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IMPORTANT ESTATE PLANNING INFORMATION FOR 2009

DEAR FRIENDS AND CLIENTS:

We hope this letter finds you well with hope for the new year, notwithstanding the economic turbulence of the past few months. In this letter, we want to alert you to a possible important change in your trust documents (see discussion below) due to the current economic situation, list some estate planning ideas for you to consider in a difficult economy, update you on the status of various laws impacting estate plans, and provide you with some general information on the Madoff scandal.

I. Firm Developments

But first, we would like all our friends to meet our new associate, **Brooke T. Cleary**. Brooke is from Connecticut originally, has a B.A. in English from the University of Connecticut where she graduated *summa cum laude*, a J.D. from Suffolk University Law School in Boston, Massachusetts, and a LL.M. in Estate Planning from the University of Miami School of Law. Miami is the only school in the nation that has this Master of Laws in Estate Planning, and, as many of you know, every January I attend their Heckerling Institute on Estate Planning, the top in the nation. So Brooke comes to us with a solid educational background, and we are impressed with her talents and abilities, depth of knowledge in our "niche" practice of tax and estate planning, as well as her enthusiasm and willingness to tackle any challenge. Currently she is admitted to practice law only in Florida, but will sit for the California Bar in February. You can learn more about all of our personnel on our website, *www.taxlawsb.com.*

Next, I am happy to announce that the full, unabridged edition of my book is now published and available on Amazon and Barnes & Noble. ***"For Love & Money, Protecting Family & Wealth in Estate & Succession Planning with a New Approach Blending Law and Psychology"*** is a collaboration with two Boston psychiatrists involving extensive research and development of models to aid families and businesses with the transitions that occur when the next generation comes into the business. Both the full edition and a condensed edition are available. (Also see the website, *www.familiesandwealth.com*.)

Now for our list of important estate planning concerns, general reminders, and a few comments about the tax and other legal implications of the Madoff situation.

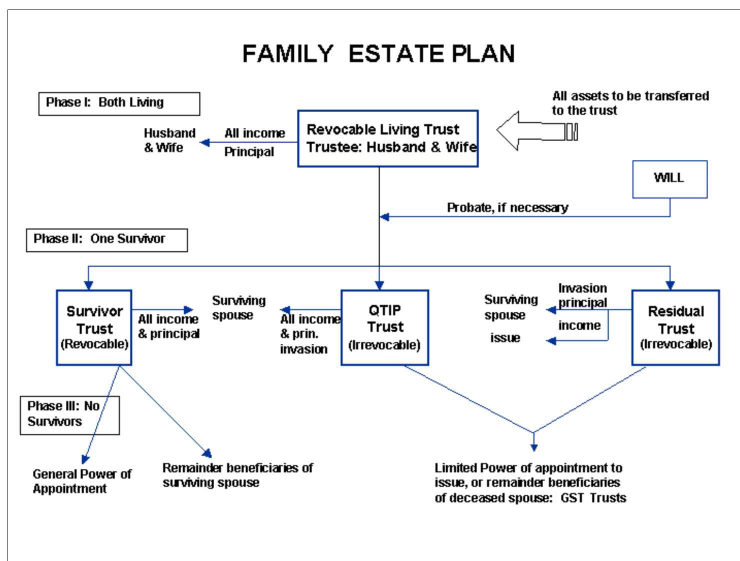
II. Important: Possible Change to Your Marital Deduction Formula in Your Trust

The following discussion only applies to married couples who have a revocable family trust designed for estate tax planning and the avoidance of probate. **<u>If only one spouse is living or you are a single person, please skip the following discussion and go directly to the next section.</u>**

We apologize for the general nature of this letter and also for the complexity of the following discussion, but it is important for you to understand what the economy means to the terms of your trust so that you can make an informed decision. Please feel free to call either Cheryl Wright or me if you have any questions.

In this <u>deflationary</u> economy, for some clients where both spouses are now living, it is necessary to consider making an amendment to your trust to accommodate falling asset values.

As you can imagine, it is exceedingly difficult to draft estate plans and trust provisions in both an inflationary economy and in a deflationary economy as well as when the current law has three different taxing schemes (2009, 2010, 2011). In some cases (e.g., where only one spouse is living), no changes are necessary to your estate plan. However, if both spouses are now living and you have experienced or expect your asset values to decrease, we may need to change your trust. Recall that the general pattern of division of the trust after the death of one spouse is as follows:



Specifically, we are concerned that in some situations, a trust with a "pre-residuary pecuniary marital deduction" formula that sets the amount of the assets owned by the first spouse to die at the time of death that will pass to the QTIP Trust after the death of the spouse and the time it takes to actually fund the QTIP Trust, would not work well if you expect that your assets will continue to decline in value after the death of that first spouse until the QTIP Trust funding. Previously, we designed trusts with the idea that family assets were expected to continue to increase in value after the death of the first spouse, in such a way that would allow us to allocate more assets to the Residual Trust, and less to the QTIP Trust, than the exemption amounts then in effect. This in turn could save significant estate taxes on the second spouse's death. That is, in a general inflationary economy.

However, in a deflationary economy, the marital deduction formula that we have usually used when both spouses are living **could possibly result in the loss of some or all of the 2009 estate tax exemption amount to be allocated to the Residual Trust (currently $3.5 million).** We can avoid this problem if we use another type of marital deduction formula, namely a "pre-residuary residual trust" in which case we can protect your exemption amount in a falling market. Previously, we could plan around most of these difficulties; however, with the uncertainty in both the economy and the future law, plus the high $3.5 million exemption amount this year, for particular situations it may be prudent to make the suggested amendment to the terms of your trust if both spouses are now living and you expect that your assets may continue to fall in value after the death of one spouse. However, this really needs to be reviewed on a case-by-case basis in light of what the family assets are and how the trust presently reads.

If you would like to make the change to the new marital deduction clause, just let us know and we will either send you a trust amendment for you to sign or you may arrange a time to come in and sign the amendment with Cheryl. Just let us know which is the most convenient for you.

There is a second issue where children or stepchildren are beneficiaries of the Residual Trust. **With the exemption now as high as $3.5 million, plus the deflationary economy, there could be a result in some instances that fewer assets will be available for the surviving spouse to be properly taken care of than the spouses had intended.** This also needs to be reviewed on a case-by-case basis.

If we do make the change in your trust document, it may or may not be necessary to change it back unless Congress makes other changes in the tax law and we know the impact of inflation to the US economy in the future. In other words, it may be necessary to revisit the marital deduction formula issue a few years from now.

As mentioned above, if you have any questions or comments please call us, otherwise we will assume that you are not concerned.

III. Steps to Consider in a Difficult Economy

- Check your brokerage account paperwork. If you have authorized them to hold margin accounts, then your funds are subject to the broker's general liabilities.

- Make sure your funds are placed so as to have as much FDIC coverage as possible. The FDIC limits were recently raised from $100,000 to $250,000 **but this is only temporary until the end of 2009**. Most coverages return to $100,000 on January 1, 2010. In addition, this amount is combined for all deposit categories per person, i.e., if you have an account in your name, and an account in the name of your trust, all at the same bank, both accounts are combined in determining the coverage limit. (More information at *www.myFDICinsurance.gov* or *www.fdic.gov*.)

- Make gifts or sale transfers now while asset values are likely lower, interest rates are low, and appropriate valuation discounts are still recognized by the IRS (so far!). For example, if

right now the stock value has been slashed in half but in the future it should rebound, consider making annual exclusion gifts of the stock when the value is low. That way the value on the rebound passes tax-free to your donees. The annual gift tax exclusion has increased to $13,000 per donor ($26,000 for both spouses) per donee in 2009. **However, carefully consider your basis in the gifted asset(s) and if that basis is higher than the current fair market value of the asset, do not gift that asset as your donees will not be able to take advantage of this loss on a subsequent sale.**

- Also recall that you can pay tuition and medical bills for children (or others) with no gift tax consequences provided you pay those bills directly to the school or the medical provider.

- Consider a modification or novation of any outstanding indebtedness with your family in order to take advantage of the current record low interest rates. The February 2009 applicable federal long term (over a nine-year term loan) quarterly payment rate (AFR) is down to 2.9% and March is "expected" to be even lower! Also note that California legislation (SB 1005, Ch. 282) allows an exclusion of up to $250,000 of cancellation-of-debt income (maximum loan amount of $800,000) pertaining to the taxpayer's principal residence. However, care must be taken to examine the possible income tax implications if you do lower the interest payments for family members and it is necessary that interest payments actually are paid.

- Consider inter-family loans as an estate planning vehicle. Parents can make very low-interest loans to children and grandchildren (see above) for their major purchases such as a home or starting a business. So long as the appreciation of the newly purchased or gifted asset over time exceeds the low interest rates, the next generation-donees will have gained all of that appreciation without any gift or estate tax consequences. Annual exclusion gifts from parents may also be made to pay down the principal, but interest must be paid as mentioned above.

- When possible, recognize a loss for tax purposes before death.

- If the market value of your California real property is significantly lower than the assessed value of the property, you can maintain a permanent reduction in property taxes by triggering a reassessment of the property. Obtaining a temporary reduction in assessed value for market conditions (which the Assessor will do) is only temporary, and the taxes will return to the higher amount as fast as the market does. Only a change in ownership triggering reassessment will re-set the base year to lower market conditions and thus limit future increases to no more than the annual 2% inflation factor. But be careful – you need to find a way, if you can, to trigger a reassessment without triggering capital gain!

- You know that when one spouse dies, the tax basis of both halves of community property assets get stepped up to the fair market value at death if it is greater than the tax basis; but it is also true that if fair market value at death is lower than tax basis then both halves of community property assets get stepped down. Therefore, if for any reason a spouse is near death, consider "transmuting" (i.e. converting the ownership character of the property) such

community property that has declined in value to separate property so that the value of the surviving spouse's assets does not get a decrease in their basis for income tax purposes.

IV. Estate Taxes

At this time, no one knows what will happen with estate taxes after the end of this year, but we do have some "rumors" to help guide us. During the campaign, President Obama stated he was in favor of retaining the estate tax with a $3.5 million exemption and a 45% rate (same as we have for 2009) and this was again confirmed in a recent article in the *Wall Street Journal*. What we hear from those close to Washington is that they do not expect new legislation to be in place by January 1, 2010, but it will probably be adopted later that year and made retroactive to January 1st. However, already in January of this year, Mr. Pomeroy from North Dakota proposed the "*H.R. 4346, The Certain Estate Tax Relief Act of 2009*" that did provide assurance that at least the exemption now in place will remain in place in 2010 and into the future. As you may recall, under present law, estate taxes are to be eliminated in 2010 (replaced by a new system of tracking capital gains), and then the estate taxes are to return in 2011 with a 55% maximum tax rate and only a $1 million estate tax exemption amount (i.e., no estate tax on an estate of $1 million in assets, or less). For 2009, the maximum tax rate is 45% with a $3.5 million estate tax exemption amount. Not having clear law in order to plan your estate, of course, is very frustrating. Current speculation includes possible elimination of discounts for family business entity valuations with passive assets (i.e., stocks and bonds, cash) and the elimination of QPRTs (qualified personal residence trusts), and the requirement that GRATs (grantor retained annuity trusts) can no longer be zeroed out. These are only speculations.

What else can you do now to lower future estate taxes?

- If you haven't done so already, **file gift tax returns** for all years in which gifts were made, even if they were only annual exclusion gifts – unless it was only cash or other easily valued assets, and if it was not going to a trust (where there might be generation skipping transfer tax exemption allocation questions). Disclosure of all prior gifts (or transactions which the IRS might want to call a gift, even if it wasn't) on a gift tax return starts a three-year statute of limitation for IRS audit. Not disclosing prior gifts means the IRS can audit the prior transaction years later during an audit of your estate tax return.

- Consider using your full gift tax exemption of $1M if you have not already done so to shift any future appreciation in value of those assets to the next generation. Always consider making the gift to an irrevocable trust to protect those gifts from possible future creditors of your family.

- Consider a valuation freeze for your assets at these lower values by using any number of possible techniques including a possible sale to your next generation for those assets either directly or in trust. If you use a trust, it is possible to avoid the payment of any income taxes on the sale proceeds by properly structuring the trust to be what is commonly called a "grantor trust."

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V. Insurance

Insurance products change over time. Trustees of ILITs (irrevocable life insurance trusts) have fiduciary duties to the trust beneficiaries, and should consider reviewing the performance and cost of the policies annually. Each year, you should ask for an in-force ledger statement from the insurance company and compare the numbers with the illustration when the policy was sold to see if it is on target. For variable policies, check if investments need to be re-allocated. Also, note that the policy may have been based on the older mortality tables (1980 CSO Mortality Tables) which actually may mean that the insurance is more costly. As of 2003 it was optional in California, and as of January 1, 2009, it is mandatory throughout the United States that all life insurance products use the 2001 CSO Mortality Tables. This updated table has longer life expectancies which can result in lower premiums for the same product.

An important reminder regarding liability insurance: we are seeing a problem in that many of our clients do not have an umbrella liability insurance policy. It is critical that you review your liability insurance and be sure that you have an adequate umbrella liability insurance policy over and above your normal liability policy. We live in a litigious society, as you know.

VI. Family Businesses

Be sure to review your partnership and LLC documents. If a date is specified for the entity to terminate, it will cease on that date and no longer exist. No one will have legal authority to act for the entity thereafter! If the entity is to terminate upon the death of a partner or member, then even if the partners elect to continue, any real property owned by the entity will likely be reassessed for property tax purposes. Also, don't forget to keep regular minutes for all corporate, partnership and LLC business decisions and transactions (and annual minutes for corporations always) and follow carefully the form of the way the entity is set up.

VII. No Contest Clauses

California's Law Revision Commission studied the issue of no contest clauses for several years, reviewing whether to make all clauses non-enforceable, on the one hand, or whether to maintain current law with some changes. The latter won out. SB 1264 was signed by the Governor (Ch. 174), is operative as of January 1, <u>2010</u>, and will apply to any instrument which became irrevocable on or after January 1, <u>2001</u>. Significantly, the new legislation bars enforcement of no contest clauses in cases where the contestant has "probable cause" to challenge the validity of the instrument. If the instrument attempts to restrict contests of other instruments (e.g., if the trust no-contest clause treats a challenge of a will or of a partnership agreement as subject to disinheritance under the trust), the enforceability of such a broad clause is severely restricted. (This overturns a line of case law.) The new law also revokes the declaratory relief provisions which had allowed a contestant to obtain a court determination as to whether a course of action was a contest or not, before taking such action. Options for reducing beneficiary litigation still include granting the trustee authority to settle certain disputes or actually moving the trust situs to another state such as Delaware which enforces no contest clauses. We will be in touch with you at a later time after the law develops further about the possibility of making changes in your appropriate documents.

VIII. General Reminders

You might want to review the last two pages of our May 2008, letter for our general estate planning reminders: Make sure that title to all of your property that should be owned by your trust or partnership or LLC is actually titled in the correct name (especially after any refinance). Make sure you have clearly stated in writing what property of spouses is intended to be community property and what is intended to be the separate property of only one spouse. Be sure your doctor, agent and any hospital have a copy of your signed "Advanced Health Care Directive" whenever you have any medical procedure done – and do not sign a new form a hospital or doctor hands you without legal advice! If you have a trust with beneficiary withdrawal provisions, be sure the trustee sends the withdrawal notices to beneficiaries every time you make a gift to the trust. And be sure to file gift tax returns (due April 15th).

- It is important that you review your retirement plan beneficiary designations to be sure that you name individuals as the beneficiary unless you name your trust and the trust has special retirement plan provisions in it. If you would like more information, please refer to the US Government Publication 590 (See *www.irs.gov/pub/irs-pdf/p590.pdf* at page 20.).

- With regard to any IRAs that you may have, consider in 2010 changing those retirement plans to Roth IRAs in order that all of the future appreciation will be available tax free. In 2010, Congress allows individual owners of IRAs to transfer their IRAs to Roths regardless of the income of the individual. Please note, however, that (1) you will be required to pay income taxes on all of the assets that you withdraw from your IRA to move it to the Roth, and (2) that there are rumors in Congress that the Roth provisions may change so you will need to double check the rules before you do a Roth conversion.

- As a reminder, there is no required minimum distributions (RMD) from your retirement plan this year (2009), if you are over age 70½. However if you were over 70½ in 2008 and you did not take your RMD for 2008, you will still be required to take that distribution by April 1, 2009, or otherwise you will face stiff IRS penalties.

- If there is any chance that one of your beneficiaries may have special needs and be entitled to any governmental benefits (e.g., disability), it is important that you let us know so that we may make the proper adjustments to your trust to be sure that your beneficiary will continue to be eligible for governmental benefits after your passing.

- If you have any assets located in another state, it is important to determine whether that state has its own estate or inheritance taxes, in which case special provisions may be needed to be added to your family trust.

- As you know, if you have valuable art, it is important for you to be sure that the art is not subject to any future claims and as such, you may want to consider buying title insurance on that art (see, for example, *www.aris-corporation.com*) unless you feel secure that your provenance/chain of title risks are well documented. We have been told that generally 25% of claims are for stolen art and 75% are for unpaid liens.

- In California, when the settlor passes away or a trustee changes, the successor trustee must send out a notice to all of the beneficiaries (and heirs for a settlor's death) that the trustee has now changed and (for a settlor's death) that those beneficiaries and heirs have 120 days to challenge the trust! We would like to alert you that we have been setting up trusts in Delaware where beneficiaries are not entitled to any such notification. Delaware also provides other benefits not otherwise available in California. If you would like to know more about Delaware Trust law, please let Cheryl know and we will forward you a short memo regarding the advantages and disadvantages of using a Delaware trust.

IX. A Few Comments About the Madoff Situation

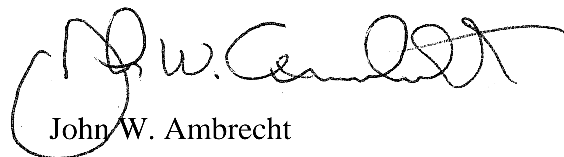
There are many legal and tax ramifications in the unhappy event you may have been invested with Mr. Madoff. The bad news is that any income a person may have received over the last six years from any Madoff investment(s) may have to be paid back. Many people are asking if there is any way to protect their assets from such a "claw back" and the answer in California is that ethical advisors cannot provide any such advice. However, in other states, the laws are different and, as such, other lawyers may be able to provide appropriate advice. Also if you have any home owners insurance you may want to check that policy to see if you may have fraud coverage endorsement. For a good explanation of the legal and tax ramifications of any such Madoff investments, you may want to review the following web sites which are from law firms presently involved in working out the issues. See *www.mosessinger.com* and/or *www.proskauer.com.*

The above information is general in nature and there will be different ramifications or applications for each person and each situation, The Internal Revenue requires us to inform you that this communication is not intended or written, nor can it be used, for the purpose of avoiding federal tax penalties.

We look forward to our continued relationship in 2009! If you would like to learn more about what this firm has been doing over the last year and all of the teaching that I have been doing around California and Arizona, please visit our web page at *www.taxlawsb.com*. We welcome any comments about this letter and our web page.

With warm regards,

AMBRECHT & ASSOCIATES



By: John W. Ambrecht