requires immediate emergency assistance.

In addition to SSDI benefits the applicant can apply for welfare benefits from the state. Normally it takes seven to 10 days to get a check through the normal process. When there is an emergency situation requiring immediate aid and assistance, the SSA can issue a partial check for $200 of the benefit that a recipient will be entitled when:

1. The person is eligible for SSDI but has not received the check because it was lost or stolen, or
2. The person has been approved for SSDI benefits but the check has not yet been issued.

Under the immediate payment program the SSA can only issue such a check once every 30 days.

VII. SSA DETERMINATION

The SSA sends letters to applicants notifying them of its decision to accept or reject their applications for disability benefits. When the applications are accepted, the reply letters will state the amount of disability benefits that the SSA will pay to the applicant. When the application is denied, the SSA letter usually will give a brief statement as to why it was rejected. The SSA is required to inform the applicant of the right to appeal the denial of benefits.

When the SSA decides to reduce or terminate benefits previously awarded, it must give written notice of that decision to the recipient of the benefits. The notice is given before the benefits are reduced or terminated. After the SSA's notice that benefits are to be reduced or terminated, the status remains such until reversed on appeal.

VIII. RECEIPT OF BENEFITS DURING THE APPEAL

If the initial application is denied, benefits will not be received until the successful conclusion of the applicant's appeal. Moreover, if benefits had been awarded and are then subsequently reduced, the recipient can appeal. During the appeal, the recipient can require that the SSA not reduce the payment of benefits pending the decision on the reconsideration. The request to receive benefits pending reconsideration must be in writing and filed within 10 days of notice from the SSA of its intent to reduce, suspend or terminate the benefits.

If the decision goes against the recipient after reconsideration, subsequent benefits are reduced even though the recipient may appeal the matter further. If after having the benefits reduced, the decision is reversed on appeal, the lost benefits are paid to the recipient. Usually the recipient fares better if he gets the SSA to pay full benefits during the appeal. Many times the reductions are unwarranted, and the recipient is denied income to which he is entitled.

The only disadvantage in requesting full benefits during an appeal is if the appeal is unsuccessful the overpayment must be repaid. Again, since there are limitations on the amount the SSA can collect in recovering overpayments, the recipient fares better if he requests full payment during the appeal.

IX. RECOVERY OF OVERPAYMENT OF BENEFITS

If a person loses all of the appeals, he must return all overpayments of benefits. Starting with October 1984, the SSA is permitted to take from a recipient's SSDI benefits the following amounts to repay previous SSDI overpayments, the lesser of the monthly SSDI benefit or 10% of the recipient's countable monthly income. The SSA can take more than the above amounts when:

1. The recipient was guilty of fraud, willful misrepresentation or concealment of assets in obtaining the overpayment, or

2. The recipient requests the deduction to be at the higher rate.

When a recipient is found to have been overpaid by the SSA, he must ordinarily repay those benefits unless the SSA has granted him a waiver. A waiver may be granted by the SSA when the overpayment was not the result of the recipient's act and the overpayment would

1. Defeat the purpose of SSDI (to help eligible persons survive), or
2. Be contrary to equity and good conscience.

In short, the SSA should grant a waiver if the recipient was innocent in causing the overpayment and cannot afford to repay it. If the SSA claims a recipient was overpaid, the recipient may request within 30 days of the SSA notification that SSDI benefits not be reduced until after a reconsideration of the SSA's determination.

X. TERMINATION OF THE DISABILITY

Once the SSA determines that a person is no longer disabled, it will notify that person of its intent to terminate SSDI benefits. The only remedy that a recipient has against the threatened SSA action to terminate benefits is to file a request for reconsideration within 60 days of the SSA notification.

SSA benefits will be terminated 10 days after the SSA notification unless the recipient files both:

1. The request for reconsideration, and
2. A written notice that the recipient wants to continue to

receive full benefits while appealing the determination that the recipient is no longer disabled.

Failure to file the requests within the allotted time usually will bar any future challenges of the SSA decision. In certain cases, however, when good cause can be shown for the delay the SSA may excuse it and permit a late filing.

XI. SSA MANDATED MEDICAL AND PSYCHIATRIC EXAMINATIONS

The SSA, as part of its determination process, may require that an applicant undergo a consultative examination by a designated doctor. The SSA has its own list of doctors to examine disability applicants when it feels there is not enough medical information to make a determination. An unfavorable consultative examiner's report virtually assures denial of disability benefits even though it is countered by the medical report of the applicant's treating physician. The SSA is supposed to give more weight to the treating physician's report unless the examiner is a specialist in applicant's particular type of disability.

When the SSA feels that a psychiatric examination is germane to the issue of an applicant's disability, it can require a consultative psychiatric examination. Specifically, the SSA can require such an examination when the medical evidence shows that the applicant has any of the following manifestations:

1. Difficulty on focusing attention.
2. Depression with weight loss.
3. Suicidal thoughts.

4. Alcoholic or drug problems.

5. Suffering a great deal of pain because of the disability.

6. Avoidance of people.

The purpose of the SSA examination is to help determine if the applicant's disability is permanent, or if it can be treated and improved. When sent to a consultative examination, the applicant should carefully document the questions asked and the manner of the examination. This becomes important if the applicant is rejected solely upon a cursory examination.

Sometimes the SSA will send the applicant to a doctor of the applicant's choice for the consultative examinations. It never hurts to ask for this choice, and it may insure a more fair evaluation.

XII. DISABILITY BENEFITS ARE NOT ATTACHABLE BY CREDITORS

Congress, in enacting the Social Security Act, specifically stated that Social Security benefits (including SSDI benefits) cannot be attached or garnished by creditors. This extends to money in a bank account that accrued from the deposit of Social Security checks. The only exceptions to the attachment prohibition are attachments to pay back federal taxes and attachments to enforce court-ordered child support or alimony.

While the benefits are not attachable, the property purchased with them is attachable by creditors. Example: If the recipient purchased a boat, creditors can take the boat and sell it even though they could not have taken the cash used in buying it.

XIII. LOSS OF BENEFITS FOR FAILURE TO FOLLOW TREATMENT

The SSA can and does terminate disability if the recipient refuses to follow prescribed treatment. The treatment must actually be prescribed and not merely suggested. A person considered disabled because of drug or alcohol addiction would lose all disability benefits upon refusal to undergo drug or alcohol treatment.

An exception to following such prescribed treatment might be if the treatment would pose a great risk (such as spinal surgery with a high potential of failure) and might leave the person permanently paralyzed.

XIV. TABLE OF BENEFITS

The following table contains estimated benefits for an eligible worker with children and with a spouse. Disability benefits are given a cost-of- living increase each year. There is also a maximum family benefit limitation equal to 150% of the benefit to the disabled worker. The table is based upon the age of the worker at the time of the disability and assumes that the worker had worked continually throughout his career. The disability benefit is the amount of the worker's benefit earned to the time of the disability. There is no reduction of the disability benefit because the worker applied for it before reaching age 65, as there is for early Social Security retirement.

Every recipient of disability benefits should be aware that earning limitations apply. Therefore, the amount of disability that a disabled worker or family member may receive will be reduced or even eliminated altogether if the person's earnings exceed the earning limitations then in effect.

The amount of Social Security disability benefits which a disabled worker may receive may be reduced if the worker also receives additional disability benefits under state, local or other federal law. The total disability benefits that a person may receive cannot exceed 80% of the disabled worker's earnings before the disability. In other words, if the disabled worker receives 45% of his pre-disability earnings in disability benefits from other sources, then his Social Security disability benefits cannot exceed 35%.

Eligibility for disability benefits requires that the worker suffer an impairment expected to last at least 12 months or result in an early death. In addition, the worker must have earned the minimum number of quarters for coverage with some of the quarters being earned in the years immediately before the disability.

MONTHLY BENEFITS

AGE AT DISABILITY	RECIPIENT	ANNUAL EARNINGS $12,000	$30,000	$57,600+
64	WORKER	$522	$956	$1,118
	CHILD	261	478	559
	SPOUSE WITH CHILD	261	478	559
	MAXIMUM FAMILY BENEFIT	783	1,434	1,677
60	WORKER	525	960	1,160
	CHILD	262	480	580
	SPOUSE WITH CHILD	262	480	580
	MAXIMUM FAMILY BENEFIT	787	1,440	1,740
55	WORKER	520	965	1,200
	CHILD	260	482	600
	SPOUSE WITH CHILD	260	482	600
	MAXIMUM FAMILY BENEFIT	780	1,448	1,800
50	WORKER	520	970	1,190
	CHILD	260	485	595
	SPOUSE WITH CHILD	260	485	595
	MAXIMUM FAMILY BENEFIT	780	1,455	1,785
45	WORKER	520	973	1,230
	CHILD	260	486	615
	SPOUSE WITH CHILD	260	486	615
	MAXIMUM FAMILY BENEFIT	780	1,459	1,845
40	WORKER	520	975	1,260
	CHILD	260	488	630
	SPOUSE WITH CHILD	260	488	620
	MAXIMUM FAMILY BENEFIT	780	1,463	1,890
35	WORKER	520	977	1,300
	CHILD	260	489	650
	SPOUSE WITH CHILD	260	489	650
	MAXIMUM FAMILY BENEFIT	780	1,466	1,950
30	WORKER	520	980	1,350
	CHILD	260	490	675
	SPOUSE WITH CHILD	260	490	675
	MAXIMUM FAMILY BENEFIT	780	1,470	2,025

NURSING HOME CARE

I. INTRODUCTION

For the first time in history a significant number of people are expected to live long enough to require long-term care, usually in a nursing home. Medical advances that have extended the average person's life span from 40 years of age in 1900 to 75 years of age in 1990 are the reason. The extension of life has unanticipated consequences in the quality of lives of those persons living such extended lives.

Cost has become a major consideration for most people as they grow old and look for security. In the 1930's when Social Security was created the average life expectancy was 65 years of age. No one foresaw that the average person would require coverage longer than a few months. Now, however, with people living so much longer, a retired person might well be forced into poverty if he lives a long life. Social Security was intended to be a retirement supplement. Many people never prepared for their retirement (possibly because they never thought that they would live that long). In any event, a large portion of our population has reached retirement without having adequately prepared for the expenses of growing old.

Another consideration in growing old is the lack of companionship. The extension of the human life span has not been equal. Women outlive men primarily because men shorten their spans by working outside the home in careers which drastically shorten their life expectancy. For example, in 1970 the average life expectancy for a steel worker was 65 years of age and for an auto worker it was 68 years. Persons living long lives will probably outlive their spouse and maybe even their children. It is common, even tragic, for a person to outlive all of the family and friends of a lifetime. A major concern of all decent retirement and nursing homes is depression.

Depression in the elderly is brought about for three reasons. The first cause of depression is a deteriorating medical condition which is understandable. The second cause is loneliness. The third cause of depression is the cost of growing old. A medical report states that the average person will spend more on medical care in the last year of life than in all of the other years of life put together. At the time in a person's life when they usually are not working and are living on fixed incomes, they must concern themselves with the problem of how to pay for their medical treatment. As mentioned earlier, Social Security will not cover everything. Only if a person completely divests himself of nearly every asset acquired during a long life will he become eligible for Medicaid coverage.

In an actual instance, the high cost of medical treatment resulted in forcing a family into bankruptcy. The husband was a retired air traffic controller. His wife had died of cancer after a long period of period of painful treatment. The couple had no medical insurance other than Medicare and no long-term-care insurance whatsoever. They spent their entire life savings on medical bills. After his wife died, the husband still owed $60,000. The long illness of the wife had bankrupted the husband.

This chapter is written for the person who has acquired assets during a long life and does not want to divest in order to obtain long-term nursing care. This chapter will cover nursing homes and the purchase of long-term- care insurance which can prevent having to become indigent in order to get care. Preparation for the possibility of needing such long-term financial care should be part of any financial plan.

II. NURSING HOMES

Nursing homes are places where people needing care go or are placed by their families. There are three types of nursing homes. They are defined by the level of professional nursing services offered the patient. Present data confirms that 5% of persons over 65 years of age live in nursing homes. In fact, 23% of persons over age 85 are in nursing homes. In addition, 60% of all persons entering a nursing home remain there over a month with the average stay being 15 months. Furthermore, 73% of all nursing home residents are women.

A skilled nursing facility is the one which most often is pictured when a person thinks of a nursing home. Patients who are seriously ill, but do not need a hospital are placed in a skilled nursing home. There are nearly 10,000 such nursing homes with nearly 700,000 beds in the United States. To be covered by Medicare a skilled nursing facility must have a physician as a medical director and at least one registered nurse on duty at all times.

Another type of nursing home is called an intermediate care facility. Such a nursing home is closer to the concept of a retirement home. In an intermediate care facility the medical care and services provided are far less than in a skilled nursing facility. A registered nurse only has to be on duty eight hours per day, and a medical director is not required by Medicare. There are nearly 5,000 such nursing homes with about 250,000 beds in the United States.

The final type of nursing facility is a board-and-care home.

These facilities are not true nursing homes and provide no nursing services. They provide room, board and basic cleanliness. In most states anyone can open such homes provided they meet basic fire and safety standards. Many of these nursing homes are nothing more than converted private homes in which private bedrooms have been assigned to the patients. Most of the abuses associated with nursing homes have arisen in the board-and-care homes. Such homes are not required to have any professional medical personnel to oversee the quality of the care provided. This is not an indictment of board-and-care homes, but it is a statement that such homes can permit the uncaring to victimize the unprotected.

Information regarding a particular nursing home can be obtained from the local health department, department of social services, or Department of Social Security if Medicare payments are to be made to them. A person can check state corporate-name files or fictitious business-name filings of a county to determine who actually owns the nursing home. In addition, a check of court records will disclose if the nursing home has ever been sued for negligent service. These are basic steps that everyone should undertake before selecting a nursing home.

III. COST OF NURSING HOMES

The cost of nursing homes increases each year throughout the United States. In 1975 the cost of nursing home care was over $7 billion. In 1987 that figure had increased to nearly $40 billion: a five-fold increase in just 12 years. As covered in the previous chapter, Medicare and Medicaid pay for most of the nursing care in the United States, but they do not pay for all of it. Medicare, for example, paid less than 2% of the nursing-home costs. The Medicare Catastrophic Act of 1988 limits annual Medicare payments for the care provided by a skilled nursing facility to 150 days of coverage. Medicare does not pay for intermediate care or board-and-care facilities because they are not considered medically necessary for treatment of a medical condition. Medicaid paid 52% of the nations nursing-home costs, but only after the covered persons exhausted their financial resources. Social Security, through the Supplemental Security Income (SSI) program, the Veterans' Administration and other federal programs may pay for some of the intermediate facility or board-and-care costs. Still, after all the government programs, individuals either personally or through private insurance had to pay 44% of the nation's nursing-home costs.

Nursing homes are expensive. A skilled nursing home can easily cost $3,000 per month. The costs vary by the type of nursing home and quality of services which they provide. Nursing homes receiving Medicare or Medicaid payments must accept their payments from Medicare and Medicaid as full payment and cannot charge the patient anything for basic services. A nursing home being paid directly from Medicare or Medicaid cannot require the patient to provide a deposit for services. Such a deposit can be demanded of private patients when Medicare or Medicaid is not paying the home directly.

ESTATE PLANNING CONSIDERATIONS

One of the considerations in any estate plan is the possibility of needing long term nursing care. If payment is sought for the nursing home care from the government, it may become necessary for the person to divest himself of all his assets before seeking government assistance for nursing home care.

This is an obvious concern for people who have worked all their lives to make a little nest egg to pass to their children. Such people find themselves penalized for being frugal and preparing for the future. In comparison, people who were in essence wastrels and spendthrifts with nothing to show for their lives work can get government assistance for nursing home care. This really is unequal treatment.

In such instances, government rules usually require the person to divest himself of all assets before becoming eligible to nursing home assistance. That can usually be done by making gifts of the estate property a certain period of time before seeking nursing home assistance. This period will vary between the states and social security as well.

This is a straightforward proposition for a competent person seeking nursing home care. The person would ascertain the appropriate waiting period after making the gifts to reduce the size of the estate to become eligible for the nursing home care and then act accordingly. After the waiting period following the gifts has run, the person can apply for the government assistance in obtaining nursing home assistance.

The problem arises when the person is incompetent and unable to make the gifts necessary to reduce the estate so as to become eligible in time for nursing home assistance. Unless such a person has prepared an estate plan covering such a contingency, then that person will not become eligible for governmental nursing home assistance until his or her estate has been virtually depleted.

It is possible to draft an estate plan so as to offer flexibility in disposing of assets through gifts to make the principal eligible for nursing home assistance. This can be done in two ways neither of which is exclusive.

DURABLE POWER OF ATTORNEY FOR FINANCIAL AFFAIRS

The first method is a durable power of attorney. In this case, if the principal becomes incompetent and needs nursing home care, rather than spend down the s estate to become eligible for nursing home assistance, the agent is given the power in the durable power of attorney document to make gifts of the principal’s property in the estate. The gifts of property are to be made to the heirs designated in the principal’s will or trust created under an estate plan as long as the sole purpose is to make the principal eligible for long tern nursing home care.

This is a voluntary provision is not present in most statutory or preprinted forms. It should be added if desired to a durable power of attorney form, such as in the sample in this book or contained in our course of Powers of Attorneys.

REVOCABLE TRUST

Many people use revocable trusts as their main estate planning device. Revocable trusts avoid probate and pass property immediately to the beneficiaries upon the grantor’s death. Revocable trusts do not, however, take property out of the grantor’s control until the grantor dies.

Thus if a grantor creates a revocable trust and subsequently becomes incompetent then the assets of the trust will be considered by the government as available for the grantor in determining eligibility for nursing home assistance.

To keep the assets of a revocable trust out of incompetent grantor’s estate for nursing home eligibility, a clause can be inserted into the trust to the effect that if the grantor becomes incompetent, the holder of the grantor’s power of attorney can do any or all of the following in order to make the grantor eligible for nursing home assistance:

1. Make gifts from the trust to the remainder beneficiaries in the trust to the extent needed to qualify the grantor for nursing home assistance even if this means terminating the trust for lack of assets.

2. Declare the trust irrevocable and renounce all future interests in the trust for the grantor

3. In a community property joint trust, the agent may transmute all or any part of the principal’s community property interests into separate and give that property in fee to the principal’s spouse.

IT MUST BE REMEMBERED THAT MAKING OF THESE GIFTS TO REDUCE THE PRINCIPAL’S ESTATE FOR NURSING HOME ELIGIBILITY USUALLY WILL NOT MAKE THE PRINCIPAL IMMEDIATELY ELIGIBLE FOR ASSISTANCE. USUALLY AFTER MAKING THE GIFTS, THERE WILL BE A WAITING PERIOD PERHAPS AS LONG AS THREE YEARS BEFORE BENEFITS WILL GRANTED. SO IN SUCH CASES, THE PRINCIPAL’S FAMILY OR INSURANCE WILL HAVE TO PAY FOR THE NURSING HOME THEMSELVES UNTIL THE PERIOD HAS RUN.

FOR EXAMPLE IF THE GRANTOR’S HOME WAS WORTH $250,000 AND THE NURSING HOME CARE IS $2,500 PER MONTH, $$30,000 PER YEAR, IF THE WAITING PERIOD AFTER THE GIFTS WERE MADE WAS THREE YEARS. THE COST WOULD BE $90,000 TO THE FAMILY BUT THEY WOULD SALE THE REMAINING $160,000 WHICH WOULD OTHERWISE HAVE TO USED UP BEFORE QUALIFYING FOR NURSING HOME CARE.

Because of the varying limits on nursing home assistance, the state welfare agency and social security administration should be contacted before the decision is made to begin making gifts from an incompetent person’s estate to see if it is worthwhile to do it as opposed to simply spending down the estate.

IV. NURSING HOME INSURANCE

a. INTRODUCTION

It is possible to purchase long-term-care insurance that will cover nursing-home care. Such insurance benefits the middle-income person the most. People with limited assets can spend away their assets and become eligible for Medicaid and Medicare. The more affluent can pay as they go and self-insure themselves. The middle class person is the one, however, who does not fall into either of these categories. Annual premiums for nursing-home insurance range from $500 to $2,000 per year. Therefore, it only pays to carry such insurance if the person has assets which he wishes to protect.

This type of insurance can literally be a lifesaver. To illustrate, in 1985 a woman 80 years of age planned her estate. She had such insurance and kept it. Her estate was worth $500,000. Two years later she developed senile dementia and entered a nursing home where she has been ever since. In all the years since then, her estate has not had to pay for the nursing home, and she has not had to divest or spend down her estate.

For most there probably is no discernible benefit in purchasing long-term-care insurance before the age of 65 unless the person suffers from acute medical problems that make such care prior to that time foreseeable. Waiting for 65 to purchase the policy does not mean that higher premiums will be paid, but most policies automatically increase their payments as the insured ages. Data shows that the chances of being in a nursing home a few days for a person less than 65 years of age are one out of 250. The odds one will stay more than 30 days are only one in a thousand. So unless there are pronounced medical considerations making nursing home care likely in the near future, it usually is not necessary to purchase it before age 65.

b. PREMIUMS

Under most long-term policies, the premiums are not fixed. As the person ages, the annual premium increases to reflect the increased likelihood of the insurance company having to provide benefits. It is important to know what the premium schedule will be as the person grows old. A low premium when the person is young and in good health may increase to an onerous amount as the person ages and may impose a financial hardship.

A desirable feature of a long-term insurance policy is a waiver-of- premiums clause after the person has been in a nursing home for a period of time. Such clauses are frequently in policies and waive premiums once the person has been receiving benefits for 90 days. Some policies actually waive premiums after 60 days of coverage.

c. RENEWABILITY

No long-term-care policy should be purchased unless it is guaranteed renewable for life. No one should purchase a policy that allows the company to terminate the policy for any reason except non-payment of the premium. An insurance company is in the business of making money. If they can cut claims by terminating coverage once a person enters a nursing home, they will do so. It would be the height of folly to purchase a policy, pay on it for years, and then permit the insurance company to terminate future coverage after a claim is submitted. If the company is selling the insurance under a group policy, the master policy should contain language that it is renewable for life.

d. PRE-EXISTING CONDITIONS

Nearly every nursing-home policy contains exclusions for pre-existing conditions. If not for these exclusions no one would buy the insurance until the day before they entered the nursing home.

Most policies define a pre-existing condition as one for which medical advice or treatment was received from a health-care provider within six months prior to coverage. Many insurers will cover pre-existing conditions after the policy has been in effect for a certain period of time. Some will never cover pre-existing conditions. In California the period of exclusion for pre-existing conditions cannot exceed six months.

e. REQUIREMENT FOR PRIOR HOSPITALIZATION

Many policies require prior hospitalization for three days or longer in an acute care hospital before the nursing home coverage will activate. California has expressly banned this requirement in long-term-care policies. Previously, many who needed nursing-home care were prevented because they were not medically ill or needing acute hospitalization. Since they could not be hospitalized first, they could not receive nursing-home coverage. No one should purchase a policy with such a requirement.

f. TERM

As people live longer, insurance companies are more reluctant to offer a policy for life. If a lifetime policy cannot be found, a person should get one that will provide coverage for as many years as possible even though subject to annual premium changes. No person should purchase a policy that cannot cover at least three years, and longer is better.

Statistically, 80% of nursing-home stays are for less than three years. For persons over the age of 75, the average stay is only 20 months. About one in 10 of the people entering a nursing home will remain there over six years. These are sizable figures and highlight the fact that such a person must have coverage for at least six years. Insurance is like playing the lottery. Until you win, you are wasting your money. If the insurance is never used, the money is wasted. If used, it will more than pay for itself.

g. BENEFITS

Most policies will not begin paying benefits for the insured person's entrance into a nursing home until the expiration of a waiting period. That waiting period is usually between 20 and 100 days. The longer the waiting period, the lower the premiums. The insured person is required to pay the nursing-home costs during the waiting period which could be as much as $9,000 for a period of 100 days.

Long-term-care benefits are paid directly to the insured unless an assignment of benefits was made to the nursing home. The insured is then responsible for paying the nursing home bills. The daily benefit varies among insurance policies and is usually between $20 and $120 per day. The daily benefit should be sufficient to cover most of the average nursing-home care cost. It makes little sense to purchase a policy that does not cover most of the expenses when such a policy can be purchased for just a few dollars more. Since the insured must pay any difference out of his own pocket, it is important that the insurance be adequate for the purpose. A good balance between cost of the policy and benefit would be one that provides $80 per day coverage. This is the average cost of a nursing home and provides a degree of savings on unneeded premiums for unused coverage.

A long-term-health-care policy should cover home-care expenses. Home health care under these policies is care provided by a professional who comes into the home to feed or bathe a patient who is convalescing at home. Some policies limit home-care coverage to the number of days spent in the nursing home. Other insurance companies do not require any nursing-home care prior to covered expenses for home-care coverage.

h. ADJUSTMENTS FOR INFLATION

It is important that the benefits under a long-term policy be tied to inflation. From 1975 to 1987 the cost for coverage for nursing homes increased five fold. Most companies providing long-term-care insurance have an option for adjusting the premium to the rate of inflation. A yearly rate of inflation increase should be in the range of 4% to 6%.

V. RIGHTS OF PATIENTS IN NURSING HOMES

There are numerous state and federal laws which protect the rights of patients in nursing homes. The laws guaranteeing them may not be in force, but they at least exist on the books. A patient has the right of personal liberty. A patient, unless declared incompetent by a court, cannot be prevented from leaving a nursing home at any time. Patients have a right to privacy which means that their medical records may not be disclosed without their consent, and their communications cannot be monitored or invaded. The patient has a right to worship as he wishes and to associate with anyone whom he wishes to associate. The patient may not be required to perform work for the nursing home unless the patient's doctor prescribes it as therapeutic. Basically, a patient has all of the rights that a person possesses who is not in a nursing home. These rights, however, can be reasonably restricted in their application, as with any rights in a society's structure of ordered liberty, but they cannot be absolutely and completely denied in all circumstances.

PART THREE

ESTATE PLANNING

The ultimate in estate planning is cryogenics. Cryogenics is freezing the body of a dead person so it can be brought back to life sometime in the future when the technology to do so is developed. In fact, it is possible to do a lay-away plan where a person has his head cut off and frozen. This is done with the hope that in the future an entire new body can be cloned and the head attached to it. The person first has to be declared dead. The question becomes: What will happen to the body? Whether we believe we come back in another form or pass to a higher plane of existence, we will nevertheless travel to a realm where no one ever returns. We cannot take it with us. That is not to say that people have not tried to do so. The Pharaohs of Ancient Egypt, the Mayans in Central America and the Celtic tribes in Europe all attempted and failed to take their worldly goods with them.

So what then is left for us to do? Lacking a philosophical bent, we can only offer practical and pragmatic answers for the living. The only answer that makes sense is that if a person cannot take the estate with him, it should be given to those for whom the person cared. For most people that means simply giving the estate to family members and loved ones. If the estate is going to be given away, it makes sense to give it to loved ones rather than to the government in the form of avoidable taxes.

The purpose of estate planning is to help a person build a large estate during life and to pass as much of it as possible to the loved ones upon death. This section attempts to present the various types of available estate planning.

An estate plan is the procedure by which a person attempts to preserve the assets of his estate during life and distribute them after death. The main considerations in estate planning are avoiding probate, reducing estate and inheritance taxes and quickly distributing the estate to the designated heirs.

A complete estate plan will consider methods for preservation of the estate during life by maximizing income while reducing income taxes that must be paid. The costs of probating a will are large. An old joke: If the person was not already dead, the cost to probate his estate would kill him.

Probate costs include court fees, appraisal fees, attorney fees and executor fees. Court costs and appraisal fees are modest: a couple of hundred dollars for an average estate. The real costs are the attorney and executor fees. The maximum amounts of attorney and executor fees are set by statute and approved by the court. They are based upon the size of the estate (value of the property to be probated) and increase as the estate increases. In California, for example, attorney and executor fees are calculated as follows:

1. 4% of the first $100,000; maximum $4,000.
2. 3% of the next $100,000; maximum $3,000.
3. 2% of the next $800,000; maximum $16,000.
4. 1% of the next $9,000,000 maximum $90,000.

For example, a $100,000 estate probated in California would have to pay maximum attorney and executor fees of $8,000: $4,000 each to the executor and attorney. The attorney and executor can agree to take less or no fee at all.

Avoidance of probate fees is a major inducement for implementing an estate plan. When a revocable trust is used, there are no probate fees. The estate passes immediately to the designated beneficiaries of the trust. No court proceeding is needed to transfer the property of a trust, so no attorney is needed. There are several means to avoid having to probate property. The probate avoidance vehicles are:

1. Summary probate proceedings in the decedent's state. A summary probate is an abbreviated procedure for small estates or for transferring the entire estate to a surviving spouse. Many states have adopted special procedures to by-pass the expense and long delay in probating such estates.
2. Giving the estate away while alive.
3. Placing the property into joint tenancy with the proposed heirs. Upon death, title for the property passes immediately without probate to the surviving joint tenants. Real property held in joint tenancy passes to the survivors without a probate by recording a notice of the death of a joint tenant.
4. Placing the estate into a revocable trust that passes the estate to the designated beneficiaries immediately upon the decedent's death.

This is the most popular form of estate planning. It is fast and bestows the maximum amount of control and property over the estate to the trustor while passing the greatest amount of property to the beneficiaries upon the trustor’s death.

In order to determine the best type of estate plan, one must fully understand the size of the estate, how he wishes to distribute it and the amount of control he wishes to relinquish to effectuate the estate plan.

CHAPTER 11

REVOCABLE TRUSTS

I. INTRODUCTION

A revocable trust is usually the best means of estate planning.

The creator of the trust, called the "trustor" or "grantor," places his entire estate into the revocable trust. The trustor usually is the trustee (the person who manages the estate). There is a beneficiary (the one who will benefit from distribution of the trust). Upon the trustor-trustee's death, the person named in the trust document as successor trustee becomes the trustee immediately without court approval being needed. Depending on the terms of the trust, the new trustee either dissolves the trust and distributes the assets immediately in the manner designated in the trust document or continues to operate the trust in the manner directed by the trust document.

Since there is no probate, there are no probate costs. The savings for the estate with a revocable trust are several times the cost of creating the trust. Because the trust is revocable, the trustor can alter, amend or revoke it at any time. If the trust is revoked, the trust assets immediately return to the trustor.

The standard estate plan that includes a revocable trust, durable power of attorney, living will, and pour-over will is usually between $500 and $1,100, depending on the type of trust. There are different types of trusts. Different trusts are tailored to whether or not the grantor is married, has children, or wants a joint trust between the spouses. Special trusts such as life insurance trusts, generation skipping trusts or charitable trusts can also be part of an estate plan.

All 50 states and the federal government accept as valid a revocable trust. If the trust was validly created in the original state, all the other states will honor and enforce it. Provisions can also be placed into a trust document stating that the terms of the trust are to be administered by the laws of a certain designated state. All states will apply the laws of the designated state in administrating the trust. Even if the trustor moves to another state, the trust will still remain valid and in effect.

II. FEDERAL ESTATE AND GIFT TAXES

The federal estate and gift tax rate is graduated and increases as the size of the estate increases over the unified credit. Example: A taxable estate of $100,000 has a tax of $23,800; a taxable estate of $250,000 has a tax of $70,000; a taxable estate of $500,000 has a tax of $155,000; a taxable gift of $2,5000,000 has a tax of $1,025.800.

A. UNLIMITED MARITAL DEDUCTION

Under federal law there is no federal gift or estate tax on property transferred between spouses. This is an unlimited credit that has only two exceptions:

1. It must be an actual gift. If the gift is in trust, all of the income must go to the spouse.
2. The spouse receiving the gift must be an American citizen. Gifts to a non-citizen spouse are not eligible for the unlimited deduction but are eligible for a $110,000 annual exclusion (Section 2523 of the Internal Revenue Code). Likewise, property passing from an American spouse to an alien spouse after death does not qualify for an unlimited marital deduction either. Special tax rules apply for such transfers, and a tax consultant should be consulted if the estate of the

American spouse exceeds $600,000.

Therefore, a person can generally pass his entire estate to a surviving spouse without incurring any federal estate taxes. This may not ultimately be the best estate plan. If the property given to the surviving spouse boosts the surviving spouse's estate over the unused portion of the unified credit, the surviving spouse's estate will have to pay estate taxes upon the death of the surviving spouse. Any gift to a surviving spouse boosts that estate over the available unified credit would subject it to taxation and should be made after using up the decedent's unified credit.

B. UNIFIED CREDIT FOR GIFTS OR ESTATES

Every person is permitted to transfer assets upon death totaling $1,000,000, through 2004, which gradually rises to an unlimited amount in 2010 and back to $1,000,000 in 2011 under the Tax Relief and Reconciliation Act of 2001 by death without incurring an estate tax under federal law. This is referred to an the unified credit for estate taxes. Prior to 2001, the unified credit was only $675,000. Congress may make the elimination of estate taxes permanent in 2010 but unless it does so the estate tax returns with a $1,000,000 exemption and a 55% maximum tax. The estate tax is discussed in greater detail in the Appendix to this book. There is imposed a gift tax through 2010 equal to the estate tax for gifts made during that period.

Under the Tax Act of 2001, Congress imposes a gift tax to restrict the transfer of income producing property from high income to low income taxpayers after the estate tax is eliminated. The gift tax exemption beginning in 2010 is $1,000,000. So even though transfers of property after death can be made tax free in 2010 for at least one year, unless made the estate tax elimination is made permanent by Congress, a gift tax on the transfer of property while alive will remain. The gift tax rate imposed under the 2001 Tax Act is equal to the top individual tax rate at the time of the gift.

About half of the states impose their own estate and inheritance taxes. These taxes should also be considered in estate planning. The Internal Revenue Code permits a small credit for state death taxes to be applied against the federal estate.

The significance of the unified credit is that it permits a husband and wife to give to their children a total combined estate of $2,000,000 through 2003 before incurring any estate taxes. A person giving his entire estate to a surviving spouse is not taking advantage of the unified credit. Not using the unified credit is ill-advised when making the gift to the surviving spouse pushes the value of that estate over the unified credit amount and subjects it to the payment of federal estate taxes on the surviving spouse's death.

C. ANNUAL EXCLUSION FOR GIFTS

Under federal tax law every individual may make an annual gift of $11,000 per person without incurring a gift tax or having the gift applied towards the unified credit. A parent having four children can give each $11,000 for a total of $44,000 each year free of gift taxes. The advantage of making these gifts is that they help reduce the size of the estate below the unified credit amount, thereby eliminating federal estate taxes.

An alien spouse does not qualify for the unlimited marital deduction. In place of the unlimited marital deduction an alien spouse is permitted to receive as a gift from the other spouse $110,000 per year tax free.

D. GIFT TAX ON CREATION OF TRUST

If the trust is revocable, there is no gift tax because the trustor can always revoke it. All income is still taxed to the trustor. If the trust is irrevocable with the trustor as the beneficiary, there is no gift tax because the trust is still for the trustor's benefit. Such a trust is called a grantor's trust, and all trust income is taxed to the trustor. If the trust is for the spouse, there is no gift tax because of the unlimited marital deduction. If the trust is for someone other than the trustor or the trustor's spouse, a gift tax is owed. The gift tax must either be paid or deducted from the unified credit or annual exclusion.

III. BASIC TYPES OF REVOCABLE TRUSTS

A. A JOINT TRUST

A common estate plan is where both spouses create one joint revocable trust. In this joint trust both spouses create one joint revocable trust and place all their property into the trust. The spouses' property is listed on schedules marked his, hers and theirs. On the death of the first spouse the trust is divided into separate trusts for the surviving spouse and the children or heirs.

This joint trust is usually the most economical estate plan because it plans for both estates. The cost for doing the joint estate plan is less than the cost of a separate estate plan for each spouse.

The trust is totally revocable during the joint lifetimes of the spouses; either spouse may terminate it at any time. Upon the death of the first spouse the trust usually becomes irrevocable as to the property of the deceased spouse, but the surviving spouse usually retains full power to revoke the trust as to the property that he contributed to it. This type of trust gives the spouse maximum control over their assets. This flexibility accommodates future changes in the surviving spouse's life following the death of the first spouse.

B. AN A-B TRUST

The A-B Trust is the common name given to the general type of revocable trust used by a married person with children where the trustor's estate exceeds the available unified credit amount. It is also called a "marital trust" or a "bypass trust." The trust exists for the benefit of the trustor during his life. At the trustor's death the trust is divided into two parts: the unused unified credit is placed into the B trust, and the rest is placed in the A trust.

The sole beneficiary of the A trust is the surviving spouse. The surviving spouse has ownership of the A trust and usually has the power to terminate it and receive the assets in her (assuming the wife is the survivor) own name. Since the assets in the A trust go to the wife, and since there is an unlimited marital deduction the estate is not subject to federal estate taxes if the spouse is a U.S. citizen. Upon the surviving spouse's death all of the property in Trust A will be included in the surviving spouse's estate for calculation of estate taxes. Example: Upon the husband's death his $2 million estate was divided $600,000 to Trust B (the mount of the unified credit at that time) and $1,400,000 to Trust A. Upon the wife's death Trust A had grown to $1,700,000. In addition, the wife had $500,000 of her own estate. So, for tax purposes, the wife's taxable estate will be $2,200,000.

The beneficiaries of the B trust are the children. Income may be attributed to the surviving spouse, but the trust does not qualify for a marital deduction. It does qualify for a deduction to the extent of the trustor's unused unified credit. Thus it is possible that there will be no federal estate tax on either trust. In the above example, if the assets in Trust B increased to $1,000,000 at the time of the wife's death, no estate taxes are due because the property placed into the Trust was originally tax free. If the $800,000 was originally placed into Trust B, the excess $200,000 would be taxable; after the taxes are paid, no additional estate taxes will be charged against it upon the death of the wife.

C. A QTIP TRUST

A QTIP trust is a special trust whereby the trustor's spouse is given all of the income from the trust with the principal being distributed to others (usually the children or grandchildren) upon the surviving spouse's death. QTIP stands for Qualified Terminal Interest Property and is a fancy name for property given to a spouse in a certain type of trust.

A QTIP trust gives the option to the surviving spouse to have the trust property treated as a gift to the surviving spouse for estate tax purposes. If the election is made, the value of the trust will be treated as a spousal gift and exempt from tax because of the unlimited marital deduction. On the surviving spouse's death the value of the trust assets will be included in the surviving spouse's estate for the determination of the surviving spouse's estate tax.

Depending on the size of the surviving spouse's estate it may or may not be good financial planning to make the QTIP election and have the value of the trust included in the surviving spouse's estate. For example, assume that the surviving spouse's estate is $100,000, and the QTIP trust is $100,000. The unified credit of the deceased spouse has previously been used. Making the election will save the trust from paying federal estate taxes until the surviving spouse dies. In the meantime the surviving spouse could draw a higher interest from the investment of the $100,000. If the surviving spouse's estate grows after making the election, tax will ultimately be required on the growth at the death of the surviving spouse.

D. A GENERATION-SKIPPING TRUST

A generation-skipping trust is a trust that skips one or more generations (grandparent's trust for grandchildren that bypasses the parents). The exception is when there are no parents surviving the grandchildren; then it is treated as a direct trust. A generation-skipping trust is complicated tax-wise. Although easy to create, it should not be created without first consulting a tax advisor because of the inherent tax consequences. $1,000,000 can normally be placed in a generation-skipping trust without incurring an estate or gift tax (provided the uniform credit has not been used previously).

Any amount placed in the trust over $1 million is taxed at a rate of 50% at the time of any distribution. A distribution occurs when the parents of the grandchildren die or the grandchildren receive money from the trust. The purpose of this law is to avoid amassing huge estates by not paying taxes. These trusts only affect very wealthy people. The tax consequences of a generation-skipping trust are so great that one should not consider funding one with more than $600,000 without professional tax advice.

IV. CREATION AND OPERATION OF A TRUST

A trust is created very easily. The trust document is drafted, usually by an attorney, and directs how the trust estate will be administered and distributed. The trustee acts in accordance with the terms of the trust. The trustor and trustee must both sign the trust document. If the trustor is also the trustee, he signs the trust agreement twice: as trustor and or trustee.

The final requirement is that the trust be funded. Funding the trust requires that the trustor place into the trust all of the property the trustor wishes to be in the trust. All of the property of the trustor should be placed into the trust. Anything left out of the trust will have to be probated unless it is joint-tenancy property or insurance policies with designated beneficiaries other that the decedent's estate.

Any property that has a title must have the title specifically transferred to the name of the trust. Merely stating in the trust agreement that such property is to be placed into the trust is insufficient to put the property into the trust legally. For example, assume that the trustor owns a home. Since a home has a title document, the title must be changed to name the trust as the owner. A quitclaim deed by the trustor to himself as trustee must be executed and recorded. This is simple to do and usually is done when the trust is created.

Placing a piece of real property into a trust should not trigger a reassessment of property taxes because the transfer is not really a sale or conveyance of the property. The property is put into a revocable trust, which the owner can terminate at any time and title to the property reverts to the owner. California law specifically states that merely placing real property into a revocable trust for estate-planning purposes does not trigger reassessment as long as the grantor is alive. This is just common sense. Reassessment occurs when there is a change of ownership. Placing the real property into a revocable trust is not really a change in ownership because the trustor still controls it and can have the property returned to him at any time.

Personal property that does not have a title (such as a television or furniture) is transferred automatically by a statement in the trust document showing the intent of the trustor to put into the trust all personal property wherever located. Property that has a title (such as a house or car) must have the title specifically changed to make the trust the owner. Merely stating an intent to place the house or other property that has a title into the trust is insufficient. The only way to put property that has a title into a trust is to actually change the title on the property so that the trust is listed on the title documents as the owner. Property once placed into a trust is treated like any other property that is not in a trust.

To sell any of the property that has no title (such as a radio or stove), one merely sells it. To sell any property that has a title (such as a car), one sells it by transferring title. All that is needed to sell real property from a trust is a deed executed by the trustee. The trustee merely signs the deed as the representative for the trust and upon recordation the title is passed. For example, the deed from the trustee will read: "John Doe, Trustee of the John Doe Revocable Trust, hereby deeds, conveys, sells, and transfers to John Smith all right, title and interest in the following property."

A revocable trust is considered for tax purposes a grantor trust. The Internal Revenue Code recognizes a grantor trust as a type of trust created for the benefit of the person creating it: all of the income from the trust is attributed to the grantor for tax purposes. Since all of the income is attributed to the grantor for as long as he is alive, the grantor remains liable for the income taxes. A revocable trust does not save the grantor any money on income taxes because it is not designed to do that. A revocable trust exists to avoid probate and save estate taxes, not to save income taxes.

A trust can be made irrevocable. Sometimes it makes good financial sense to do so. For assets in a trust not to be included in a trustor's estate, the trustor must not have control over the trust and must not have reasonable expectation that the trust will revert back to him. If the trust is revocable, the trustor has a great deal of control over the trust. The fair market value of the assets of the trusts will be included in the trustor's estate upon death for estate tax calculations. If the trust is made irrevocable, and the trustor has no control over the trust, the assets in the trust and all appreciation in value will not be included in the trustor's estate. This could pass a great deal of appreciation to the trustor's heirs without having it taxed. It is because a life insurance trust is irrevocable that the proceeds of the insurance on the decedent are not included in his estate.

A revocable trust does not need to be recorded. Unlike a will it is a private document. The only documents that need recordation are the deeds transferring real property into the trust. In some states a revocable trust is required to be registered and a copy lodged with the probate court. To register, a short statement is filed listing the trustee and giving some basic information. Registration gives the court jurisdiction to oversee the trust. There are no penalties, however, for failure to register. The states requiring registration are Alaska, Colorado (after the death of the grantor, and no registration is required if there is an immediate distribution to the beneficiaries), Hawaii, Idaho, Michigan, New Mexico and North Dakota. Florida and Nebraska do not require registration with the probate court, but both states allow it and suggest it.

V. THE FEDERAL ESTATE TAX RETURN

Federal estate tax return Form 706 is required to be filed whenever the decedent has an estate greater that $600,000. The requirement to file the estate tax return does not depend on any taxes being due or probate being required. If the estate is greater than $600,000 the tax return has to be filed.

Form 706 tax return has to be filed even if the entire estate is going to the surviving spouse under a trust and is entirely exempt from estate tax as an unlimited marital credit. Likewise, a Form 706 tax return has to be filed even if the entire estate is given to charities exempt from tax under the Internal Revenue Code.

VI. TERMINATION OF A TRUST

A trust must terminate within twenty-one years after the death of the last person who was alive and mentioned in the trust when it was created. This is known as the Law of Perpetuities. "Terminate" infers all of the assets of the trust are totally distributed. If it appears from reading the trust document that the trust would continue more than 21 years after the death of the person alive that is mentioned, the trust is invalid. Clauses are usually inserted in the trust document to guarantee that the trust will not violate the Law of Perpetuities.

Except for the Law of Perpetuities, a trust terminates whenever the terms of the trust agreement state it will terminate. Usually it terminates on the death of the surviving spouse or the death of the trustor's last child.

VII. GRANTOR'S REVOCATION OF THE TRUST

If a trust is revocable, all that is needed for an effective revocation is for the trustor to notify the trustee in writing that the trust is terminated on a certain date and to demand the trust assets be returned to the trustor. When the trustor is the trustee, he simply affixes a letter to the trust document revoking the trust and executes new deeds from the trust back to the trustor as an individual.

Revocation is simple and quick. That is one of the prime advantages of the trust over any other form of estate plan. Control over the assets of the trust is never lost. Until the trustor dies he retains the ability to immediately revoke and terminate the trust merely by stating that the trust is revoked.

VIII. A CHARITABLE REMAINDER TRUST

A charitable remainder trust is an inter vivos (living) trust: a trust made during the lifetime of the trustor. Property is placed into an irrevocable trust with a charity as beneficiary. The trustee, who is usually the charity, is instructed to pay a fixed percentage of the trust assets to the trustor for the life of the trustor. The trustor is given a federal tax deduction for the value of the gift to the charity. The trustor pays ordinary income tax on the payments received from the trust.

The gift to the charity is tax free. The charity is tax exempt and can sell the appreciated property without having to pay capital gains. The charity can reinvest the proceeds of the sale and pay the trustor from the interest on the investment. Because the charity can invest the whole amount without paying capital gains, it can generate more interest income from the sale than the person who transferred it to the trust. For this reason it is better to place highly appreciated property that is not earning a great deal of income, such as idle land, into the trust. The return that the trustor gets from the trust is higher than if the assets are sold and reinvested by the trustor because capital gains taxes on the trustor's sale of the highly appreciated property will take much of his profit.

A living person can make a gift to a qualified charity and receive a federal income tax deduction for the gift. The maximum deduction is 50% of the taxpayer's adjusted income for the year with the balance of the gift being carried over for the next five years. Where the gift is appreciated property the amount of the deductible is 30% rather than 50% unless special elections are made. Because of the complexity of the tax law in this area, any large gifts to a charity should only be made after consulting a tax professional.

Charitable gifts made through a will or trust are allowed full deductions of fair market value from the decedent's estate for federal estate-tax purposes. These estate charitable deductions reduce the taxable value of the estate, reducing the estate tax. Example: A decedent has an estate worth $1,000,000 and gives $400,000 to a charity. The decedent's estate deducts that $400,000 gift leaving an estate of $600,000. The $600,000 threshold equals the decedent's unified credit and therefore there is no federal estate tax owed.

Charitable remainder trusts can be excellent vehicles for estate planning for well-to-do people. Life insurance policies can be bought with the trust payments, thereby replacing the value of the property transferred to the charitable trust.

IX. ATTACHMENT OF TRUST ASSETS FOR TRUSTOR'S AND BENEFICIARY'S DEBTS

All states allow creditors to attach any revocable trust created by a trustor. This allows the creditor to get paid for any debts or other obligations owed by the trustor. The rationale for allowing the attachment is that the trustor has effective ownership of the trust assets by the fact that he can revoke the trust and receive the property in his own name. A court has the power to order the trustor to terminate the trust, receive the assets and pay the creditors.

Most trusts have clauses in them that state that the interest of the trust beneficiaries cannot be attached to pay the debts or obligations of any beneficiary. This provision is called a spendthrift clause. Courts will enforce spendthrift provisions and deny any attachments, except in a revocable trust where the trustor is also the beneficiary. Moreover, if there is no spendthrift clause, the trust can be attached to pay a beneficiary's debts. In addition, most states permit a beneficiary's share of a trust to be attached to pay spousal or child support obligations even if there is a spendthrift clause in the trust. In like manner California has recently passed legislation stating that a spendthrift clause will not shield a trust from attachment for payment of a tort judgment against a beneficiary.

X. THE EFFECT OF A TRUST ON DOWER AND CURTESY LAWS

If the provisions of a trust are in conflict with a state's law regarding how much of a decedent's estate goes to the surviving spouse, the surviving spouse can elect to take a share of the trust or to receive a statutory share of the estate. If the spouse elects to take the statutory share, the trust must pay as necessary to comply before distributing the remainder.

To avoid this conflict and confusion in states with statutory provisions to provide for a surviving spouse, the spouse can disclaim his statutory rights and agree to take only the disposition given by the trust document. Moreover, if the trust does not give the surviving spouse at least his statutory share, the spouse should consult with an attorney for advice on the legal consequences before accepting any offer.

XI. INCOME TAX TREATMENT OF A REVOCABLE TRUST

As long as the grantor of the revocable trust is the trustee and treated as the owner of the trust, no tax return for the trust should be filed. The income and deductions for the trust should be listed on the grantor's personal tax return.

A Form 1041 should be filed by the trust when the grantor is not the owner (the trustee). This return should then list to whom any distributions of income were made and pay the trust income tax on any income not distributed.

XII. JUDICIAL REVIEW OF A TRUST ADMINISTRATION

A common fear that many people have is that the trust will be mismanaged, and no one will be able to stop it. All states permit concerned persons to petition the court for review of the administration of a trust. A trustee is a fiduciary and owes both the trust and the beneficiaries a fiduciary duty to act reasonably and responsibly. If the court finds that a trustee has breached his duty of care, it will remove the trustee and surcharge him (find the trustee liable) for all of the damages caused by the trustee's misconduct.

Even if the trust document states otherwise, probate courts always have the power to review the actions of a trustee. The court will never permit a trustee to misuse the faith and power of his position and hide behind the trust document to avoid judicial scrutiny. Anyone, not just the beneficiaries, can take their suspicions of abuse to the court, and the court will investigate. In Bakersfield, California, an attorney conspired with a trustee to raid an elderly woman's trust. Concerned neighbors expressed their concern to the court, which ordered an investigation. Ultimately the attorney was sentenced to seven years in prison. The defense that everything was done in accordance with the terms of the trust was not persuasive.

XIII. TRUSTEE

The original trustee of a revocable trust is usually the grantor. Since the grantor of a revocable trust has unlimited power to alter or revoke the trust, the grantor can do anything he wants with the trust. When the grantor dies or resigns as trustee, a successor trustee takes over. Most trusts contain certain clauses which state who the successor trustee will be and give the grantor power to replace the stated successor or to appoint a successor trustee if none is stated. When there is no successor trustee, the probate court having jurisdiction over the trust will appoint the successor trustee. No trust will ever fail just because there is no trustee.

A trustee can always resign and be replaced just as though he died. Most trust agreements contain a list of proposed successor trustees to replace dying or resigning trustees. If the trust does not provide for a successor trustee and the trustor is dead or did not retain the right to amend or revoke the trust, the probate court will appoint a trustee. Before a trustee can resign, the trustee, unless the trustor is the trustee, will be required to provide a full accounting of the trust business during the time he managed it. All beneficiaries together may waive the accounting.

Normally, the trustor waives any bond for any trustee or successor trustee named in the trust document. Such a bond would be paid by the trust, diminishing the trust estate. If the trustor did not have faith in the named trustees, he should not have named them. The court will require a bond of a court appointed trustee unless all the beneficiaries agree to waive it.

Most trusts require the trustee to make annual accountings of the trust assets unless the grantor is the trustee or all the beneficiaries waive them. In addition, any concerned person who feels that the trust is being mismanaged can seek a court order directing the trustee to perform an accounting. The court can order an accounting even if the trusts agreement waives them. A major concern that many people have is that the trustee may mismanage the trust assets and the beneficiaries will be helpless. Such is never the case. The probate court always has the jurisdiction to oversee every trust, whether or not such jurisdiction is spelled out in the trust document. No court will ever let a trustee intentionally mismanage or steal trust assets. Anyone, not just beneficiaries, can raise their concerns to the court, which will order a hearing to investigate the matter.

Most trusts have language that a successor trustee takes over when the trustee becomes unable to perform the duties. This may cause problems when the trustee is the trustor and does not believe he is incompetent. Many agreements permit a trustee to be replaced when two competent doctors determine the trustee to be incompetent. Likewise, if a court adjudges a person incompetent, the successor trustee immediately assumes the responsibility.

CHAPTER 12

PROBATE

I. DEFINITION OF PROBATE

"Probate" is the name for the entire legal proceeding in a probate court to determine how to distribute the estate of a deceased person. Probate is the legal mechanism whereby a court determines who gets the estate. Probate of a deceased's estate is necessary when the decedent did not plan his final affairs beyond preparing a Will. Appropriate estate planning avoids probate altogether while providing for the immediate transfer of the estate to the designated heirs.

Probate proceedings are long, cumbersome and expensive. They are avoidable with proper estate planning. In recognition of the difficulties and expense of probate many states have enacted laws waiving probate or streamlining procedures for small estates (usually under $60,000). These summary probates usually involve nothing more than filing petitions with the court stating that the estate is too small to be managed effectively and that it should be distributed without administration to the heirs. Summary probate procedure is available only for small estates. Above a certain value, usually $60,000, a regular probate is required. A person whose estate exceeds $60,000 should develop a simple estate plan and avoid probate.

II. THE PROBATE COURT

The probate of a deceased person's estate is handled through a probate court. It is a special department or court under a court of general jurisdiction. The probate court oversees the administration of the probate estate. The probate court is responsible for performing the following functions:

1. Appointing the legal representative of the estate.
2. Supervising the representative.
3. Receiving and evaluating the inventories, accountings and other reports of the representatives.
4. Assuring that all bills, taxes and claims against the estate are paid by the representative.
5. Overseeing the distribution to the heirs.
6. Closing the estate and releasing the representatives from further responsibility.

The estate remains under the control of the personal representative until the probate court issues the final order of distribution. It can take years for an estate to be closed and the assets distributed to the heirs.

III. THE LAST WILL AND TESTAMENT

A Will is the final testament a person makes to ensure his earthly possessions go to whom he wants them to go. A Will is totally revocable during one's life. A Will usually must be in writing and witnessed by two or more adult persons. The witnesses usually cannot be heirs mentioned in the Will.

In some states an oral Will made in immediate contemplation of death may be valid and distribution will be made according to its terms. The creator of the Will (testator) must be legally competent to make the Will and not be insane or otherwise mentally impaired.

Unless a clause of the testator's last Will specifically revokes all prior Wills, all of the Wills of the testator must be read together. The probate court then will determine how the estate will be distributed. Therefore, all Wills should have a simple clause revoking all of the testator's prior Wills.

A Holographic Will is a Will that is written entirely in the handwriting of the testator. Some states, such as Colorado and California, do not require a Holographic Will to be witnessed. Most states require a Holographic Will to be witnessed. Many states will not accept a Holographic Will as valid if there are any pre-printed or typed portions of the Will. Some states will permit pre-printed language in the Will if the material provisions are written entirely in the testator's own handwriting. To be safe a Holographic Will should have two or more witnesses. That means, however, that it is no longer a Holographic Will, but an ordinary Will. Generally, Holographic Wills should not be used because they raise the potential issue of forgery. A case in point was the alleged Holographic Will of HOWARD HUGHES. The distribution of his estate of several billion dollars hinged on a purported unwitnessed Holographic Will. After years of legal wrangling, the court ruled that the Will was a forgery, but there are still some experts who believe it wasn't. If it was real, however, the issue of competency then exists because most sane people would not give away millions to strangers.

Except for oral Wills, a Will must be signed, dated and, unless typed, be written entirely in the handwriting of the testator or be an approved Statutory Will (a pre-printed Will authorized by statute in the testator's state of residence). A written Will, to be valid, usually requires, at least, two (2) witnesses who are unrelated to the testator and who are not receiving property under the Will. Many states have created Statutory Wills. These Statutory Wills comply with all of the terms for a valid Will in the state. They are pre-printed blank Wills on which the testators simply fill the blanks, sign and have notarized. Nearly all states have approved Statutory Wills for their citizens which are sold in stationery and office supply stores. A Statutory Will still has to be probated the same as any other Will. Statutory Wills are usually designed for use in the simplest of estates.

It is important, to bear in mind, that whenever a pre-printed do-it-yourself Will is used that the person must pay particular attention to detail. A telling example of this is an actual case where a woman used a pre-printed Will. She was unmarried and had lived for 30 years with a man whom she never married. She had a child whom she had not seen for over 30 years. She left everything to her male companion in the Will. Unfortunately, the Will she had bought and used was titled "Single Without Children." Her son filed a claim as a pretermitted heir and was awarded her entire estate. The man, who had been with the decedent for 30 years, received nothing because the woman chose the wrong pre-printed Will.

If a deceased person's Will cannot be found, the general presumption in law is that the person destroyed it. The estate will be then distributed in accordance with the state's laws of intestacy. It is next to impossible to prove the existence of a missing Will and what it contained to the satisfaction of a court. If an heir can do so and also convince the court that the Will was inadvertently destroyed, the court might possibly distribute the estate as intended. Example: George made a Will and gave a copy to a friend and placed the original Will in his son's house, which was destroyed by fire. The court might distribute the estate according to the copy. The evidence needed to prove to the court that the deceased did not destroy a missing Will is overwhelming.

The better tactic is for the person to sign two duplicate Wills with a general provision stating, "I have executed this last Will and testament in duplicate with one copy being held by my attorney. On my death if the Will in my possession cannot be found, it is not to be presumed that I revoked it. The Will in the possession of my attorney can be admitted in probate and treated as though it was the Will in my possession."

Because a lost Will is presumed to have been revoked, a probate court will not accept a copy of a Will into probate unless it can be shown to its satisfaction that the original Will was not destroyed by the deceased. The general presumption is that the decedent revoked the Will if it is missing. Producing a copy of the Will proves the contents of what was in it but does not prove that the deceased did not revoke it. Example: A fire kills the testator and destroys the Will at the same time. It then falls upon the heirs to prove that the testator did not destroy the Will prior to the fire. Therefore, a person should always execute a Will in duplicate with a clause therein that if the Will is not found in the deceased person's possessions, it is not to be presumed to have been destroyed.

IV. LEGAL COMPETENCE TO MAKE A WILL

In order to create a Will that is valid, the testator must be legally competent to do so. The issue of competency is critical when determining a Will's validity. Will contests based upon competency are the most difficult cases in the law to win. In a Will contest, the creator of the Will is dead, and the intent of a deceased testator has to be proven by extraneous and parol evidence.

To establish legal competency, it must be proven to the Probate Court that:

1. The testator was an adult or emancipated minor.
2. The testator knew the nature and quality of his estate.
3. The testator knew those who were the natural objects of his bounty (must have known his or her family).
4. The testator was mentally competent and not suffering from any insane delusions as pertained to the members of his family.
5. The testator was not on mind-altering drugs or alcohol when the Will was executed.
6. The testator knew that he was making a Will.

If any of these elements are not met, the Will is invalid no matter how many witnesses were present when it was executed. Competency is interesting because it does not have to be permanent. A person can be insane, have a temporary return to sanity, sign the Will and relapse into insanity: the Last Will and Testament will be valid.

The issue of competency most commonly arises when an elderly person creates a Will close to the time of death or while under some type of medical treatment that might cloud judgment. Most Will contests arise by someone claiming the decedent was tricked into signing a Will.

A person is said to have died intestate if that person died without having executed a valid Will. The estate of a decedent whose Will is declared invalid will be treated as if he died without a Will. An unemancipated deceased minor's estate will be treated as though the minor died intestate. Minors cannot write a valid Will. If a Will is declared invalid for any reason (failure to be witnessed, having improper witnesses, being under age, lacking mental capacity, etc.), the decedent's estate will be distributed as though he died without creating a Will.

When a person dies intestate, the estate usually is divided among the immediate family as follows:

1. If there is a spouse and a child, the estate is divided evenly between the two.
2. If there is a spouse and more than one child, one third of the estate goes to the spouse, and the rest is divided among the children.
3. If there is a spouse and parents and no children, the estate is split between the spouse and parents.
4. If there are parents and no spouse or children, it goes

to the parents.

5. If there are no parents, spouse or children, the estate goes to any brothers and sisters.

The probate court will keep searching for heirs until it finds someone to receive the estate. To find an heir to Howard Hughes' estate the court ultimately found a distant cousin by adoption several times removed.

V. INVALIDATING A WILL

A probate court will declare a person's Last Will and Testament invalid when:

1. The testator was an unemancipated minor, usually under eighteen years of age.
2. The testator did not sign it or have enough witnesses, or the witnesses were heirs and thus disqualified, or the witnesses were minors. In most states people named in a Will as receiving property cannot be witnesses and their signatures are invalid. If there are not two, and in some cases three, good witnesses, the Will is declared invalid.
3. The testator was mentally incompetent at the time the Will was executed.
4. The testator was forced to make the Will as a result of fraud, duress or undue influence of another.
5. The oral Will was found invalid because it exceeded the statutory amount that can be passed by an oral Will.
6. A Holographic Will was not entirely in the handwriting of the testator or not signed or not dated.

When a Will is declared invalid, the last valid Will of the decedent will be admitted into probate. If there is no valid previous Will, the decedent's estate will be distributed in accordance with the decedent's state laws.

VI. CONSIDERATIONS IN MAKING A WILL

A Will is a final statement of a person about how his estate is to be distributed. A probate court will not employ a Ouija board or conduct a seance in order to determine the testator's intent on issues not covered in the Will. The court will apply the state's law and general equitable principles. One should consider the following factors before making a Will:

1. What specific bequests (gifts) are to be made?
2. How should the remainder of the estate be distributed?
3. Who should be the executor of the estate?
4. Should a bond be required on the executor?
5. What powers should be given the executor? How much should the court supervise the executor?
6. Should adopted or step-children inherit from the estate?
7. Should a testamentary trust be established?
8. Who should be nominated as guardian for minor children?
9. Should any debts be canceled that are owed by heirs, or will they be deducted from the inheritances?
10. If assets are to be sold to pay debts, is there a priority as to how they will be sold?

It simply makes no sense to leave such important matters to be decided by a judge who has no understanding of the decedent or his wishes.

VII. PROBATING COMMUNITY PROPERTY

A small minority of states (California, Arizona, Idaho, Louisiana, New Mexico, Texas, Nevada, Washington, Wisconsin and to an extent Oklahoma) have laws that state all property acquired by either spouse during a marriage (except by gift, devise or bequest) is jointly and equally owned by both spouses. Earnings by both spouses for their work during the marriage along with retirement benefits earned during the marriage also belong equally to both spouses. Upon death only one half of the community property is placed in the deceased spouse's estate. The other half of the community property remains the sole property of the surviving spouse and is not included in the decedent's probate.

When a spouse dies intestate in some community property states, such as California, the surviving spouse automatically acquires title in the community property without probate. Since community property is considered by law to be owned equally by both spouses, a spouse's estate consists of only one-half of the property. Either spouse can direct through a Will how his half of the community property will be distributed. A surviving spouse is not automatically entitled to the deceased spouse's share of the community property. Example: George and Ellen are married in a community property state. George gives his half of the community property and all of his separate property by Will to his children, not to his wife, Eileen.

If the deceased spouse does not have a Will, his half of the community property will be distributed by state laws. California has a special provision that requires all community property to pass automatically to the surviving spouse if a spouse dies intestate. In the example above, if George died without a Will, then Eileen would inherit automatically, with no probate, all of George's interest in the community property. A probate would still be needed for all of George's separate non-community property.

VIII. STEPPED-UP BASIS ON PROPERTY RECEIVED FROM A DECEDENT

The basis (value for tax purposes) of property received from a decedent through a trust or through probate is its fair market value on the date of the decedent's death. Example: A person bought a home for $10,000. On his death it was worth $40,000. The basis of the property when heirs receive it will be $40,000. If the heirs sell it for $40,000, there will be no capital gains taxes due. If the heirs sell the house for $60,000, they will have to pay capital gains taxes on $20,000 (selling price $60,000 minus stepped-up basis $40,000).

Community property is considered owned by both spouses and is given special tax treatment. Under federal law when one spouse dies, the basis of both halves of the community property will be increased to fair market value. This is a great tax advantage. Example: A couple bought a home for $20,000 that had increased to $500,000 upon the husband's death. The basis for the husband's share in the community property is increased to fair market value $250,000. Under the special treatment for community property, the wife's share is also increased to fair market value $250,000. The surviving wife can sell the house for $500,000 without having to pay any capital gains taxes. If, however, the spouses held the house as joint tenants, only the husband's half would have been increased to fair market value. The wife's basis for her half would have remained at $10,000. If the wife later sold the house for $500,000, she would have to pay capital gains tax on $240,000 ($500,000 - $260,000 total basis). The stepped-up basis for community property is a great tax advantage over mere jointly-held property between spouses.

IX. HEIRS

An heir is someone who succeeds by operation of law to the estate of a person who died intestate. By contrast, someone receiving land under a Will is called a “devisee” because a gift of land is called a “devise”. A person receiving personal property is called a “legatee” because the gift in the Will is called a “legacy”. Each state identifies those persons that can be heirs under its laws. A living person has no heirs, only "heirs apparent." Heirs must survive a decedent.

Generally, heirs are the spouse, parents, children, brothers and sisters (immediate family) of the decedent. If none survive the decedent, the laws will extend heirship to the next-of-kin closest in relationship to the decedent.

In contrast, step-children have no greater rights in a step-parent's estate than those of a total stranger. Unless the step-children were adopted, which legally makes them the same as biological children, step-children are viewed as strangers for inheritance purposes.

If an heir is to receive property from an estate but can't be found, the probate court will order the property of the heir to be delivered to the county treasurer, county administrator or other designated agent. The agent will hold the property for the missing heir until the heir or a person acting for the heir or his estate applies for release of the property. Payment to the designated agent relieves the personal representative of further responsibility to the heir.

When the property consists of real or personal property other than cash, the court may order the property to be sold, converted to cash and kept in an interest-bearing account. If the money in the bank account is not claimed within a fixed statutory period, it is transferred to the state as "escheated property."

X. PERSONAL REPRESENTATIVE

The person appointed by the court to act for the estate of a deceased person is the personal representative. There are two types of personal representatives: (1) the executor or executrix and (2) the administrator. The executor (a man) or the executrix (a woman) is appointed by the court to represent the estate when the testator (creator) of the will dies. A person nominates an executor or executrix in the Will, but it is the court that does the actual appointment. If the court is not satisfied with the decedent's chosen representative, it will appoint another. An administrator is a man (administratrix, if a woman) appointed by a court to administer the estate of a decedent who died intestate.

The personal representative is given certain specific statutory powers to handle the affairs of the estate in most transactions without court approval. Through his Will the decedent can give the executor more powers and authority to act than are normally contained in the statutory powers conferred by the court. Usually court approval must be sought before real estate can be sold. A testator, however, may require in his Will that the real property be sold. If he does, court approval is not necessary.

The personal representative, whether the executor or the administrator, is responsible for performing the following duties in the probate:

1. Marshals (assembles and inventories) the assets of the estate.
2. Establishes a checking account in the name of the estate.
3. Arranges for appraisal of the assets of the estate, both real and personal property.
4. Seeks payment on any insurance policies owed on the life of the deceased person.
5. Substitutes as the representative of the deceased person in any litigation pending at the time of death.
6. Files any litigation needed to collect debts owed to the estate or to maintain and preserve the estate.
7. Pays all bills, including funeral bills and medical bills for the last illness owed by the estate.
8. Prepares tax returns and pays all federal and state taxes for the estate and the decedent.
9. Submits an accounting to the court for review.
10. Petitions the court for authority to distribute to heirs.
11. Distributes the estate to heirs.
12. Applies to the court for final discharge, terminating his authority to act and releasing him from liability.

It usually takes a minimum of six months for a personal representative to do all this. It can take significantly longer. Some estates have been open for years. This is the prime factor in favor of a revocable trust, which can transfer property immediately, upon the trustor’s death, subject only to the payment of appropriate estate and income taxes.

The personal representative appointed by the court is responsible for the payment of all taxes owed by the estate from the assets in the estate. If the personal representative distributes the estate before payment of all taxes due and owing, the representative may become personally liable for the taxes to the extent of the property transferred. Example: The representative distributes $50,000 to the heirs, and the IRS then determines that an additional $60,000 is owed in taxes. The personal representative may be responsible for any portion of the $50,000 not recovered from the heirs.

XI. AN ACCOUNTING

The personal representative is required to file an inventory with the court when the estate is opened. An inventory is a complete listing of every asset in the estate and its value. While the estate is open, the representative is required to keep track of every penny received or spent by the estate.

Before the estate can be closed, the representative is required to account for every penny that entered and left the estate. There must be a complete accounting for the estate. All of the heirs can agree to waive an accounting. That might be done when the accounting is unnecessary because the heirs trust the executor, or when it will be too costly given the difficulty or expense in performing it. Unless the accounting is waived, the estate cannot be closed.

XII. LETTERS OF PROBATE

In a probate the court appoints a personal representative. The appointment of a representative is manifested by a court document. The court order appointing an executor in an estate where there is a Will is called "letters testamentary." The court order appointing an administrator in an estate where there is no will is called "letters of administration."

The letters are the official appointment of the personal representative to act for the estate. Once these letters have been issued, the personal representative is legally entitled and indeed obligated to undertake the management of the affairs of the probate estate. No one should ever deal with a person claiming to be the personal representative of an estate without first seeing the letters of appointment.

XIII. A WIFE'S DOWER RIGHTS

Some states still have the ancient common law right of "dower." Under the concept of dower the law gives an interest to the wife in the real property of the husband owned by him at any time during the marriage. The wife's right (dower) was contingent upon her surviving him, and it became an absolute right after she did so.

The dower interest was a life estate in one-third of the real property that the husband owned during the marriage.

The wife's dower could not be defeated by the husband during his life or by his Will, and her interest was not subject to the claims of her husband's creditors. The dower terminates upon divorce. Many states have abolished dower and replaced it with statutory shares in the deceased husband's estate.

XIV. A HUSBAND'S CURTESY RIGHTS

Some states still have the ancient common law doctrine of "CURTESY" governing the husband's statutory share of his wife's estate. CURTESY grants the husband an interest in the real property of the wife owned by her during the time of the marriage. The husband's CURTESY was contingent upon him surviving her, and it became an absolute right when he did so, provided a child was born during the marriage.

CURTESY entitles the husband to a life estate in all of the wife's real property owned by her during the marriage. The husband's CURTESY could not be defeated by the wife during her life or by her Will and was not subject to the claims of her creditors. CURTESY terminates upon a divorce. Most states have replaced the doctrine of CURTESY with statutory shares for the surviving husband in the deceased wife's estate (between a third and a half).

XV. COMMON LAW STATES

The following are the states that follow the common law marital property rules. In these states a person owns separately and apart from the spouse everything titled solely in his name and everything purchased by his own property, income, or salary. The titles to property actually control who owns. This is different from the law in community property states, which hold that all property acquired during a marriage, except by gift, devise, or bequest belongs equally to both the husband and wife. The common law states are:

ALABAMA	ALASKA	ARKANSAS	COLORADO
CONNECTICUT	DELAWARE	FLORIDA	GEORGIA
HAWAII	ILLINOIS	INDIANA	IOWA
KANSAS	KENTUCKY	MAINE	MARYLAND
MASSACHUSETTS	MICHIGAN	MINNESOTA	MISSISSIPPI
MONTANA	NEBRASKA	NEW JERSEY	NEW HAMPSHIRE
NEW YORK	N. CAROLINA	N. DAKOTA	OHIO
OKLAHOMA	OREGON	PENNSYLVANIA	RHODE ISLAND
S. CAROLINA	S. DAKOTA	TENNESSEE	UTAH
VERMONT	VIRGINIA	W. VIRGINIA	WYOMING

Every common law state has its own laws determining the statutory share that a surviving spouse receives from a deceased spouse's estate. In the following states the surviving spouse receives a one-third life estate. This is the right to use the property to obtain income but not the right to sell it:

Connecticut Kentucky Rhode Island Vermont

In the following states, the surviving spouse's percentage varies, depending on whether the deceased spouse had children. The surviving spouse usually gets at least one-half of the estate, one-third if there are children.

Alabama	one-third of the augmented estate.
Alaska	one-third of the augmented estate.
Colorado	one-half of the augmented estate.
Delaware	one-third of the estate.

District Of Columbia	one-half of the estate.
Florida	30% of the estate.
Hawaii	one-third of estate.
Iowa	one-third of estate.
Maine	one-third of the augmented estate.
Minnesota	one-third of estate.
Montana	one-third of augmented estate.
Nebraska	one-third of augmented estate.
New Jersey	one-third of augmented estate.
New York	one-third of augmented estate.
North Dakota	one-third of augmented estate.
Oregon	one-fourth of the estate.
Pennsylvania	one-third of the estate.
South Dakota	one-third of the augmented estate.
Tennessee	one-third of the estate.
Utah	one-third of the estate.
W. Virginia	up to one-half of the augmented estate.

In the following states, the surviving spouse's percentage varies depending on whether the deceased had children. If there are no children the surviving spouse usually gets one-half of the estate but only one-third if there are children.

Arkansas	Illinois	Indiana	Kansas
Maryland	Massachusetts	Michigan	Missouri
New Hampshire	N. Carolina	Ohio	Oklahoma
S. Carolina	Virginia	Wyoming	

Georgia is unique. Instead of a fixed share, Georgia requires the deceased spouse's estate to support the surviving spouse for one year. This might or might not exceed the one-third of the estate usually given in other states.

Most states base the statutory share on the augmented estate of the deceased spouse. The augmented estate consists of everything owned by the decedent: joint-tenancy property, trust property, etc. The amount of the statutory share is calculated from the augmented estate. The probate court has the power to cancel joint tenancies and trusts created by the deceased spouse in order to give the surviving spouse a statutory share.

The purpose of using the augmented estate is to ensure that the deceased spouse passes, at a minimum, a statutory share of the estate to the surviving spouse. Not all states, however, use the augmented estate. Instead, other states simply rely on the property actually undergoing probate.

XVI. USE OF AN ATTORNEY IN A PROBATE

An attorney is not required to probate an estate. In a simple probate a representative with normal intelligence and no legal training can handle the probate procedures quite well. There are a number of do-it-yourself probate manuals on the market that can assist a non-lawyer in the probate. An attorney will be needed if there is any type of lawsuit against the estate by third parties, such as a creditor's claim or a will contest. Most states have laws stating that only can bring or defend a lawsuit in court for another. Therefore, the personal representative cannot act as an attorney in a court unless he is a licensed attorney.

XVII. ESTATE AND INHERITANCE TAXES

A common misconception is that probate exists as a means for the state or federal government to collect taxes. That is not the case. Estate and inheritance tax rates are based on the size of the estate and the relationship of the heirs to the deceased. It is irrelevant to the taxing entities whether or not a probate is conducted when determining the tax liability.

For example, assume that a person gives $800,000 at his death to his children. It makes no difference if the $800,000 comes to the children from probate or through a revocable trust. There is greater cost if the estate is probated rather than passing it through a trust, but the tax rates are the same. The tax is on the money and property distributed after death, not whether or not it comes from probate.

Some states will freeze jointly-held property (such as bank accounts, real estate and brokerage accounts) until the taxing entities have time to assess the value of the decedent's interest in the property. In particular, New Jersey and South Carolina require 10 day's written notice to taxing agencies before securities, deposits or assets of a decedent may be transferred outside of probate. In the states that freeze the assets pending a tax determination, a limited amount may nonetheless be transferred to a spouse or children without having to give the required notice. New Jersey permits $5,000 to be transferred to the surviving spouse without having to wait the required 10 days.

The purpose of permitting limited transfer for use by the family is to keep the spouse and family from destitution while the taxing authorities determine what amount of tax is owed. It is markedly unfair to seize the joint property of one person merely because the other joint tenant died. Consequently, the notice period is usually small.

There is a lifetime federal unified credit of $1,000,000, through 2004 and which increases to an unlimited amount in 2010 and then reduces back to $1,000,000 in 2011 under the Tax Act of 2001, for estate taxes. For gifts the unified credit stays at $1,000,000. This means that no federal estate taxes will be owed unless an estate exceeds the unified credit (minus the value of lifetime gifts). Under the Internal Revenue Code a personal representative can file a request with the IRS (and sometimes the state taxing agency) for a final assessment of the taxes owed by the estate. The IRS has three years in which to assess additional taxes. If the personal representative makes a request for a prompt assessment, the IRS has to complete the assessment within 18 months. After the assessment is done, the personal representative can pay the tax, distribute the remaining estate to the heirs and be discharged without any liability for future taxes.

XVIII. USE OF JOINT WILLS

Joint Wills are trouble and must be avoided. The problems are obvious. A married couple makes a Joint Will; one spouse dies; the survivor wishes to change the Will; the ultimate beneficiaries, usually the children, object. Whether the surviving spouse can alter a Joint Will depends both on the language of the Will and the state law where the Will is probated. If the Will states that after the death of one spouse the survivor cannot amend or revoke, most states would enforce that provision on contractual grounds. These states take the position that the deceased spouse would not have executed the Joint Will had he known that it could be changed after death.

If the Joint Will does not have the language making it irrevocable and unamendable, the court Will try to decide the intent of the parties when they drafted it and base its decision on that determination. There simply is not any real justification for running this type of risk. Individual Wills are relatively cheap, especially statutory Wills, so cost should not be the determinative factor in deciding upon use of a Joint Will.

XIX. CHANGING A WILL

A "codicil" is an amendment to a Will. It does not revoke the entire Will, but it does change certain provisions. The probate court will read the Will and all codicils together to determine the final intent of the deceased. A codicil is, in essence, a mini-Will. It is prepared, signed and witnessed in the same manner as an ordinary Will. Particular care must be taken in writing a codicil to define just what changes are to be made in a Will. If an heir is to be removed or added, it must be clearly stated. A codicil should be kept together with the Will to assure that it will not be overlooked when the estate is probated. A codicil is governed by the same rules as a Will. Therefore, if a codicil is missing, it will be presumed to have been previously revoked unless conclusively proven otherwise.

All changes to the Will must comply to the same formalities used in making a codicil or new Will. A person who simply deletes old provisions or inserts new clauses brings the validity of the Will into question. A person can revoke his Will at any time by another Will or simply by destroying the old Will. Some states would consider the writing of the new clauses an effective revocation of the old Will yet ineffectual in creating a new Will.

A person should never write a change on the face of a Will. All changes to a Will should be by a valid codicil or a new Will in accordance with the requirements of the state of domicile. Given the ease with which new Wills can be created, especially Statutory Wills, there is no reason to risk invalidation of an existing Will by writing on it. Just prepare a new Will or a codicil.

XX. WHEN A WILL SHOULD BE CHANGED

Unless changed, once a will is drafted, it is valid forever. As time passes, a person's needs and circumstances change. A will drafted years earlier may no longer fulfill the current needs and desires of the person. A will should be changed to reflect the true intent of the person.

The following changes in a person's life should immediately cause a review of the person's will:

1. A change in marital status. Marriage makes the new spouse a pretermitted heir. A divorce might not cut the ex-spouse out of the will.
2. Children are born or adopted. State laws allow unmentioned children to claim a portion of an estate as

pretermitted heirs. These children, however, might not receive under state law what the decedent would have given them.

3. Step-children. In most states step-children of a deceased have no rights to inherit under a step-parent's estate. Therefore, if a step-parent wishes to make dispositions to a step-child, that intent must be specifically stated in a will.
4. The value of the estate changes and the earlier gifts were too much, too little or there is now enough to give to others as well.
5. The intended heirs, executors, guardians or trustees have died.
6. Changes in estate or inheritance tax laws that make changing the will advisable to save on taxes.
7. The necessity for testamentary trusts for surviving spouse and children no longer exists.

A Will should be reviewed every few years for possible changes. Tax laws change frequently, and wills should be reviewed to ascertain their effect on the estate.

XXI. DISINHERITING A CHILD

Most states permit a parent to disinherit a child: prevent the child from receiving anything from the parent's estate. While possible, the intent to specifically disinherit a child must be detailed in writing. The laws of all states presume that a parent does not intend to disinherit a child unless specifically stated in the will. If a child is simply not mentioned in the will, the court will presume it was an error and award the child his intestate share of the estate.

Louisiana has several probate laws different from the rest of the nation. While the rest of the nation derived its basic law from English Common Law, Louisiana derived its law from French Napoleonic Code. Louisiana permits the disinheriting of a child only on one of 12 different grounds. Therefore, in Louisiana a parent cannot disinherit a child, no matter how specifically the intent to do so is stated in the will, unless one of the 12 grounds are met. These grounds run from a minor marrying without consent to planning to murder a parent.

XXII. PRETERMITTED HEIRS

A probate court will presume that a parent did not intend to disinherit a child unless the intent is specifically stated in the will. This comes into play in the pretermitted heir situation. A pretermitted heir is an heir, usually a child, who is not mentioned in the will, but who would have inherited under a state law if there had been no will. When the court finds the existence of a pretermitted heir, the court will award that heir his intestate share of the estate. For example, assume that Mary wrote a will leaving her estate to her three children. Mary later had a child out of wedlock and died shortly thereafter. Mary's will did not mention the new baby. The court, however, will find the baby a pretermitted heir and award the baby her intestate share of the estate which is one-fourth.

A step-child is not a pretermitted heir and has no right of inheritance under the law. California has created a novel statutory provision that permits a person to claim a defacto adoption if certain elements are met. California requires there be a parent-child relationship between the people and that an adoption was not possible because of some legal impediment. If these elements are met, the court will treat the person the same as an adopted child and award him an intestate share of the estate.

As with a pretermitted heir, a court will presume that a deceased spouse did not intend to disinherit a surviving spouse unless it is specifically stated in the will. A pretermitted spouse is a surviving spouse who is not mentioned in the deceased spouse's will. In all states, a surviving spouse will inherit something from a deceased spouse's estate under each state’s laws. It matters not that the surviving spouse is pretermitted or disinherited by a clause in the will, the state law will provide for inheritance, in some fashion, either by giving a statutory share in the decedent’s estate or a community property in the community estate. When the court finds a pretermitted spouse, it will award that spouse the intestate share of the estate. Example: Mary wrote a will leaving her estate to her three children. Mary then remarried and died 20 years later. Mary's will did not mention the husband. The court will find the new husband a pretermitted spouse and award him his intestate share of the estate, usually a third.

XXIII. EFFECT OF A TESTATOR'S DIVORCE ON A WILL

A few states, like California, have enacted laws that specifically prevent an ex-spouse from inheriting under a deceased ex-spouse's will that had been drafted at the time of their marriage. In most states, however, an ex-spouse will be entitled to share in the estate where the decedent failed to rewrite the will after the divorce. Most states take the view that the decedent must have wanted to make gifts to the ex-spouse because the will was not changed. Those courts will honor that perceived intention.

No one should ever assume that a divorce removes the rights of the ex-spouse to inherit under a will. In cases of divorce, a new will or a codicil should be drafted to state that the ex-spouse is not inheriting under the will. A new will should be written as soon as the divorce papers are contemplated and should certainly be in place when the divorce is filed. Some die during a divorce (in fact its been the basis of many mystery movies). The marriage is still legal. Thus the surviving spouse receives property under the deceased spouse's old will even though granting the divorce would have invalidated the will. Example: An attorney defended a woman charged with the murder of her wealthy husband. The woman had shot her husband six times. He defended her successfully claiming she was mentally ill at the time. Because it was not murder, she inherited his estate of $26 million.

XXIV. ANCILLARY PROBATES

An ancillary probate is a proceeding conducted in a state other than the state that was the decedent's permanent residence. Every state is responsible for probating the real and personal property located within it. If a deceased owned property in more than one state, a probate may be required in each such state in addition to the state of the decedent's domicile. Example: Robert died with a home in Georgia and another in Alabama. Probates must be opened in both Georgia and Alabama for the house in each state. If a decedent owns oil and gas leases in six states, there will be ancillary probates in each of the states plus a probate of the majority of the decedent's estate in the state of domicile.

Additional problems arise if the states have differing requirements for a valid will. Example: The domicile state requires two witnesses, but the state with the ancillary probate requires three witnesses. The will may be invalid in the ancillary probate state, and the property located therein will be distributed by its law of intestacy.

XXV. WILL CONTESTS

A will contest is a legal proceeding whereby someone, usually an heir or beneficiary, attacks or contests the validity of a will or a distribution made under it. A will contest results in a trial before the court to determine if the will was validly executed and should be enforced. The main contentions for contesting a will are:

1. Improper execution.
2. Lack of competency.
3. Lack of intent to make a will.
4. Pretermitted spouse.
5. Pretermitted heir.
6. Fraud, duress or undue influence.

Generally, only two witnesses are needed for a will, but a few states have rather eccentric requirements. Vermont requires three witnesses; Louisiana follows the Napoleonic Code requiring three witnesses, one of whom must be a notary public. These factors are important if there is a possibility of an ancillary probate. If the will might be probated in another state, it must comply with that state's and the decedent's home state's requirements for a valid will. In the case of an ancillary probate, if the will does not comply with the ancillary state's requirements for a valid will, it will be declared invalid and the estate distributed by the laws of intestacy.

All states require that proof be submitted that the decedent actually signed the will. Some states actually require some or all of the witnesses to come before the court and testify about the signing of the will. Other states, such as California, permit the witnesses to sign a declaration called a proof of subscribing witnesses in which the witness swears under penalty of perjury that he actually saw the testator sign the will.

A few states, like Louisiana, permit witnesses to sign the will before a notary public. When this is done, the will is said to be self-authenticating, and the witnesses need not appear in court to validate their signatures. When the witnesses are dead or unavailable and their signatures were not notarized, some states, California for instance, permit handwriting experts to testify that the decedent signed the will. This is a last resort and is difficult if the decedent had a long illness that affected his signature. It is a good idea to use witnesses who are younger and in better health than the testator.

If the Will is successfully contested, the probate court may invalidate the entire will or only the challenged portion of it. If the entire will is invalidated, the last valid will is reinstated. If there is no such valid prior will, the estate will be distributed pursuant to the laws of intestacy.

XXVI. CREDITOR CLAIMS

After a probate is opened a notice of the probate proceeding is published in a newspaper of general circulation in the area where the decedent lived. This publication informs creditors of the decedent that a death has occurred. The publication also informs the creditors that they have a fixed period of time ranging from four to six months to file claims with the probate court for the amounts they are owed.

If any creditor that was given valid notice, directly or by publication, fails to file a claim within the statutory period of time, he is barred from recovery. The reason for having a cut-off period is to close the estate on a certain date. Otherwise, the probate would be open forever while old unpaid claims were being submitted. Once filed, the executor must approve or reject the claim. If the claim is approved, it will be paid from the estate at the closing. If the claim is rejected, the creditor has a fixed time to file a lawsuit to collect the claim. After that time, collection is permanently barred.

This creditor period is the main reason for the delay in closing a probate and distributing the estate. The advantage of a revocable trust is that the property is transferred immediately. The disadvantage is that the creditor claims follow the estate. The claims will be paid. Still it makes better sense to pay them immediately through a trust rather than wait months for the action to work its way through the courts.

Funeral expenses are paid out of the estate. They are granted a priority over other bills. They are among the first bills paid once the estate has been marshaled (assembled). Many people today make their own funeral arrangements by paying for the service ahead of time. Many states, such as Ohio, Nevada, South Dakota and Washington require money paid under a pre-need plan to be placed in a trust fund. In the event the funeral home goes out of business, the money is returned to the client. Sometimes a person purchases a funeral policy to pay the funeral expenses, and the insurance company can pay insurance proceeds directly to the funeral home. Some states, such as Maryland and Tennessee, require all payments on funeral policies to be made to the estate and forbid funeral homes being named beneficiaries on such policies.

If the unsecured property in the estate is not large enough to pay all of the creditors, the personal representative will sell the secured property if it can be sold for more than is owed on it. The representative will apply the proceeds from the sale of the secured property to the secured creditors: those holding loans secured by the designated property. Any amount received in the sale that exceeds the amount of the claims is paid to the estate.

If the secured property is not sold. It is distributed in accordance to the terms of the Will or laws of intestacy, if there is no Will. The persons receiving the property will still have to continue making payments for it if they wish to keep it. Otherwise, the secured creditor can repossess the property.

After claims of the secured creditors are satisfied, all the unsecured creditors divide the remaining estate according to their percentage of claims against the estate. Example: Ed dies owing George $50,000 secured by a printing press. The executor of the estate sells the press for $30,000 and pays it to George. The remaining $20,000 becomes an unsecured debt of George against the estate. Ed's estate totals $100,000 with $200,000 in unsecured claims. George's $20,000 unsecured claim is 10% of the total unsecured claims. Therefore, George receives 10% of the unsecured estate, which is $10,000.

XXVII. FAMILY ALLOWANCES

Many states, like California, permit a surviving spouse or minor children to claim a fixed amount from decedent spouse or decedent parent's estate free from all creditor claims. This family allowance can be in addition to anything bequeathed in the will. In some states if an heir elects to take a family allowance, the heir cannot take under the will.

The family allowance can also be taken despite the terms of the will. The will may specifically give the wife nothing, but the wife may still be entitled to the family allowance under state law. A family allowance was one of the means used by the states to replace dower and curtesy. In a small estate the family allowance is the only way that the family may receive anything from the decedent's estate.

XXVIII. SIMULTANEOUS DEATH

A simultaneous death occurs when both the husband and wife die together so close in time that it cannot be ascertained with certainty who died first. When there is simultaneous death, each spouse's estate is distributed as though the other spouse has died first. The husband's estate passes to his heirs in the manner it would have passed had the wife actually died first. Jointly held property is divided equally among the two estates. Every state except Alaska and Louisiana have adopted the Uniform Simultaneous Death Act, which covers this situation.

Many wills avoid this problem altogether by simply containing clauses that require the spouse or other heir to survive the testator by a fixed period of time in order to inherit, usually 60 days.

XXIX. TIME IT TAKES TO PROBATE AN ESTATE

The time required to settle an estate varies from state to state. It depends on whether there is litigation or creditor claims. In California it takes a minimum of six months to close an estate. Four months is the statutory creditor claims period, and the other two months are the general period of public notice for opening and closing an estate.

Some states require that an executor actually close the estate within a fixed period of time. In Kansas the mandatory time to close an estate is nine months. In Wyoming one year is the time period. Where litigation is involved years may pass before an estate can be closed. If a revocable trust is used, there is no estate to close because the trust estate passes immediately upon death to those next entitled to receive it under the terms of the trust.

XXX. THE FINAL JUDGMENT OF DISTRIBUTION

After the accounting has been performed and either accepted by the court or waived by the heirs, the court will order which creditor claims are to be paid and how the final distribution to the heirs is to be made. The final judgment acts as a deed for real property. Recording the final judgment is the same as having received a deed from the personal representative for the real property distributed under the final judgment.

XXXI. AFTER-DISCOVERED PROPERTY

An estate can always be reopened if property not covered by the terms of the final judgments have what is called an omnibus clause that states how such after-discovered property is to be distributed, thereby avoiding reopening the estate. Generally such an omnibus clause states, "The remainder of the estate along with any undiscovered property shall be distributed as follows:..."

When an omnibus clause is used in the final judgment of the probate court, there is usually no reason to reopen the probate because of after-discovered property. Finding after-discovered property may result in additional estate or inheritance taxes. The taxes go with the property. If additional taxes are owed because of the existence of this newly discovered property, the heirs receiving the property will be responsible for the taxes to the extent of the value of the assets received from the estate.

CHAPTER 13

JOINT TENANCY AND GIFTS

I. JOINT TENANCY

Joint tenancy is a statutorily created form of property ownership which permits co-ownership by two or more persons with the right of survivorship. Upon the death of one of the owners, called a joint tenant, his interest passes automatically to the surviving joint tenants without the need of any probate or judicial proceeding. This automatic passage of property outside of any probate is the reason joint tenancies have become a popular tool of estate planning.

A joint tenancy in property must be expressly created by a written instrument, usually the title or deed for the property. The instrument must contain language that reads substantially "To

A and B as Joint Tenants." Anyone can be a joint tenant with any other person. Usually spouses or parents and their children are joint tenants, thereby avoiding probate of the property when one spouse or the parents die. For example, assume that a father has a piece of property. The father executes a joint-tenancy deed which places his four children on the deed with him as joint tenants. Upon the father's death, the father's remaining share in the property is divided automatically without probate among his four children. Each of the children own an undivided one-fourth of the property.

The creation of joint tenancy in real property is relatively simple and painless. The one transferring the property states in the deed that the property will be received by the new owners as joint tenants. For example, assume that George Smith sells property to buyers Adam Quick and William Hauser as joint tenants. Upon the death of either Adam Quick or William Hauser, the other surviving joint tenant will inherit the property without the necessity of a probate. Likewise, George Smith places his daughter Alice Smith as a joint tenant on the title of real property that he owns. Upon his death the interest held by George Smith will pass on to his daughter Alice Smith without a probate.

It makes no difference what type of deed is used to create a joint tenancy. A quitclaim deed, warranty deed, grant deed or even an installment sales contract can be used to create a joint tenancy as long as the operative language is included in them. A joint tenancy is created by specific language to the effect that the recipients are receiving the property "as joint tenants." Example: George Smith creates a joint tenancy with Alice Smith with the language "From George Smith to George Smith and Alice Smith as Joint Tenants." The effect of such language is to give Alice Smith one-half of the property immediately plus a right of survivorship in George Smith's remaining share of the property.

Personal property has no title and needs a written document stating it is intended to be joint tenancy property. Common sense dictates that without such a document it is impossible to prove the property was held in joint tenancy. For example, assume that a person dies with a ring worth hundreds of thousands of dollars. The ring is personal property and has no title. If the decedent had not previously executed a joint tenancy document placing the ring in joint tenancy with his children, the ring would have to be probated (assuming the ring was not put into a revocable trust).

A joint tenant owns an equal and undivided interest in the property, whether that interest was purchased or acquired by a gift. Each joint tenant's interest can be attached by the creditors of that joint tenant. For a case in point, a young woman's mother had placed her home in joint tenancy with her. The young woman had gotten into an auto accident and did not have insurance. She had been sued for damages and had a judgment taken against her. The creditor was executing against the mother's house to sell it and take the daughter's half interest. The woman was desperate to save her mother from losing her house. A payment plan was negotiated that allowed the mother to remain in her home until her death. Then it would be sold, and the balance of the judgment paid. The main drawback of a joint tenancy is that it is a complete passing of the interest given to the joint tenant.

Not all states permit property to be held in joint tenancy. Other states have laws that severely restrict its use. The following states have implemented laws regulating the use of joint tenancy property:

ALASKA	does not permit the use of joint tenancies except between husband and wives.
N. CAROLINA	permits joint tenancies only on bank accounts. It is not permitted otherwise even between spouses.
PENNSYLVANIA	has had a series of court decisions that question whether there can be a joint tenancy in real property. Personal property joint tenancy still appears to be valid.
TENNESSEE	does not permit the use of joint tenancies for any property except between husbands and wives.
TEXAS	does not permit the use of joint tenancies for any property except between husbands and wives.

A joint tenancy can be terminated and turned into a tenancy in common (a co-ownership of the property without a right of survivorship) by any of the following acts:

1. Conveyance by one joint tenant of part or all of his

interest. Any conveyance will terminate the joint tenancy because the other joint tenants did not agree to give the new co-tenant a right of survivorship in their interest in the property. In most states, such as California, a joint tenancy can be terminated by a joint tenant executing a deed covering his interest in the property to himself as a tenant in common. Example: George is a joint tenant with Ed. George can terminate the joint tenancy by executing a deed from himself to himself with the language "From George to George as tenant in common." George and Ed then become tenants in common. When George dies, his interest in the property will not pass automatically to Ed under right of survivorship.

2. Mortgaging by one joint tenant of his share of the joint tenancy property without the consent of the other joint tenants. For example, if George takes a loan on his share of the property. The joint tenancy terminates.
3. Leasing by one joint tenant of the joint tenancy property without the consent of the other joint tenants.
4. A few states permit the termination of a joint tenancy by a statement to that effect in a will. This, however, is a minority view not followed by the majority of states.

Once a joint tenancy is terminated, the right of survivorship also terminates. After the owner's death, the property must be probated to pass to the deceased owner's heirs.

About twenty states recognize, in some form, a special form of joint tenancy between a husband and wife called tenancy by the entirety. When property is held as tenants by the entirety, neither spouse may obtain a partition of the property or do anything that will defeat the right of survivorship of the other. A tenancy by the entirety cannot be unilaterally terminated by the act of just one spouse. A tenancy by the entirety can only be terminated by the following:

1. A divorce which changes the ownership of the property into that of tenants in common.
2. A mutual written agreement where the spouses agree to terminate the tenancy by entirety.
3. An execution against the property by a joint creditor of both spouses. A creditor of just one spouse cannot execute against the property. In contrast, creditors can take and execute against ordinary joint tenancy property when they have a judgement against only one spouse.

Community property states permit community property to be held in joint tenancy. In such a case, title is taken with the words "community property held in joint tenancy." The significance of these words is not to be ignored. By stating that the property remains community property even though it is held in joint tenancy, the property retains its community property status for tax purposes.

II. TAX BASIS CONSIDERATIONS

Joint tenancy property is treated differently for tax purposes based upon whether the joint tenants are spouses or not. Under federal law, except for married joint tenants, it is presumed that all of the joint tenancy was purchased by the decedent. Thus all of the joint tenancy property is placed into the deceased joint tenant's estate for tax unless the surviving joint tenant provided some of the purchase price. If the surviving joint tenant contributed, the value of the deceased joint tenant's estate will be reduced by that amount. When the property is held in joint tenancy by a married couple, only one-half of the value of the joint tenancy property is placed in the deceased spouse's estate; who actually paid for the property is immaterial.

The basis (value for tax purposes) of the property received from a decedent through a trust or probate is its fair market value on the date of death. For example, assume that a person bought a home for $10,000 and upon death it is worth $40,000. The basis of the property when the heirs receive it will be $40,000. If the heirs sell it for $40,000, there will be no capital gains taxes due. If the heirs subsequently sell the home for $50,000, they will pay capital gains tax on $10,000 ($50,000 minus the $40,000 stepped-up basis).

Community property, unlike joint tenancy, is considered owned by both spouses and is given special tax treatment. When one spouse dies the federal tax basis of both halves of the community property will be raised to fair market value. Example: A couple bought as community property a home for $20,000 that had increased to $500,000 at the time of the husband's death. The basis of the husband's share of this community property is increased to $250,000. The surviving wife's share is also increased to fair market value of $250,000. The surviving spouse can sell the house for $500,000 without having to pay any capital gains taxes. If the spouse had held the property as joint tenants, only the husband's half would be increased to fair market value. The wife's basis for her half interest in the house would remain at $10,000. If the wife later sold the house for $500,000, she would have to pay capital gains taxes on $240,000 ($500,000 selling price minus $250,000 husband's basis minus $10,000 wife's basis).

The increased basis for community property is a great tax advantage over joint tenancy. If the joint tenancy deed does not state that the property is community property, upon either spouse's death the IRS will treat the property not as community property but as joint tenancy (separate property owned equally by each spouse). The IRS will not permit the surviving spouse's basis in half the property to be raised to its fair market value. Usually married couples unknowingly take community property as joint tenants and do not include language in the deed that it is community property held in joint tenancy. Upon the death of one of the spouses the survivor suddenly finds he will not get a raised basis solely because of how title was taken.

III. GIFT TAX CONSIDERATIONS

As a rule, a taxable gift is created when a person changes title to create a joint tenancy and avoid probate. The major exception to this rule is the use of joint tenancies between spouses. There is unlimited federal marital credit for all transfers between married spouses when the recipient is an American citizen. A spouse may give any amount of property to the American spouse without incurring a federal gift tax.

The creation of a joint tenancy is a gift of one-half of the property placed into the joint tenancy. The interest transferred to someone other than a spouse is subject to a gift tax. Unless the property is worth less than $11,000 (the annual federal gift exclusion amount per recipient), a gift tax must be paid, or the value of the gift will be used to reduce the unified credit that everyone is allowed to pass property free of federal gift and estate taxes.

IV. DANGERS

Besides the tax considerations, there are significant dangers in creating joint tenancies. A person should be aware of these before creating a joint tenancy. When creating a joint tenancy, the interest transferred to the other joint tenant is a full and completed gift. The person creating the joint tenancy has forever divested all control and ownership of the property interest transferred to the other joint tenant.

Creditors of the other joint tenant can attach that joint tenant's share of the property to pay judgments once property is placed into joint tenancy. For example, assume that a mother places her home worth $200,000 into joint tenancy with her son. The son subsequently has a judgment against him for $80,000 for business losses. The son by virtue of his mother's joint- tenancy gift owns one-half of the home which is an interest worth $100,000. The son's creditors force the sale of the mothers home and attach $80,000 of the son's share of the sale proceeds to apply to their judgment. The mother will get $100,000 of the proceeds, be forced out of her home, and be $100,000 poorer.

Another problem that arises with joint tenancies: instead of a judgment taken against him, the son gets a divorce. In many states a divorce court will divide all of the property owned by the spouses, even that acquired by gifts or bequests, to make an equitable settlement. The joint tenancy property may be ordered sold and applied to the son's $80,000 judgment. The property may also be sold to satisfy the son's obligation for spousal or child support. In any event the mother will lose $100,000 of assets during her life and be forced from her home.

It usually does not make good sense for a person, particularly a parent, to place property into joint tenancy with someone other than a spouse. The risks and potential liability for the debts and obligations of the joint tenant to whom the property is being given usually outweigh the small advantage gained to avoid a probate. Use a revocable trust.

V. GIFTS

One of the simplest ways for a person to avoid probate is to give away all property during life. Common sense points out that property given during life does not have to be probated after the death of the donor. Making gifts poses its own unique problems. Most of the problems were addressed in the section about joint tenancies. The creation of joint tenancies is a gift of the interest conveyed into the joint tenancy. The problems arising with the making of gifts for probate avoidance are:

1. The property given away is lost. The donor no longer owns it and the donee (person receiving the gift) now totally controls it.
2. The donee gets the donor's basis in the property. The appreciation of the property during the time the donor had the property is subject to capital gains taxation when sold this means that the donee, not the donor, will have to pay the tax. This is a significant tax consideration.
3. In the event the donee dies before the donor, the donor re-inherits the property and must pay inheritance or estate taxes on the property he previously gave to the donee.
4. The property given to the donee may be lost in a divorce of the donee or taken by the donee's creditors.
5. The value of certain gifts will be included in the

> donor's estate. Gifts made within three years of death are not included in the donor's gross estate for tax purposes, with the following exceptions: life insurance, retained life estates, transfers taking effect at death, revocable transfers and releases of such transfers within three years of death. Gifts made within three years of death are, however, included in a donor's estate for purposes of determining eligibility for special-use valuation, redemptions to pay estate taxes and deferral for payment of estate taxes.

It is not uncommon for an elderly parent to give the family home or other property to a child that the child later sells forcing the parent to move into a retirement home. The parent cannot stop the sale. The child thinks that it is in the best interests of the parent to force the parent to move into a nursing home, and the proceeds from the sale will be used to pay for it. This is not an isolated instance.

A common tax problem arises where appreciated property is given away in life rather than after death. The donee's basis for the property remains the same as it was in the donor's hands: it is not the property's fair market value. The donee must pay a great deal of unnecessary capital gains taxes upon the sale of the property. Example: A father gives the home that he owned for 50 years to his daughter a year before his death. The home cost $10,000 in 1940 and is worth $300,000 upon his death. The daughter received the father's basis of $10,000 when the gift was made. When the daughter sells the house for $300,000, her capital gain is $290,000. The taxes on the capital gain are $81,200. If the property is passed to the daughter through a revocable trust or probated, it receives a raised basis to fair market value upon the parent's death. The daughter can sell the property for $300,000 and pay no capital gains taxes. The daughter will save $81,200 in capital gains taxes.

An unfair situation that once arose was where a father gave a business worth $800,000 to his two sons. The basis of the business was approximately $40,000. The sons paid approximately $35,000 in gift taxes. Two years later after the father's death the sons sold the business for $810,000. The sons' basis in the business was the father's basis of $40,000 plus the $35,000 in gift taxes they paid: a total of $75,000. The sons had to pay capital gains taxes of $150,700 on the capital gains of $735,000. If the property had been placed in a revocable trust or probate, it would have received a raised basis on the father's death, and the total taxes after the sale would have been only about $35,000, a savings of $150,000.

Another disastrous situation arising from a gift is that the property could be lost in a divorce, and the donor could find the property being transferred to the donee's ex-spouse. Many states still award alimony and establish the basis of property settlements on all the assets of the spouses. In such states the property a parent gifts to a married child can be awarded to the child's spouse in a divorce. The result of this could be the loss of property which had been in the family for generations.

Another real situation occurs when the donee dies before the donor. When a donee dies before the donor, the property might be reinherited by the donor. A probate might be necessary or taxes (inheritance or estate) might have to be paid even though the property is being returned to the original donor. Example: A parent gives his only child property worth $1,000,000. The child dies. If the property is not a joint tenancy with the parent, a probate is necessary to return the property to the parent. There may even be estate or inheritance taxes on the reinheritance of the same property which the parent originally owned. This situation can be avoided with a revocable trust, passing the property to the child only if the child survives the parent.

CHAPTER 14

DURABLE POWERS OF ATTORNEY

I. INTRODUCTION

A companion book for Powers of Attorney has been written for this legal series. The use of powers of attorney in estate and financial planning is so important that the basics are set forth in this chapter.

A general power of attorney is a written document wherein a person called the "principal" gives to another person called the "attorney in fact" the authority to act on the principal's behalf. A general power of attorney lapses and becomes invalid at the moment the principal becomes incompetent. At the time it is needed most a general power of attorney becomes invalid and the right of the attorney in fact to act for the principal ceases, lapses, and terminates. This has always been the criticism of a general power of attorney.

To address this situation most states have adopted the Uniform Durable Power of Attorney Act or the Uniform Probate Code or have enacted their own legislation to permit durable powers of attorney.

A. UNIFORM DURABLE POWER OF ATTORNEY ACT

The Uniform Durable Power of Attorney Act was adopted by the following jurisdictions

ALABAMA	CALIFORNIA	DIST. OF COLUMBIA

DELAWARE	IDAHO	INDIANA
KANSAS	MISSOURI	MONTANA
MASSACHUSETTS	NEBRASKA	N. DAKOTA
PENNSYLVANIA	TENNESSEE	SOUTH CAROLINA
VERMONT	VIRGIN ISLANDS	WEST VIRGINIA
WISCONSIN		

The following is the Uniform Durable Power of Attorney Act as adopted by California. This is basically the same form of the Act that was adopted by the other states. It is stated here for reference purposes.

UNIFORM DURABLE POWER OF ATTORNEY ACT IN CALIFORNIA
(the form of the California act is very similar, if not identical, to the Uniform Acts adopted in other states. All references are to the Civil Code of California.)

Section 2400. Durable Power of Attorney Defined

A durable power of attorney is a power of attorney by which a principal designates another his attorney in fact in writing and the writing contains the words "This power of attorney shall not be affected by subsequent incapacity of the principal," or "This power of attorney shall become effective upon the incapacity of the principal," or similar words showing the intent of the principal that the authority conferred shall be exercisable notwithstanding the principal's subsequent incapacity.

Section 2400.5. Proxy by Attorney in Fact Is Not a Durable Power of Attorney

Where a durable power of attorney gives an attorney in fact the power to exercise voting rights, a proxy given by the attorney in fact to another to exercise the voting rights is subject to all the provisions of law applicable to such proxy and is not a usable power of attorney subject to this Article.

Section 2401. Acts of Attorney in Fact Binding on Principal and Successors in Interest.

All acts done by the attorney in fact pursuant to a durable power of attorney during any period of incapacity of the principal have the same effect and inure to the benefit of and bind the principal and his successors in interest as if the principal were competent.

Section 2402. Prior Nomination or Subsequent Appointment of Guardian, Conservator, or Other Fiduciaries.

(a) If, following execution of a durable power of attorney, a court of the principal's domicile appoints a conservator of the estate, or other fiduciary charged with the management of all of the principal's property or all of his property except specified exclusions, the attorney in fact is accountable to the fiduciary as well as the principal. The fiduciary has the same power to revoke or amend the power of attorney that the principal would have had if he were not incapacitated, but if a conservator is appointed by a court of this state, the conservator can revoke or amend the power of attorney only if the court in which the conservatorship is pending has first made an order authorizing or requiring the fiduciary to revoke or amend the durable power of attorney to the fact to make health care decisions, as defined in Section 2430 for the principal.

(b) A principal may nominate, by a durable power of attorney, a conservator of the person or the estate of both, or a guardian of the person or estate or both, for consideration by the court if protective proceedings for the principal's person or estate are thereafter commenced. If the protective proceedings are conservatorship proceedings in this state, the nomination shall have the effect provided in Section 1810 of the Probate Code, whether or not such writing is a durable power of attorney.

Section 2403. Effect of Death or Incapacity of Principal - All Powers of Attorney, Durable or Otherwise.

(a) The death of a principal who executed a written power of attorney, durable or otherwise, does not revoke or terminate the agency as to the attorney in fact or other persons who, without actual knowledge of the death of the principal, act in good faith under the power. Any action so taken, unless otherwise invalid or unenforceable, binds successors in interest of the principal.

(b) The incapacity of a principal who has previously executed a written power of attorney that is not a durable power of attorney does not revoke or terminate the agency as to the attorney in fact or other persons who, without actual knowledge of the incapacity of the principal, act in good faith under the power. Any action so taken, unless otherwise invalid or unenforceable, binds the principal and his successors in interest.

Section 2404. Acts of Attorney in Fact in Good Faith Reliance on Power-Affidavit Showing Lack of Actual Knowledge as Conclusive Proof of Nonrevocation or Nontermination.

As to acts undertaken in good faith reliance thereon, an affidavit executed by the attorney in fact under a power of attorney, durable or otherwise, stating that he did not have at the time of the exercise of the power actual knowledge of the termination of the power by revocation or by the principal's death or incapacity is conclusive proof of the nonrevocation or nontermination of the power at that time. If the exercise of the power of attorney requires execution and delivery of any instrument that is recordable, the affidavit when authenticated for record is likewise recordable. This section does not affect any provision in a power of attorney for its termination by expiration of time or occurrence of an event or other than express revocation or a change in the principal's capacity.

Section 2405. Application and Construction of Act to Effectuate Uniformity.

This Article shall be applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this Article among states enacting it.

Section 2406. Title.

This Article may be cited as the Uniform Durable Power of Attorney Act.

Section 2407. Provisions Severable on Invalidity.

If any provision of this Article or its application to any person or circumstances is held invalid, the invalidity does not affect other provisions or applications of the Article which can be given effect without the invalid provision or application, and to this end the provisions of this Article are severable

B. UNIFORM PROBATE CODE

The Uniform Probate Code has been adopted by the following states:

ALASKA	ARIZONA	COLORADO	CONNECTICUT
HAWAII	IOWA	KENTUCKY	MAINE
MARYLAND	MICHIGAN	MINNESOTA	NEVADA
NEW JERSEY	NEW MEXICO	NEW YORK	OHIO
OREGON	RHODE ISLAND	SOUTH DAKOTA	UTAH
WASHINGTON	WYOMING		

Section 5 of the Uniform Probate Code is the pertinent provision that authorizes durable powers of attorney and reads as follows:

POWERS OF ATTORNEY

Section 5-501. When the Power of Attorney is Not Affected by Disability.

Whenever a principal designates another his attorney in fact or agent by a power of attorney in writing and the writing contains the words "This power of attorney shall not be affected by disability of the principal," or similar words showing the intent of the principal that the authority conferred shall be exercisable by him as provided in the power on behalf of the principal notwithstanding later disability or incapacity of the principal at law or later uncertainty as to whether the principal is dead or alive. All acts done by the attorney in fact or agent pursuant to the power during any period of disability or incompetence or uncertainty as to whether the principal is dead or alive have the same effect and inure to the benefit of and bind the principal or his heirs, devisees and personal representative as if the principal were alive, competent and not disabled. If a conservator thereafter is appointed for the principal, the attorney in fact or agent, during the continuance of the appointment, shall account to the conservator rather than the principal. The conservator has the same power the principal would have had if he were not disabled or incompetent to revoke, suspend, or terminate all or any part of the powers of attorney or agency.

Section 5-502. Other Powers of Attorney Not Revoked Until Notice of Death or Disability.

(a) The death, disability, or incompetence of any principal who has executed a power of attorney in writing other than power described in Section 5-501, does not revoke or terminate the agency as to the attorney in fact, agent or other person who, without actual knowledge of the death, disability, or incompetence of the principal, acts in good faith under the power of attorney or agency. Any action so taken, unless otherwise invalid or unenforceable, binds the principal and his heirs, devisees and personal representative.

(b) An affidavit, executed by the attorney in fact or agent stating that he did not have, at the time of doing an act pursuant to the power of attorney, actual knowledge of the revocation or termination of the power of attorney by death, disability or incompetence, is, in the absence of fraud, conclusive proof of the nonrevocation or nontermination of the power at that time. If the exercise of the power requires execution and delivery of any instrument which is recordable, the affidavit when authenticated for record is likewise recordable.

(c) This section shall not be construed to alter or affect any provision for revocation or termination contained in the power of attorney.

C. STATUTORY ENACTMENTS

All states have enacted some type of legislation authorizing the use of durable powers of attorney for financial affairs. Most of these states have also created their own statutory forms for durable powers of attorney for health care. These forms, where their use is mandatory or whose requirements significantly differ from the basic form in this book, are included at the end of this chapter. It is recommended that the reader compare his individual state durable power of attorney for health care form to decide whether to use it rather than the basic form contained in this book.

A durable power of attorney is a special type of power of attorney. It contains specific language stating that the principal intends for the power of attorney to remain in full force and effect during any period of mental incapacity that may afflict the principal.

A durable power of attorney has the effect of eliminating and replacing the necessity of a voluntary conservatorship or a guardianship of either or both the Principal and the Principal's estate. A durable power of attorney can also give the attorney in fact the power to make decisions of any type or just specific health care decisions when the principal is unable to do so.

Many states have approved statutory forms for durable powers of attorney. Usually the use of these forms is not mandatory as long as the form actually used contains the same basic information. The use of a statutory form is recommended over a nonstatutory form because there is less chance of a dispute concerning the meaning or intention of clauses contained in the forms. Virtually all states have adopted a durable power of attorney for health care act (sometimes called a medical health proxy or medical directive).

This chapter also contains a basic uniform durable power of attorney for health care form that can be used in those states that have not adopted a statutory form of their own or which do no requirement the use of their statutory form. It is always a good idea to consider the use of the statutory form if the state has one, even if it is not required, so as to limit potential attacks against its validity. Even so, the basic form, in this book, often presents the grant of authority and the Principal's wishes in a clear and more concise fashion that most optional statutory forms.

II. DURABLE POWER OF ATTORNEY FOR FINANCIAL AFFAIRS

In all states except Louisiana and Pennsylvania a general or limited power of attorney lapses immediately on the principal becoming mentally incompetent. Traditionally under state law when a person became incompetent the court appointed a conservator or guardian for both the person and his estate. Allowing a general power of attorney to remain in effect would impair the ability of the conservator or guardian to manage the affairs of the estate and provide for the incompetent principal.

A general power of attorney gives the attorney in fact the authority to act on the principal's behalf and becomes invalid when it is needed the most, at the time the principal becomes incompetent. In order to be a valid durable power of attorney, the instrument must contain specific language stating the intent of the principal that the power of attorney will continue during the period of the principal's mental incapacity.

A durable power of attorney for financial affairs is exactly what the name states. It is a power of attorney to handle the financial affairs of the principal during the time that he is incompetent. This power of attorney is limited only to financial affairs and does not extend to making health care decisions. To make health care decisions for the principal, separate durable power of attorneys for health care or a combined financial and health care durable power of attorney must be executed. A durable power of attorney for financial affairs might be limited to specific purposes, but generally that is not the case. If a durable power of attorney for financial affairs is limited in scope and a matter arises that is included in the power of attorney, a conservatorship or guardianship must be opened, which was what the durable power of attorney was designed to avoid. It is possible for a principal to give to more than one attorney in fact a durable power of attorney. One attorney in fact might have a limited durable power of attorney; whereas the other attorney in fact might have a general durable power of attorney.

A durable power of attorney for financial affairs can have a clause in the instrument that states that the power of attorney does not become effective until and unless the principal becomes incompetent. This is a safety feature that prevents the attorney in fact from acting for the principal until it is proven that the principal is in fact incompetent. For this reason it is called a "springing" power of attorney because it "springs" into force only when the principal is declared incompetent. The declaration of mental incapacity is usually covered in a clause that requires two or more medical doctors to diagnose the principal as incompetent. A notable disadvantage of a springing durable power of attorney is that during the period of time the principal is incompetent and before the doctors make the necessary diagnosis, no one is authorized to make valid business and health care decisions for the principal.

A durable power of attorney lapses on the death of the principal or the arrival of the termination date in the durable power of attorney instrument, regardless of the principal's competency. The whole purpose behind durable powers of attorney is to have a person authorized to act on the principal's behalf when the principal becomes mentally incompetent. In reality, this is the time when such a power of attorney is most necessary. Under the Uniform Durable Power of Attorney Act, all acts undertaken by the attorney in fact after the death of the principal but while in ignorance of the principal's death are still valid contracts against the principal's estate.

In executing a power of attorney for financial affairs, the attorney in fact is usually not required to give the principal annual accountings unless required by the power of attorney instrument. A few states such as North Carolina require the attorney in fact to file an annual accounting with its court, but a competent principal can waive the requirement.

A major concern many people have over a durable power of attorney is that the attorney in fact may take and otherwise mismanage their assets, after their mental incapacity, and their beneficiaries will be helpless to stop it. This is never the case. The probate court always has jurisdiction to oversee every durable power of attorney regardless of whether or not such power is documented in the durable power of attorney document. No court will ever let an attorney in fact intentionally mismanage or steal assets over which he may have control by virtue of a durable power of attorney. Anyone can raise their concerns to the court, and the court will order a hearing to investigate the matter. All states permit concerned persons to petition the court to review the administration of a durable power of attorney. An attorney in fact is a fiduciary and owes the principal a fiduciary duty to act both reasonably and responsibly. If the court finds an attorney in fact has breached his duty of care, it will remove the attorney in fact and surcharge (find the attorney in fact liable) for all of the damages caused by the attorney in fact's misconduct. Even if the durable power of attorney document states otherwise, probate courts always have the power to review the actions of an attorney in fact for improper conduct. The court will never permit an attorney in fact to misuse the faith and power of his position and then hide behind the durable power of attorney document to avoid judicial scrutiny. Anyone can take their suspicions of abuse to the court, and those suspicions will be investigated.

Under the Uniform Durable Power of Attorney Act, if a court appoints a conservator or guardian for the estate of a person who has created a durable power of attorney for financial affairs, the attorney in fact becomes accountable to the court appointee as well as the principal. The court appointed conservator or guardian can also terminate the durable power of attorney.

As long as he is legally competent, the principal retains the power to revoke the power of attorney. If the attorney does not act in accord with the wishes of a competent principal, the power of attorney can be revoked, terminating the authority of the attorney in fact. All that is needed for an effective revocation is for the principal to notify the attorney in fact that the durable power of attorney is revoked on a certain date and to demand the durable power of attorney assets held by the attorney in fact be returned to the principal by the date of revocation. The principal simply affixes a letter to the durable power of attorney document stating the durable power of attorney is revoked effective the certain date. If the power was recorded, the revocation must also be recorded to give constructive notice of the revocation to the world.

An attorney in fact can always resign. When the attorney in act resigns, he is replaced in the same manner as though he had died. Many durable power of attorney instruments name a successor attorney in fact to replace a dead or resigning attorney in fact. If the durable power of attorney does not provide for a successor attorney in fact, the durable power of attorney will terminate on the death or resignation of the attorney in fact. In a few states, most notably North Carolina, before an attorney in fact can resign, he must provide a full accounting of the durable power of attorney business during the time that he. If legally competent, the principal may waive the accounting.

Only a legally competent person can serve as an attorney in fact. If an attorney becomes incompetent all of his subsequent actions on behalf of the principal are voidable. An incompetent person cannot create a valid contract. Many durable power of attorney instruments have language that a successor attorney in fact takes over when the attorney in fact becomes unable to perform the duties of the attorney in fact. Even is the principal is unable to replace the attorney in fact because he, himself is incompetent, the attorney in fact may nevertheless be removed.

Durable powers of attorney for financial affairs forms can be purchased at office supply or stationary stores. Some states (such as California) publish statutory forms for durable powers of attorney for financial affairs. The use of these forms is usually not mandatory to create a valid durable power of attorney.

DURABLE POWER OF ATTORNEY FOR FINANCIAL AFFAIRS

KNOW ALL MEN BY THESE PRESENTS, that I, ____________________ __________________ residing at ____________________________________ ____do declare this to be a durable power of attorney.

This power of attorney shall not be affected by subsequent incapacity of the principal.

I hereby revoke all prior powers of attorney regardless of the type and to whom they may have been given.

I hereby nominate, constitute and appoint __________________ __________________ whose address and telephone number is:________ ____ as my true and lawful attorney in fact, for me and in my name, place and stead and for my use and benefit to exercise the following powers:

This durable power of attorney shall become effective:

( ) Immediately upon execution of this durable power ofattorney.

( ) Only after certification by two licensed physicians that I lack the mental capacity to make financial decisions for myself.

(1) Subject to any limitations in this document, I hereby grant to my agents full power and authority to act for me and in my name in any way that I myself could act with respect to the following matters to the extent that I am permitted to act through

an agent:

(a) Real estate transactions.

(b) Tangible personal property transactions.

(c) Bond, share, and commodity transactions.

(d) Financial institution transactions.

(e) Business operating transactions.

(f) Insurance transactions.

(g) Retirement plan transactions.

(h) Estate transactions.

(i) Claims and litigations.

(j) Tax matters.

(k) Personal relationships and affairs.

(l) Benefits from military service.

(m) Records, reports and statements.

(n) I grant full and unqualified authority to my agents to delegate any and all of the foregoing powers to any person or persons whom my agents shall select.

(2) To ask, demand, sue for, recover, collect, and receive such sums of money, debts, dues, accounts, legacies, bequests, interest, dividends, annuities and demands whatsoever as are now or shall hereafter become due and owing payable or belonging to me and have, use, take all lawful ways and means in my name or otherwise for the recovery thereof by attachments, arrests, distress or otherwise and to compromise and agree to acquittances or other sufficient discharges for the same.

(3) For me in my name to make, seal and deliver, bargain, contract, agree for, purchase, receive and take lands, tenements and hereditaments and accept the possession of all lands and all deeds of assurance in the law therefor and to lease, let, demise,

bargain, sell, remise, release, convey, mortgage and hypothecate lands, tenements and hereditaments on such covenants as they shall think fit.

(4) To sign, endorse, execute, acknowledge, deliver, receive and possess such applications, contracts, agreements, options, covenants, deeds, conveyances, trust deeds, security agreements, bills of sale, leases, mortgages, assignments, insurance policies, bills of lading, warehouse receipts, documents of title, bills, bonds, debentures, checks, drafts, bills of exchange, notes, stock certificates, proxies, warrants, commercial paper, receipts, withdrawal receipts and deposit instruments relating to accounts or deposits in or certificates of deposit of banks, savings-and-loans or other such institutions or associations, proofs of loss, evidences of debts, releases and satisfaction of mortgages, judgments, liens, security agreements and other debts and obligations and such other instruments in writing of whatever kind and nature as may be necessary or proper in the exercise of the rights and powers herein granted.

(5) Also to bargain and agree for, buy, sell, mortgage, hypothecate and in any and every way and manner to deal in and with goods, wares and merchandise, choses in action and to make, do and transact all and every kind of business of whatever nature and kind.

(6) Also for me and in my name and as my act and deed to sign, seal, execute, deliver, and acknowledge such deeds, leases,

mortgages, hypothecations, bottomries, charter parties, bills of lading, bills, bonds, notes, receipts, evidences of debt, releases and satisfactions of mortgage, judgments and other debts and such other instruments in writing of whatever kind and nature as may be necessary or proper.

(7) To have access at any time or times to any safe deposit box rented by me wheresoever located and to remove all or any part of the contents thereof and to surrender or relinquish said safe deposit box and any institution in which any such safe deposit box may be located shall not incur any liability to me or to my estate as a result of permitting my agent to exercise this power.

(8) I hereby expressly authorize any attorney of mine, past or present, to release and disclose to my agent any information any of them may have concerning my legal affairs or other facts that they may have concerning my personal affairs and any legal service, counsel, or assistance provided to me either before or after the execution of this power of attorney. Any privilege hereby is expressly waived as to such disclosures. This waiver shall extend to communications to my agent only and shall not be deemed to authorize release of information to third parties and shall not be deemed a general waiver of the privilege. My agent may, however, authorize release of such information to such third parties as my agent deems to be reasonable or necessary in the exercise of the powers granted in this instrument.

(9) I hereby grant all of the following powers to my attorney

in fact that may be necessary in order to make me eligible for nursing home assistance if it is deemed in my best interests.

A. Make gifts from any revocable trust I have created to the remainder beneficiaries in the trust to the extent needed to qualify the myself for nursing home assistance even if this means terminating the trust for lack of assets.

B. Declare any revocable trust I have created irrevocable and renounce all future interests in the trust for me.

C. In any community property joint trust created between myself and my spouse, the attorney in fact may transmute all or any part of my community property interests into separate property and give that property in fee to my spouse.

I specifically approve this provision _________________________

(10) Giving and granting unto said attorney in fact full power and authority to do and perform every act necessary, requisite or could do if personally present with full power of substitution and revocation, hereby ratifying and confirming what my said attorney shall lawfully do or cause to be done by virtue hereof.

The attorney in fact under this durable power of attorney is specifically not given and does not have the authority or power to revoke, amend or alter any living will declaration, last will and testament or any revocable or irrevocable trust that I have created or will create.

The attorney in fact ☐ is ☐ is not granted reasonable compensation for services rendered under this power of attorney.

The attorney in fact ☐ is ☐ is not permitted to engage in self-dealing with my estate.

Special instructions or authority: ____________________________

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If ____ is not available or becomes ineligible to act as my agent to make decisions for me, or if I revoke the appointment or authority to act as my agent to make decisions for me, I designate and appoint ____________________

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as my alternative, true and lawful attorney in fact with all of the powers enumerated above including the power to make financial decisions on my behalf. If ____is not available or becomes ineligible to act as my agent to make decisions for me, or if I revoke the appointment or authority to act as my agent to make decisions for me, then I designate and appoint ____ as my alternative true and lawful attorney in fact with all of the powers enumerated above including the power to make financial decisions on my behalf.

IN WITNESS WHEREOF I have hereunto signed my name this _____ day of ________________, _________.

____

In executing this durable power of attorney, I am aware that I have the following rights:

(1) This document gives the person whom I designate as my attorney in fact the power to make financial decisions for me subject to the limitations or statements of my desires that I have included in this document.

(2) The person that I designated in this document has a duty to act consistent with my desires as stated in this document and where my desires are unknown to act in my best interests.

(3) Unless I specify a shorter period in this document, this power will exist for seven (7) years from the date I execute this document and, if I am unable to make financial decisions for myself at the time this seven (7) year period ends, this power will continue to exist until the time when I become able to make financial decisions for myself.

(4) Notwithstanding this document, I have the right to make financial decisions for myself so long as I can give informed consent with respect to the particular decision. In addition, no financial transaction shall be undertaken over my objection.

(5) I have the right to revoke the appointment of the person designated in this document by notifying that person of the revocation in writing.

(6) I have the right to revoke the authority granted to the person designated in this document to make financial decisions for me by notifying anyone dealing with the person orally or in

writing.

(7) The person designated in this document to make financial decisions for me has the right to examine my financial records and to consent to their disclosure unless I limit this right in this document.

(8) To be validly executed, this durable power of attorney must be witnessed by two adults and also be notarized.

Dated: ____________________

____

ATTESTATION

I declare under penalty of perjury under the laws of the State of ______________________________ that the person who signed this document is personally known to me (or proven to me on the basis of convincing evidence) to be the principal, that the principal signed and acknowledged this durable power of attorney in my presence, that the principal appears to be of sound mind and under no duress, fraud, or undue influence, that I am not the person appointed as attorney in fact by this document, and that I am not a health care provider, the operator of a community care facility, the operator of a residential care facility for the elderly nor an employee or an operator of a residential care facility for the elderly.

I further declare under penalty of perjury under the laws of the State of ______________________________ that I am not related to the principal by blood, marriage, or adoption, and to the best of my knowledge I am not entitled to any part of the estate of the principal on the death of the principal under a will now existing or by operation of law.

Dated: ______________________

________________________________ ________________________________

WITNESS

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ADDRESS

________________________________ ________________________________

WITNESS

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ADDRESS

CERTIFICATE OF ACKNOWLEDGMENT OF NOTARY PUBLIC

State of ______________________

County of ______________________

On ____________________ before me, ____________________________

personally appeared ____

personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS MY HAND AND OFFICIAL SEAL.

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Signature

Most of the states which have statutory forms have combined both financial affairs and health care on the same form and therefore leave it to the Principal to indicate both the type and extent of the authority being transferred. Some states do, however, also have separate durable powers of attorney just for financial affairs whose use is usually not mandatory.

III. DURABLE POWER OF ATTORNEY FOR HEALTH CARE

Within the last 15 years, all of the states have come to realize it is not always necessary to require a conservator or guardian to be appointed for an incompetent if the person has taken care to protect himself for this eventuality. The states have adopted either the Uniform Durable Power of Attorney Act or the Uniform Probate Code or have enacted their own durable power of attorney legislation. All states now permit a person to grant an attorney in fact the power of attorney to act on the principal's behalf, including health care decisions, after the principal has become mentally incompetent. A durable power of attorney for health care is a specialized form of power of attorney that gives the power to an attorney in fact to make health care decisions for a principal who has become incompetent. Durable powers of attorney for health care are valid in all states.

What an attorney in fact can do is governed by state law. States that have adopted statutory forms for durable powers of attorney usually list limitations in their statutes that bind the attorney in fact. Many states limit the scope of the medical decisions that can be made for a principal without a court conservator or guardian over the person. The medical decision limitations define acts reasonable attorney in fact would not make anyway. For example, in California an attorney in fact cannot authorize convulsive treatment, psychosurgery or commitment to a mental institution. Decisions on such technical topics should be made only after joint consultation with an attorney, the principal's doctors and the court. The attorney in fact does have the power to place an incompetent principal in a nursing home. In like manner, many durable power of attorney instruments (specifically those for health care) have clauses requiring the attorney in fact to be replaced with a designated successor when he becomes incompetent or otherwise unable to perform the duties of attorney in fact.

Unlike a durable power of attorney for financial affairs, a durable power of attorney for health care cannot be terminated by a court appointed conservator or guardian for a person who has one. Some states have created mandatory statutory forms for the creation of durable powers of attorney for health care whereas other states have no particular forms or their statutory forms are not mandatory. The use of statutory forms is not mandatory. Even though the forms may not be mandatory, their use should be considered because there is less chance of ambiguities arising in a statutory form. Following is both a uniform durable power of attorney for health care and a combined uniform durable power of attorney form for financial affairs and health care for use in states that have not adopted a statutory form or which permit use of alternative forms. Both Ohio and Tennessee require any durable power of attorney to have a specific notice provision in it in order to be valid. A companion book for Powers of Attorney have been written for this legal series which contains the statutory forms for the states where their use is mandated or recommended.

DURABLE POWER OF ATTORNEY FOR HEALTH CARE

KNOW ALL MEN BY THESE PRESENTS, that I, _______________ _________________________________ residing at_____________________ ____ do declare this to be a durable power of attorney.

This power of attorney shall not be affected by subsequent incapacity of the principal.

I hereby revoke all prior powers of attorney regardless of the type and to whom they may have been given.

I hereby nominate, constitute and appoint ___________________ ____ whose address and telephone number is: ____ ____

as my true and lawful attorney in fact, for me and in my name, place and stead, and for my use and benefit, to exercise the following powers:

This durable power of attorney shall become effective:

(   ) Immediately upon execution of this durable power of attorney.

(   ) Only after certification by two licensed physicians that I lack the mental capacity to make health care and financial decisions for myself.

(1) To make health care decisions on my behalf. "Health care decisions" means decisions on my care, treatment and procedures to be used to maintain, diagnose and treat my physical condition.

This durable power of attorney as it pertains to health care decisions does not carry the power to authorize any of the following acts:

(a) Any commitment or placement in a mental health facility,

(b) Any convulsive treatment, or

(c) Any psychosurgery.

Furthermore, I hereby expressly authorize any physician, hospital, or other person or organization to release and disclose to my agent any information any of them may have concerning any treatment, diagnosis, recommendation or other fact, which they may have concerning my physical condition and any health care, counsel, treatment or assistance provided to me either before or after the execution of the power of attorney, any privilege hereby being expressly waived as to such disclosures. This waiver shall extend to communications to my agent only and shall not be deemed a general waiver of the privilege. My agent may, however, authorize release of such information to such third persons as my agent deems to be reasonable or necessary in the exercise of the powers granted in this instrument.

(3) Subject to any limitations in this document, my agent has the power and authority to do all of the following:

yes ( ) no ( ) (a) Authorize an autopsy.

yes ( ) no ( ) (b) Make a disposition of a part or parts of my body under the Uniform Anatomical Gift

Act.

yes ( ) no ( ) (c) Direct disposition of my remains.

The attorney in fact under this durable power of attorney is specifically not given and does not have the authority or power to revoke, amend or alter any living will declaration or last will and testament that I have created or will create.

The Attorney in Fact (   ) is (   ) is not granted reasonable compensation for services rendered under this Power of Attorney.

Special instructions or authority: ___________________________

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If ______________________________is not available or becomes ineligible or unable for any reason to act as my agent and to make decisions for me, or if I revoke appointment or authority to act as my agent, then I designate and appoint __________________________ ___________________, address: _________________________________ __________________ phone: ___________________ as my alternative, true and lawful attorney in fact with all of the powers enumerated above, including the power to make health care decisions on my behalf.

IN WITNESS WHEREOF, I have hereunto signed my name on this ________ day of ______________________, at ____.

____

In exercising this DURABLE POWER OF ATTORNEY am aware that I have the following rights regarding this Durable Power of Attorney.

1. This document gives to the person whom I designate as my attorney in fact the power to make health care decisions for me subject to the limitations and statement of my desires that I have included in this Document. The power to make health care decisions for me may exclude consent, refusal of consent, or withdrawal of consent to any treatment, service or procedure to maintain, diagnose or treat physical or mental condition. I may state in this document any type of treatment or placements that I do not desire.

2. The person whom I designated in this document has a duty to act consistent with my desires as stated in this document or otherwise made known or, if my desires are unknown, to act in my best interests.

3. Except as I have otherwise specified in this document, the power of the person whom I have designated to make health care decisions for me may include the power to consent to my doctor not to give treatment or to stop treatment which could keep me alive.

4. Unless I specify a shorter period in this document, this

power will exist for seven (7) years from the date I execute this document, and if I am unable to make health care decisions for myself at the time the seven (7) year period ends, this power will continue to exist until the time I become able to make health care decisions for myself.

5. Notwithstanding this document, I have the right to make medical and other health care decisions for myself so long as I give informed medical consent with respect to the particular decision. In addition, no treatment may be given to me over my objection, and health care to keep me alive may not be stopped if I object.

6. I have the right to revoke the appointment of the person designated in this document by notifying that person of the revocation in writing.

7. I have the right to revoke the authority granted to the person designated in this document to make health care decisions for me by notifying the treating physician, hospital, or other health care provider orally or in writing.

8. The person designated in this document to make health care decisions for me has the right to examine my medical records and to consent to their disclosures unless I limit this right in this document.

Dated: _______________

____

ATTESTATION

I declare under penalty of perjury under the laws of the State of _______________ that ___________________________, the person who signed this document is personally known to me or proven to me on the basis of convincing evidence to be the Principal, that the Principal signed or acknowledged to this Durable Power of Attorney in my presence, that the Principal appears to be of sound mind and under no duress, fraud, or undue influence; that I am not the person appointed as attorney in fact by this document, and that I am not a health care provider, the operator of a community care facility, nor an employee of an operator of a community care facility, nor the operator of a residential care facility for the elderly, nor an employee of an operator of a residential care facility for the elderly.

I further declare under penalty of perjury under the laws of the State of _______________________ that I am not related to the Principal by blood, marriage, or adoption, and to the best of my knowledge I am not entitled to any part of the estate of the Principal upon the death of the Principal under a will now existing or by operation of law.

DATED:______________________

___________________________________ ______________________________

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___________________________________ ______________________________

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____________________________________ ___________________________________

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CERTIFICATE OF ACKNOWLEDGMENT OF NOTARY PUBLIC

STATE OF ______________

COUNTY OF ______________

On _________________ before me, ______________________________ personally appeared ____ personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS MY HAND AND OFFICIAL SEAL.

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Signature

DURABLE POWER OF ATTORNEY

FOR BOTH HEALTH CARE AND FINANCIAL AFFAIRS

KNOW ALL PEOPLE BY THESE PRESENTS, that I, ______________________________________ residing at ____, phone number ________________ do declare this to be a Durable Power of Attorney.

This Durable Power of Attorney shall not be affected by subsequent incapacity of the principal.

This Durable Power of Attorney shall become effective:

( ) Immediately upon the execution of this Durable Power of Attorney.

( ) Only after certification by two licensed physicians that I have been determined to lack the capacity to make health care and financial decisions for myself.

I hereby revoke all prior powers of attorney regardless of the type or to whom they may have been given.

I hereby nominate, constitute and appoint ______________________________________, whose address and telephone number are: ____, as my true and lawful Attorney in Fact, for me and in my name, place and stead, and for my use and benefit, to exercise the following powers:

(1) To make health care decisions on my behalf. Health care decisions means decisions on my care, treatment, or procedures to be utilized in order to maintain, diagnose or treat my physical

condition. This Durable Power of Attorney, as it relates to health care decisions, does not carry with it the power to authorize any of the following acts:

(A) Any commitment or placement in a mental health facility,

(B) Any convulsive treatment, or

(C) Any psychosurgery.

Furthermore, I hereby expressly authorize any physician, hospital, and any other person or organization, to release and disclose to my agent any information any of them may have concerning my physical condition and any health care, counsel, treatment, or assistance provided to me either before or after the execution of this power of attorney, any privilege hereby being expressly waived to such disclosures. This waiver shall extend to communications to my agent only and shall not be deemed a general waiver of the privilege. My agent may, however, authorize release of such information to such third persons as my agent deems to be reasonable or necessary in the exercise of the powers granted in this instrument.

(2) Subject to any limitations in this document, my agent has the power and authority to do all of the following:

yes ( ) no ( ) (a) Authorize an autopsy.

yes ( ) no ( ) (b) Make a disposition of a part or parts of my body under the Uniform Anatomical Gift Act.

yes ( ) no ( ) (c) Direct disposition of my remains.

(3) Subject to any limitations in this document, I hereby grant to my agent full power and authority to act for me in my name, in any way which I myself could act, with respect to the following matters as each of them to the extent that I am permitted to act through an agent:

(A) Real estate transactions,
(B) Tangible personal property transactions,
(C) Bond, share and commodity transactions,
(D) Financial institution transactions,
(E) Business operating transactions,
(F) Insurance transactions,
(G) Retirement plan transactions,
(H) Estate transactions,
(I) Claims and litigation,
(J) Tax matters,
(K) Personal relationships and affairs,
(L) Benefits from military service,
(M) Records, reports and statements,
(N) Full and unqualified authority to my agent to delegate any and all of the foregoing powers to any person or persons whom my agent shall delegate.

(4) To ask, demand, sue for, recover, collect, and receive such sums of money, debts, dues accounts, legacies, bequests, interest, dividends, annuities, and demands whatsoever as are now or shall hereafter become due, owing payable or belonging to me and have, use and take all lawful ways and means in my name or otherwise, and to compromise and agree for the acquittance or other sufficient discharge of the same.

(5) For me in my name, to make, seal, and deliver, to bargain, contract, agree for, purchase, receive, and take lands, tenements, hereditaments and accept the possession of all lands, and deeds of assurances, in the law therefor, and to lease, let,

demise, bargain, sell, remise, release, convey, mortgage, and hypothecate lands, tenements and hereditaments upon such covenants as they shall think fit.

(6) To sign, endorse, execute, acknowledge, deliver, receive, and possess such applications, contracts, agreements, options, covenants, deeds, conveyances, trust deeds, security agreements, bills of sale, leases, mortgages, assignments, insurance policies, bills of lading, warehouse receipts, documents of title, bills, bonds, debentures, checks, drafts, bills of exchange, notes, stock certificates, proxies, warrants, commercial paper, receipts, withdrawal receipts and deposit instruments relating to accounts or deposits in or certificates of deposits of banks, savings and loans or other such institutions or associations, proof of loss, evidences of debts, releases and satisfaction of mortgages, judgments, liens, security agreements, and other debts and obligations, and such other instruments in writing of whatever kind and nature as may be necessary or proper in the exercise of the rights and powers herein granted.

(7) Also to bargain and agree for, buy, sell, mortgage, hypothecate, and in any and every way and manner deal in and with goods, wares and merchandise, choices in action, and to make, do and transact all business of whatever nature and kind.

(8) Also for me and in my name, and as my act and deed, to sign, seal, execute, deliver, and acknowledge such deeds, leases, mortgages, hypothecations, bottomries, charter parties, bills of

lading, bills, notes, receipts, evidences of debt, releases and satisfaction of mortgages, judgments and other debts, and other such instruments in writing of whatever kind and nature as may be necessary and proper.

(9) To have access at any time or times to any safe deposit box rented by me, wheresoever located and to remove all or any part of the contents thereof, and to surrender or relinquish said safe deposit box, and any institution in which such safe deposit box is located shall not incur any liability to me or to my estate as a result of permitting my agent to exercise this power.

(10) I hereby grant all of the following powers to my attorney in fact that may be necessary in order to make me eligible for nursing home assistance if it is deemed in my best interests.

A. Make gifts from any revocable trust I have created to the remainder beneficiaries in the trust to the extent needed to qualify the myself for nursing home assistance even if this means terminating the trust for lack of assets.

B. Declare any revocable trust I have created irrevocable and renounce all future interests in the trust for me.

C. In any community property joint trust created between myself and my spouse, the attorney in fact may transmute all or any part of my community property interests into separate property and give that property in fee to my spouse.

I specifically approve this provision ___________________________

(11) I hereby expressly authorize any attorney of mine, past or present, to release and disclose to my agent any information any of them may have concerning my legal affairs or other facts, which they may have concerning my personal affairs and any legal service, counsel or assistance provided to me either before or after the execution of this power of attorney, any privilege hereby being expressly waived as to such disclosures. This waiver shall extend to communications to my agent only and shall not be deemed to authorize a release of information to third parties and shall not be deemed a general waiver of the privilege. My agent may, however, authorize release of such information to such third persons as my agent deems to be reasonable or necessary in the exercise of the powers granted in this instrument.

(11) Giving and granting unto said attorney in fact full power and authority to do and perform every act necessary, requisite or proper to be done in and about my property as fully as I might or could do if personally present, with full power of substitution and revocation, hereby ratifying and confirming that my said attorney shall lawfully do or cause to be done by virtue hereof.

The attorney in fact under this durable power of attorney is specifically not given and does not have the authority or power to revoke, amend or alter any revocable or irrevocable trust that I have created or may create in the future.

The Attorney in Fact (   ) is (   ) is not granted reasonable compensation for services rendered under this Power of Attorney.

The Attorney in Fact (   ) is (   ) is not permitted to engage in self-dealing with my estate.

Special instructions or authority: ___________________________

____

If ________________________________is not available or becomes ineligible or unable for any reason to act as my agent and to make decisions for me, or if I revoke appointment or authority to act as my agent, then I designate and appoint ____________________________, address: ____, phone: ___________________ as my alternative, true and lawful attorney in fact with all of the powers enumerated above, including the power to make health care decisions on my behalf.

IN WITNESS WHEREOF, I have hereunto signed my name on this _ _______ day of ______________________, at ______________________________ _________________________.

____

In exercising this DURABLE POWER OF ATTORNEY, I am aware that I have the following rights regarding this Durable Power of Attorney.

1. This document gives to the person whom I designate as my attorney in fact the power to make health care decisions for me subject to the limitations and statement of my desires that I have included in this Document. The power to make health care decisions for me may exclude consent, refusal of consent, or withdrawal of consent to any treatment, service or procedure to maintain, diagnose or treat physical or mental condition. I may state in this

document any type of treatment or placements that I do not desire.

2. The person whom I designated in this document has a duty to act consistent with my desires as stated in this document or otherwise made known or, if my desires are unknown, to act in my best interests.

3. Except as I have otherwise specified in this document, the power of the person whom I have designated to make health care decisions for me may include the power to consent to my doctor not to give treatment or to stop treatment which could keep me alive.

4. Unless I specify a shorter period in this document, this power will exist for seven (7) years from the date I execute this document, and if I am unable to make health care decisions for myself at the time the seven (7) year period ends, this power will continue to exist until the time I become able to make health care decisions for myself.

5. Notwithstanding this document, I have the right to make medical and other health care decisions for myself so long as I give informed medical consent with respect to the particular decision. In addition, no treatment may be given to me over my objection, and health care to keep me alive may not be stopped if I object.

6. I have the right to revoke the appointment of the person designated in this document by notifying that person of the revocation in writing.

7. I have the right to revoke the authority granted to the person designated in this document to make health care decisions for me by notifying the treating physician, hospital, or other health care provider orally or in writing.

8. The person designated in this document to make health care decisions for me has the right to examine my medical records and to consent to their disclosures unless I limit this right in this document.

Dated: ______________________

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ATTESTATION

I declare under penalty of perjury under the laws of the State of _______________ that ___________________________, the person who signed this document is personally known to me or proven to me on the basis of convincing evidence to be the Principal, that the Principal signed or acknowledged to this Durable Power of Attorney in my presence, that the Principal appears to be of sound mind and under no duress, fraud, or undue influence; that I am not the person appointed as attorney in fact by this document, and that I am not a health care provider, the operator of a community care facility, nor an employee of an operator of a community care facility, nor the operator of a residential care facility for the elderly, nor an employee of an operator of a residential care facility for the elderly.

I further declare under penalty of perjury under the laws of the State of _______________________ that I am not related to the Principal by blood, marriage, or adoption, and to the best of my knowledge I am not entitled to any part of the estate of the Principal upon the death of the Principal under a will now existing or by operation of law.

DATED:___________________

_________________________________ _________________________________

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________________________________ ________________________________

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________________________________ ________________________________

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CERTIFICATE OF ACKNOWLEDGMENT OF NOTARY PUBLIC

STATE OF _________________

COUNTY OF _________________

On____________________ before me, __________________________

personally appeared ____ personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS MY HAND AND OFFICIAL SEAL.

____
Signature

CHAPTER 15

ASSET PRESERVATION THROUGH THE USE OF SELF-SETTLED SPENDTHRIFT TRUSTS

Probably the most interesting and controversial changes to estate planning to occur within the last 50 years have been the adoption in a minority of states of spendthrift trusts for the asset protection of the trust grantor and not just the beneficiaries' interests in the trust. This is such a major departure from the asset protection law of the majority of states that it may have, in the future, a profound effect as to how people hold title to their property in the United States.

A spendthrift trust has always been a special type of trust, the assets of which, by its own terms, could not be attached by creditors of the trust beneficiary. The history behind the spendthrift trust extends far back into English common law under which assets, primarily land, were kept intact for passage down through a family line.

By definition under the **RESTATEMENT (SECOND) OF TRUST SECTION** 152(2) (1959), a spendthrift trust is "a trust in which by the terms of the trust or by statute a valid restraint on the voluntary and involuntary transfer of the interest of the beneficiary is imposed." This has been taken to mean by all state courts that beneficiaries of a spendthrift trust cannot in any way transfer, sell or alienate their interest in the trust. Likewise, creditors of a beneficiary of a spendthrift trust, which in the past did not include a grantor if also a trust beneficiary, could not force the trustee to pay the debts of a beneficiary from the beneficiary’s interest in the trust.

HISTORY OF SPENDTHRIFT TRUSTS

The validity of a spendthrift trust as a shield from a beneficiary’s creditors was recognized by the United Supreme Court in its decision ***NICHOLS VS. EATON*** 91 U.S. 716 (1875). The case involved a trust provision calling for the termination of a trust beneficiary’s right to require the trustee to pay income to the beneficiary upon the beneficiary’s bankruptcy followed by the beneficiary’s income interest being replaced by a purely discretionary trust. Under the terms of the newly created discretionary trust, the trustee would not be under any requirement to make any payments to or for the benefit of the beneficiary. Such payments would be at the sole unfettered discretion of the beneficiary. Since such payments were discretionary and not mandatory, the Court held that the creditors of the beneficiary could not attach the assets of the trust or compel the trustee to make a distribution of the trust assets to the beneficiary so they, the creditors, could attach them. In rendering its holding the Supreme Court made clear its reasoning that a creator of trust can make arrangements to assure that the property transferred to a trust would be used for the benefit of a beneficiary and not be taken first by the creditors of the beneficiary. The Court stated:

> “[T]he doctrine that the owner of property cannot dispose of [that property], but that [the beneficiaries sought to be benefitted by the gifts in trust]....must hold [the property given into the trust for their benefit] subject to the debts due his creditors...is one which we are not prepared to announce as a doctrine of this court.”

Following the United State Supreme Court’s decision all of the states subsequently adopted the rationale set forth in ***Nichols*** and have held that spendthrift trusts are valid and protect the trust assets from attachment by the creditors of the trust beneficiary.

So complete has been this judicially created bar from a spendthrift trust’s attachment by the creditors of a trust beneficiary, that when attachment has been permitted, it has only been by legislative act. The most important and pervasive exception to rule that creditors of a spendthrift trust may not attach the trust is for claims of child or spousal support against a debtor parent or spouse who is the beneficiary of a spendthrift trust. Virtually all states have by legislation enacted laws permitting such creditor claims against a spendthrift trust for which the debtor parent or spouse is a beneficiary. Also both the states and federal government are usually able to attach a beneficiary’s interest in a spendthrift trust to satisfy that beneficiary’s tax obligations. California has gone even farther and permitted a spendthrift trust to be attached to pay the damage award of a beneficiary convicted of sexual assault. These are all limited exceptions to the general rule which remains firmly entrenched that absent a legislative acts stating otherwise, the assets of a spendthrift trust are not attachable by the creditors of a trust beneficiary.

By trust beneficiary, it had always been taken to mean someone other than the Grantor. It was always understood that while a grantor could be one of the beneficiaries or even the sole beneficiary of a spendthrift trust, the assets attributed to the Grantor in the Trust would remain attachable by the Grantor's creditors. To do otherwise, the courts have always believed would give the Grantor a means to avoid paying his or her lawful debts by simply transferring his or her assets into a trust for himself or herself. The law in virtually all states permits creditors of a trust grantor to attach the assets of the trust when the trustee has the authority to transfer the assets of the trust back to the grantor. As such, when the grantor is a beneficiary the trustee has authority to transfer some or all of the trust assets to the grantor and thus the grantor's creditors can attach the trust assets which can be transferred to the Grantor whether the Grantor wants those assets or not.

Most states have completely and totally rejected the concept of the "self-settled" spendthrift trust. This is the name given to a spendthrift trust where the grantor is a beneficiary. While the trust itself is valid, it will not protect the trust from creditors of the grantor. This is why living trusts also known as revocable trusts are not protected from the grantor's creditors while the grantor is alive. As long as the grantor of a typical revocable trust is alive, he or she may revoke the trust and reacquire the assets. For that reason, the grantor's creditors may attach the trust assets.

The majority rationale against recognition of self-settled spendthrift trusts as a means of a grantor to avoid his or her creditors arise squarely from the belief that no one should be permitted to shield his or her property from existing creditors and yet have, at the same time, effective control and use of that property.

USE OF THE SELF-SETTLED SPENDTHRIFT TRUSTS TODAY

Until 1997, it was impossible for a person to shield his or assets from existing creditors through the use of a self-settled spendthrift trust. That has changed to an extent. As of April 2000, four states, have enacted legislation which permits self-settled spendthrift trusts in one form or another. These states are:

1. Alaska (See H.B. 101, 2Oth Leg.Sess (Alaska. Apr.1, 1997) Alaska Stat Sec. 34.40.110 (1999) and 34.050(1)(3) (Michie.1999)
2. Delaware (See Del. Code Ann., tit 12, Sec 3573 (1998)
3. Missouri (See Mo.Rev.Stat Sec. 456.080, (1998)
4. Nevada (See Nev Rev Stat. 166 (1999)

For a grantor to qualify for asset protection under a self-settled spendthrift trust in any of the above jurisdictions, he must strictly comply with the statutory requirements for the state involved.

NEVADA’S ACT

The self-settled spendthrift trust law of Nevada will be discussed as an example as how the concept works. Prior to implementing its self-settled spendthrift trust legislation, Nevada followed the majority of states wherein a spendthrift would only protect someone other than the grantor of the trust. If a grantor was among the beneficiaries of a spendthrift trust, the creditors of the other beneficiaries could not attach the trust but the creditors of the grantor were permitted to attach the trust for claims against the grantor.

As of April 2000, a person can create a self-settled spendthrift trust in one of the above four states in which a grantor is also a beneficiary and which will be safe from attachment by creditors of the grantor except under very specific exceptions. To create a valid self-settled spendthrift trust in Nevada, the following requirements must be met:

1. There must be a Trustee who is
   (a) a Nevada resident
   (b) a qualified bank trust department with an office in Nevada, or
   (c) a qualified trust company with an office in Nevada
2. The Trust must be in writing
3. The trust must be irrevocable
4. The Trust must have a spendthrift provision wherein the

trustee is not required to distribute any of the income or principal to the grantor, and

5. The Trust may not be formed with the intent to hinder, delay or defraud ***known*** creditors of the grantor.

Once the trust is properly created, the grantor may be the primary beneficiary of the trust and receive virtually all of the distributions of income and principal while at the same time having the trust assets shielded from his or her creditors. For this to work, care must be taken to assure that all statutory requirements are met. While the trust must be irrevocable, the grantor can still retain some operative rights such as the right to order the trustee not to make a distribution. The grantor cannot order a distribution to be made but can order one not to be made. A Trustee other than the grantor can have discretion to make distributions of income and principal to the grantor Nev.Rev Stat. Sec. 166.040(2)(b) (Supp. 1999).

Nevada is very broad in its definition of a self-settled spendthrift trust. Under section 166.015(1) of the Nevada Revised Statutes, a self-settled spendthrift trust will be governed and enforced by Nevada law whether made in or outside Nevada if:

(a) all or a part of the land, rents, issues or profits in the trust are located in Nevada, or

(b) all or part of the personal property, money, dividends upon stock, and other intangible personal property in the trust are in Nevada, or the declared domicile of the creator of a spendthrift trust affecting personal property is in Nevada, or

(d) at least one qualified trustee has powers that include maintaining records and preparing income tax returns for the trust, and all or part of the administration of the trust is performed in Nevada.

In addition to the above, a trust will be governed by Nevada if the trust document itself states that it is to be governed by Nevada law.

If the self-settled spendthrift trust has been properly drafted then attachments for the creditor claims of the grantor are strictly limited. Under Nevada Revised Statute 166.170, creditors of a grantor in existence at the time property is transferred into a self-settled spendthrift trust must commence action within two years after the property transfer or six months after they discovered or should have discovered the transfer which ever occurs first. Creditors of the grantor arising after the transfer of the property into the trust must commence their action within two years of the transfer. Anyone becoming a creditor of a grantor more than two years after the transfer of the property into the trust should be forever barred from attaching the property, with the exception of tax liens or claims for child or spousal support as discussed above.

ALASKA'S ACT

Alaska was the first state to enact a self-settled spendthrift trust act. Alaska's legislation is effective only for spendthrift trusts created after April 2, 1997. For trusts created prior to that date the settlor’s interest may still be attached for payment of claims against the settlor.

The pertinent part of legislation as it relates to a grantor’s interest in a trust, Alaska Stat. 34.40.110 states that the “transfer restriction prevents a creditor existing when the trust is created, a person who subsequently becomes a creditor or another person from satisfying a claim out of the beneficiary’s interest, unless the

(1) transfer was intended in whole or part to hinder, delay, or defraud creditors under AS 34.40.010;

(2) trust provides that settlor may revoke or terminate all or part of the trust without consent of a person who has a substantial beneficial interest in the trust and the interest would be adversely affected by the exercise of the power held by the settlor to revoke or terminate all or part of the trust; in this paragraph “revoke or terminate” does not include a power to veto a distribution from the trust, a testamentary special power of appointment or similar power, or the right to receive a distribution of income, corpus, or both in the discretion of a person, including a trustee, other than the settlor.”

(3) trust requires that all or a part of the trust’s income or principal, or both, must be distributed to the settlor”

The above Alaskan law is quite similar to Nevada in several important respects as it relates to creditor of the grantor’s attachment of the grantor’s beneficiary interest in the trust. As in Nevada, a grantor’s interest in the trust cannot be attached if:

(1) the trust is irrevocable but the grantor can maintain a veto power over distributions

(2) the grantor cannot terminate all or part of the trust without the consent of the other affected beneficiaries.
(3) the trust does not mandate or order distributions be made to the grantor of income and/or principal, and
(4) the settlor if acting as trustee cannot have the discretion of making distributions of income or principal to himself as beneficiary.

As these issues are the same as Nevada, the Nevada discussion on them above would apply here as well.

Where Alaska law and Nevada law differ is in what is referred to as the period of contestability. This is the period of time set forth under the statute wherein a creditor may bring an action to in effect, pierce the trust for payment of the grantor’s claims. In Nevada the contestability period is two years whereas in Alaska it is four years. What this means is that a creditor of the grantor at the time the trust is created has four years after property is transferred into the trust or one year after discovery of the transfer or when he should have discovered it, whichever is later, to bring an action against the trust as a fraudulent transfer. Likewise a creditor of the grantor who becomes one after the trust is created must bring an action within four years of the transfer of property into the trust in order to attach it. Once property is in the property for more than four years, subsequent creditors of the grantor cannot attach it.

DELAWARE’S ACT

Delaware’s law regarding spendthrift trusts and their applicability is in essence the same as Alaska's. Under Del. Code.Ann.tit 12, Sec 3570, a spendthrift trust is valid as to a grantor if the trust instrument:

"a. Expressly incorporates the law of this State to govern the validity, construction and administration of the trust;

b. Is irrevocable, but a trust instrument shall not be deemed revocable on account of its inclusion of 1 or more of the following:

1. A transferor's power to veto a distribution from the trust.
2. A testamentary special power of appointment or similar power held by the transferor.
3. The transferor's potential or actual receipt of income, including rights to such income retained in the trust instrument income; or
4. The transferor's potential or actual receipt of principal is such potential or actual receipt of principal is either in the sole discretion of a qualified trustee or qualified trustees or is pursuant to an ascertainable standard in the trust instrument."

As discussed in Nevada and Alaska above, a spendthrift trust for a grantor must be irrevocable. In addition to giving a trustee sole discretion to make distributions to a grantor, Delaware permits the trust agreement to specify a specific formula for distributions to a grantor and still have the trust be a spendthrift one. Use of a specific formula, however, defeats the purpose of a spendthrift clause because even if the assets cannot be attached directly, creditors will know how much and when such distributions will be made pursuant to the formula and thereby prepare for their attachment once the distributions are paid. While the grantor may retain the right to veto a distribution of the trust, it is unclear that the veto would actually be permitted in a situation where the distribution is mandated by the trust instrument and the only reason the grantor has for vetoing it is to prevent the grantor's creditors from seizing it.

The period of contestability of a transfer of property into the trust is same as for Alaska, four years after the transfer or one year from when discovery of the transfer was made or should have been made. Persons who become creditors of the grantor more than four years after transfer of property to the trust are barred form attaching the property. The Delaware Act applies to spendthrift trusts created after July 1, 1997.

MISSOURI'S ACT

The Missouri spendthrift law is the broadest of any of the states. Mo.Rev Stat. Sec 456/080(3) states as follows:

> "(3) A provision restraining the voluntary or involuntary transfer of beneficial interests in a trust will prevent the settlor's creditors from satisfying claims from the trust assets, except:
>
> (1) Where the conveyance if assets to the trust was intended to hinder, delay, or defraud creditors or purchasers,
>
> (2) To the extent of the settlor's beneficial interest in the trust assets, is at the time the trust was established or amended;

(A) The settlor was the sole beneficiary of either the income or principal of the trust or retained the power to revoke or amend the trust, or

(B) The settlor was one of a class of beneficiaries and retained the right to receive a specific portion of the income or principal of the trust that was determined solely from the provisions of the trust instrument."

Missouri does not have a period of contestability as long as the transfer was not made to defraud creditors. This is a vague standard which has always been taken to mean a transfer of property done at a time when the settlor was insolvent and unable to pay his obligations and for inadequate consideration. It is a tenuous concept and requires affirmative proof by the creditor of the financial distress of the grantor at the time the trust was created or that the transfer was part of a pre-designed scheme to defraud creditors. Transferring property to a trust and then subsequently developing a plan to defraud creditors shields the assets from subsequent judgments by defrauded creditors so timing is important as to when a suit is made.

Missouri like Delaware permits a specific formula to be used for determining distributions to the grantor in addition to the option of giving sole discretion to the trustee. As in the Delaware discussion, the use of specific formula assures the creditors of the grantor that the fixed determined amount of distributions will be available for attachment once made to the grantor. There is no provision under Missouri law for the grantor to veto the distribution and therefore the amount could possibly be attached by the grantor’s creditors once it has been actually paid.

CONSTITUTIONAL QUESTIONS AND CONFLICTS

While a state has the authority to implement laws for its citizens and those doing business within its borders, there may be conflicts with the laws of other states when person creating self-settled spendthrift trust crosses into other states or does business in other states. As stated above, 46 states and District of Columbia do not recognize self-settled spendthrift trusts as protecting the assets of the grantor who is also a beneficiary of such a trust. The question then arises what will happen if a grantor of such trust is sued in such a state.

Because the concept of using a self-settled spendthrift trust to protect the assets of the settlor is new, no case law has developed yet to see how non-self-settling states would view suits against the grantor. However, it is extremely likely that in such an event that the non-self-settling jurisdiction (one of the 46 states and the District of Columbia majority) would disregard the trust and order payment of any judgment from the trust assets. This is consistent with the long established treatment of spendthrift trusts and was in fact how the minority states handled the issue prior to their enactment of their self-settled spendthrift trusts legislation.

The Constitutional argument is very complicated. If a non-self settling jurisdiction were to give full faith and credit to a self-settled spendthrift trust created in another state, it would be giving rights to a trust not permitted to trusts formed under its own laws. There would be an immediate conflict between the rights afforded its own citizens and those of citizens coming in from another state. The public policy determination, long settled, that no one should be able to protect or hide their assets from just judgments obtained as a result of their acts would be set aside through the use of out-of-state self-settled spendthrift trusts.

It would seem very unlikely that the majority of states would accept a self-settled spendthrift trust as protecting the grantor's assets in the trust from judgments in that state against the grantor.

However, even if a non self-settling spendthrift trust jurisdiction disregarded the trust, it still could only enforce a judgment against the trust if either the trustee or trust assets were in the state. The only person or entity who could transfer assets in the trust to pay any judgment is the trustee. If the trustee is not subject to state jurisdiction because the trustee is not in the state, then there is no way to obtain jurisdiction over the trustee so as to order the trustee to pay the judgment. Likewise, if no trust assets are in the non-self-settling state, the court of such a state could not assume in-rem jurisdiction over such property to and apply it to satisfying the judgment.

All of this assumes that under the terms of the trust document that the grantor does not have the power to replace the trustee. As long as the Grantor cannot replace the trustee, he would not be able to order the trustee to make a distribution to the grantor. Therefore, the court would not be able to order the grantor to replace the trustee with someone who would make the distribution to the grantor in order to pay off the judgment. This is very important because in the recent past individuals have been using offshore assets protection trusts known as APL's to protect their interest. These are trusts formed in other countries over which the American courts have no jurisdiction. In such instances, American courts have held the trusts invalid and punished the creators as violating American law.

In ***FTC V. AFFORDABLE MEDIA, LLC.*** 179 F.3D 1228 (9th Cir. 1999) the grantors of self-settled offshore APT were jailed for contempt pending repatriation of the assets. In the case of ***IN RE PORTNOY***, 201 B.R. 685 (1996) a transfer to an APT was found in violation of public policy when a foreign trust was created to shield the grantor's assets from a personal guarantee that was to be called. Both of these APT cases were prior to the enactment of the self-settled spendthrift acts of Alaska, Delaware, Missouri or Nevada but there is no reason to believe given the reasoning of those court's that their outcome would be different today. Generally it is better to assume that federal courts, state courts and federal agencies are more apt to regard a self-settled spendthrift formed under a valid state law as more legitimate and enforceable than one established under the laws of foreign country and thereby exempt from review under American law.

CONCLUSION-LICENSE TO STEAL?

It may seem to many that the new asset protection laws which permit self-settled spendthrift trusts are thinly disguised licenses to steal. Certainly, an argument can be made for that position. Now, under the laws of Alaska, Delaware, Missouri and Nevada, that if a person properly creates a self-settled spendthrift trust in a state that allows them, then after a certain period of time, the trust will become exempt from attachment for any judgment against the grantor. The time limit for this period varies among the states from two years in Nevada to four years in Delaware and Alaska and immediately in Missouri but it will happen in time. What this means is that a person can transfer assets into the trust and if no lawsuit or liability against the grantor arises during this period of contestability that at its conclusion the assets are automatically free from attachment at a later date.

The rights of the creditors under self-settled spendthrift trusts in states permitting them are different depending on status. The creditors are separated into two classes: those in existence when the trust was created and those arising after the trust was created.

1. For the second class of the creditors the treatment is rather straightforward if the creditors become so after the period of contestability has run, then they cannot bring suit to attach the trust assets. State law will determine if they can seize the trust assets by attachment during the period of contestability which they usually can if they can show an intent to avoid creditors.

2. For creditors in existence at the time the trust was created their treatment is more complicated. Generally, a current creditor in order to protect his or her interest must bring a suit against the trust as soon as the transfer is known even if the debtor is not yet in default in order avoid the period of contestability from running. In Nevada for instance, such a suit must be brought within two years of the transfer into the trust or six months after discovering the trust of facts that would leading a person to discovering the existence of the transfer to the trust which ever occurs later. If the suit is not timely brought, the assets in the trust cannot be attached for payment of the grantor's debts.

In short, assets transferred into a self-settled spendthrift trust will be totally exempt from subsequent creditors after the contestability has run whatever it is for the state being used. There is no other provision in American law which permit people to create such a complete shield for their assets.

In order to create a self-settled spendthrift trust, the revocable trusts in the Estate Planning Two book published by ***LAWYER AT LARGE LLC.*** and ***ATTORNEY ET AL, LLC***. can be used with the following simple changes:

1. Delete the Article making the trust revocable. Instead insert a new article stating something to the effect: **"THIS TRUST SHALL BE IRREVOCABLE. THE GRANTOR HAS THE INTENT OF MAKING CREATING AN IRREVOCABLE SELF-SETTLED SPENDTHRIFT TRUST UNDER THE LAWS OF THE STATE OF _____________"** (insert the name of the state in which self-settled spendthrift trusts are permitted)
2. Insert in the Article of the trust which calls for the name of the state whose governing law will be used the name of the state which permits self-settled spendthrift trusts which is the same state as in number one above.
3. Designate a trustee other than the grantor and it would be best to even state that the grantor cannot be the trustee. It is best that the trustee be a resident of the state named in number 1 and 2 above. In fact Nevada requires it.
4. You must state that the trustee has absolute discretion to make distributions of income and principal to the grantor as beneficiary but the beneficiary may not require or force the beneficiary to do make such distributions.
5. You may also insert language limiting the grantor’s power to remove a trustee, but there is no guarantee that it will work as it has never been tested, something to the effect that:

   "The grantor may not replace a trustee pursuant to a court order from a court outside of the state whose governing law is used if such replacement is done solely with the intent to have the new trustee make a distribution of assets of the trust for payment of the debts of the grantor if the current trustee could not be

> ordered by the such court to make the distribution directly under the governing state’s laws. In such an event, it should be left to a court of the governing state to determine if the trustee replacement is proper or if it violates the law or public policy of the governing state."

There is no way to determine if such a clause would be enforceable but its intent is to make clear that of the grantor's intent that the trust assets should not be attached for the grantor's debts wherever located if the attachment would violate the law of the governing state.

You might circumvent this issue entirely by stating that the grantor cannot replace the replacement the trustee and that replacement can only be a court of the governing state. As such only assets located the state, which does not have governing authority over the trust could be attached by one of its courts.

The use of self-settled spendthrift trusts will afford almost complete protection for a grantor’s assets if the assets are transferred into a state which permit such trusts and the trustee is a resident of such a state and the grantor cannot replace the trustee or order the trustee to make a distribution. If any of these elements are missing, then it becomes problematical whether a judgment obtained against a grantor in a state which does not permit self-settled spendthrift trusts can be enforced against the trust.

IMPORTANT NOTICE:

TAX CHANGES BY THE, THE ECONOMIC GROWTH AND TAX RELIEF ACT OF 2001 AND THE BUDGET ACT OF 1997

The **JOB & GROWTH TAX RELIEF RECONCILIATION ACT OF 2003**, the **ECONOMIC GROWTH AND TAX RELIEF ACT OF 2001** along with the **BUDGET ACT OF 1997** together have resulted in the most sweeping tax changes as affecting individuals' estate and financial planning since President Reagan's first term. The major changes are as follows:

(A) CHANGE IN THE UNIFIED CREDIT

The federal unified credit which is the amount that a person can give away tax free while alive or after death which was $675,000 was raised immediately to $1,000,000 and will continue to rise to the year 2009 when it is abolished for one year then reinstated at $1,000,000 unless Congress votes to make the elimination of estate taxes permanent. The rate of unified credit schedule is as follows:

YEAR	EXEMPTION AMOUNT	TOP ESTATE TAX RATE
2002	**$1,000,000**	**50%**
2003	**$1,000,000**	**49%**
2004	**$1,500,000**	**48%**
2005	**$1,500,000**	**47%**

2006	**$2,000,000**	**46%**
2007	**$2,000,000**	**45%**
2008	**$2,000,000**	**45%**
2009	**$3,500,000**	**45%**
2010	**ESTATE TAX REPEALED FOR ONE YEAR UNLESS MADE PERMANENT**	**NONE**
2011	**$1,000,000**	**55% IF REPEAL NOT MADE PERMANENT**

GIFT TAX NOT REPEALED

The gift tax is not repealed in 2009 along with the Estate Tax. To prevent taxpayers transferring property which generates income tax from higher to lower rate taxpayers, the 2001 Tax Act retains a modified gift tax. Beginning in 2010, total gifts made in excess of a lifetime $1,000,000 exemption would be subject to a gift tax equal to the top individual income tax rate at that time.

(B) CHANGE IN STEPPED-UP BASIS OF INHERITED PROPERTY.

Prior to the 2001 ACT, property inherited from a decedent was given a stepped up basis to fair market value. This meant that it could immediately be sold without incurring any capital gain taxes.

Now once estate taxes are fully repealed in 2010, the basis of assets received from a decedent will carry over from the decedent, rather than be stepped up to fair market value at the date-of- death or alternate valuation date as is now the law. Two exceptions to the rule will be available to help many estates:

a. $1.3 million of basis will be allowed to be added to certain assets; and

b. $3 million of basis will be permitted to be added to assets transferred to a surviving spouse.

However, to further complicate the matter, not all property is eligible for an increase in basis. Property acquired by a decedent by gift from a non-spouse less than three years before death is excluded (to prevent “gifts” of low basis assets in anticipation of stepped-up bequests). Similarly, property that constitutes a right to receive income in respect of a decedent is excluded. Stock in foreign investment arid personal holding companies also is ineligible for an increase in basis.

C REDUCTION IN THE CAPITAL GAIN RATE

The federal capital gain rate was cut under the Budget Act of 1997. The new rates are:

Prior to Jan 1, 2001, the following were the capital gain rates:

1. 28% maximum on collectibles
2. 25% maximum on real estate gains attributable to depreciation
3. 10%/20% rate on stock, bonds and real estate. The rate is 10% on gains falling in the 15% bracket and 20% for gains above this.

Beginning in January 1, 2001, for assets held more than five (5) years:

4. 8%/20% rate on stocks, bonds and real estate held more than

five years. The rate is 8% on gains falling in the 15% bracket and 20% for gains above this.

Beginning on January 2, 2006, there is another rate:

5. 8%/18% on stock, bonds and real estate held for more than five years and acquired after 12/31/00. The rate is 8% on the 15% bracket and $18% for gains above this. There is a special election possible after Jan 2, 2006 to “convert” property acquired before 12/31/00 into property acquired afterward.

UNDER THE 2003 ACT

Reduction in tax rates on dividends and capital gains.

Under the 2003 Tax Act, the maximum tax rate on dividends distributions by corporations to individuals and on individual capital gains is reduced to 15% in 2003 through 2008.

For Taxpayers in the 10% and 15% ordinary income tax rate brackets, the rate on dividends and capital gains is reduced to 5% in 2003 through 2007, and to zero(0) in 2008.

The new rates apply to capital gains realized on or after May 6, 2003, and to dividend income received in 2003 and after.

D.

INCOME TAX RATE CUTS

Under the 2001 Tax Act, there was a ***$958*** billion consolidation and reduction of the marginal tax rates for individuals. Under the 2001 Act was created a new 10 percent rate bracket. The other individual income tax rates (except the 15 percent rate) were also cut for 2001, effectively by 0.5 percent across the board.

There will now be six rate brackets for individuals. The new 10 percent rate is carved out of the existing 15 percent bracket .

Under the 2003 TAX ACT, the 10% bracket will apply to the first $14,000 of income for couples, $7,000 for singles, and $10,000 for heads of household, and adjusted for inflation thereafter).

UNDER THE 2003 TAX ACT

Under the 2003 tax act, reductions in income tax rates in excess of 15% for 2004 and 2006 are accelerated to 2003 which resulted in new rates of 25, 28, 33 and 35% respectively.

These reductions benefit married couples with taxable income greater than $47450 and single taxpayers with taxable income greater than $28,400.

E. REDUCTION OF THE MARRIAGE PENALTY

The 2001 and 2003 Tax Acts reduced but could not eliminate the marriage penalty under Federal Tax Law. The marriage penalty will not change until 2005. Then in 2005 partial relief will be given in two form:

(1) Joint filers will be given a standard deduction that is twice the amount of standard deduction provided to single filers, phased in 2003 and 2004, and

(2) The high-end of the income level falling under the 15 percent tax rate bracket will be expanded to an amount equal to twice that of single taxpayers.

These changes will not help married taxpayers above the 25% tax bracket who do not take the standard deduction. Likewise the change does not impact taxpayers in the 15% bracket of the pre-2001 ACT. As such both groups of taxpayers will continue to subject to the full marriage penalty.

ALTERNATIVE MINIMUM TAX RELIEF

To ensure that the benefits of the marriage penalty relief are not subject to the alternative minimum tax, AMT, the exemption amount for the AMT is increased by $9,000 for married taxpayers and by $4,500 for single taxpayers in 2003 and 2004.

(F) HOME SALE TAX CUT

Under the Budget Act of 1997, the first $500,000 in a couple’s profit from the sale of a principal residence and $250,000 for an individual will be excluded from taxation. This credit can be used every three years. The home must be the principal residence for 2 of the previous 5 years. This replaces the previous credit of to $125,000 and available once to taxpayers over the age of 55.

(G) IRA CHANGES

(1) FOR HOME PURCHASES

Penalty free withdrawals of up to $10,000 are now permitted pursuant to the Budget Act of 1997 for home purchase expenses by first time home buyers or their children or spouses if the person was without ownership interest in a home within 2 years of the purchase.

(2) FOR TUITION EXPENSES

Penalty free withdrawals from IRA’s are now permitted for the payment of tuition expenses for the person, child, spouse or grandchild.

(3) IRA ACCOUNTS

A new type of IRA was created in the Budget Act of 1997 called the IRA Plus (ROTH) Account. Contributions to these accounts are not tax-deductible and count toward the $2,000 per year limit but the interest, dividends and capital gains earned are tax free until withdrawn as an IRA distribution.

Under the 2001 Tax Act, the contribution limits for both traditional and Roth IRAs rise from a $2,000 annual cap to $5,000 as follows: $3,000 for the years 2002- 2004; $4,000 for 2005-2007; and $5,000 for 2008 and thereafter along with annual adjustments for inflation after 2008.

A special catchup provision was created for taxpayers who are age 50 and above. Such taxpayers will be permitted to contribute what has been termed as “catchups” to their IRA accounts. Such catchup taxpayers can contribute to an IRA an additional $500 in 2002- 2005; $1 ,000 in 2006 and all years thereafter. These “catchup” payments can either be deductible or made to a Roth IRA, if the base-line AGI limits are met for regular contributions for the year.

(H) CREDITS FOR PARENTS

(1) CHILD TAX CREDIT

The 2003 Tax Act eliminated the phase in period of the $1,000 child tax credit and granted it immediately for 2003 and 2004. The $400 per child increase in the credit for 2003 will be paid immediately. Advance payments will be sent beginning inn mid-July 2003 to parents based on their 2002 return.

2. ADOPTION CREDIT

The 2001 TAX ACT increases the credit for adoptions to $10,000 for both special needs adoptions (currently at $6,000) and non-special needs adoptions (currently at $5,000). Starting in 2002, the ACT also doubles the income phase-out range*s starting point from $75,000 to $150,000.

3. DEPENDENT CARE TAX CREDIT

The 2001 Tax Act increases the dependent care credit rate from 30 to 35 percent. It also increases the amount of eligible employment-related expenses from $2,400 to $3,000 (from $4,800 to $6,000 for more than one qualifying individual), and increases the beginning point of phase-out income to $15,000 of adjusted gross income, starting in 2002.

(4) EDUCATION SAVINGS ACCOUNT

Under the Budget Act of 1997, a married couple with an income less than $150,000 or single parents with income less than $95,000 can establish education savings accounts similar to IRAs for children and contribute. Contributions are not deductible on the parents’ tax return but earnings are tax free IRC Section 530(b).

The 2001 Tax Act raised the limit on contributions from $500 to $2,000. The new law also exempts special needs beneficiaries from the prohibition against contributions being made after a beneficiary turns 18. Starting in 2002, contributions will be allowable not only from individuals but also from corporations, tax-exempt organizations and other entities. Contributions counted toward any tax year will be permissible until April 15 of the following year, rather than being cut off on December 31.

Under 2001 Tax Act more taxpayers are eligible to contribute to an education savings account by raising the phase out limits. The 2001 Tax Act doubled the contribution phase-out range for joint filers of $ 150,000–$ 160,000 to double that of single filers ($ 190,000– $220,000).

The 2001 Tax Act also permits proceeds in education savings accounts to be used to pay for elementary and secondary school tuition, both public and private, as well as the costs of higher education. Permitted expenses covered under the 2001 ACT include tutoring, computer equipment, room and board, uniforms and extended day program costs.

(5) COLLEGE TAX CREDIT

There is a $1,500 a year tax credit for the first two years and $1,000 per year thereafter. This credit begins to phase out for couples earning $80,000 to $100,000 and individuals earnings $40,000 to $50,000.

(6) STUDENT LOAN DEDUCTION

The Budget Act of 1997 created two education related credits. The Hope Scholarship Credit : The first $1,000 of tuition and $500 of the second $1,000 of tuition. The Life Earning Credit: 20% of qualified tuition for any year the Hope Scholarship is not used. It is 20% if the first $5000 to the year 2003 which thereafter raises to $10,000.

The 2001 Tax Act extended the credits as follows:

(1) HOPE and Lifetime Learning tax credits can be claimed in the same year as education IRA distributions, as long as the IRA distribution is not used to pay for the same costs used to claim the education credit.

(2) Penalty-free contributions to education IRAs and qualified state tuition programs to be made in the same year.

The 2001 Tax Act raises the amount of student loan interest which can ve deducted. The prior tax law only permitted taxpayers to deduct up to *$2,500* in student loan interest above-the-line. The deduction also had been severely limited by the requirement that a taxpayer*s adjusted gross income must fall under a certain threshold and the interest must be attributable to payments made during the first 60 months in which interest payments are required.

The 2001 Tax Act removed the above restrictions. The 2001 Tax Act raises the income phase-out thresholds (to ***$55,OOO - $65,OOO,*** from $40,000-$50,000, for single taxpayers, and to $100,000-$130,000, from $60,000-$75,000, for joint taxpayers). The 2001 Tax Act also repeals completely both the annual dollar limit on the amount of the deduction and the 60-month limit.

7. COLLEGE TUITION DEDUCTION

The 2001 Tax Act creates an above-the-line deduction for qualified higher education expenses. For 2002-2003, a single taxpayer with adjusted gross income below $65,000 ($130,000 if married) will be entitled to an above-the-line tuition deduction of $3 ,000 each year. The deduction will increase, for the years of 2005 and 2005, to $4,000 for single taxpayers with incomes falling below $65,000 and for married taxpayers filing jointly with incomes below $130,000. The Act gives both single taxpayers with incomes up to $80,000 along with for joint filers with incomes up to $160,000 a maximum deduction of $2,000 in 2004 and 2005. This deduction cannot be claimed for the same student in the same year as a HOPE or Lifetime Learning credit is claimed for the student.

8. EMPLOYER-PROVIDED CHILD CARE CREDIT

The 2001 ACT allows employers a credit equal to 25 percent of qualified expenses for employee child care and 10 percent of qualified expenses for child care resource and referral services, to a maximum $150,000 per year credit. Effective beginning after 2001.

I. PENSION PLAN CONTRIBUTIONS

Under the 2001 Tax Act, the limits on contributions to pension plans rise considerably.

Beginning in in 2002, the limit on annual addi**tions to a defined contribution plan will** rise to $40,000.

For defined benefit plan, the annual limit on benefits will rise from $140,000 to $160,000.

For 401(k) plans, the limit on salary reduction contributions to IRC §401(k)-type plans (including 403(b) annuities and salary reduction SEPs) will rise from $10,500 to $15,000 by 2006 (scheduled to rise to $11,000 in 2002, and increase by an additional $1,000 each year until 2006).

J. SMALL BUSINESS EXPENSES AND DEDUCTIONS

The 2003 Tax Act made two significant tax changes which help small businesses.

1. The 2003 Tax Act increased the amount of investment that may be immediately deducted by small businesses from $25,000 to $100,000. The amount of investment qualifying for this immediate deductions begins to phase out at $400,000.

2. The additional first year bonus depreciation is increased for 30% to 50% for investments placed in service after May 5, 2003 and before January 1, 2005.

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