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ESTATE PLANNING FOR 2011 AND BEYOND – READING BETWEEN THE LINES

DEAR FRIENDS AND CLIENTS:

As you no doubt know, on December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the “Act”). You have probably already heard that the Act extends the Bush-era tax cuts and includes positive changes in the estate, gift and generation-skipping tax laws (the “Succession Laws” or “Succession Taxes”), many of which are summarized later in this letter. However, what has been largely ignored in the publicity surrounding the Act is that by reading between the lines we can see that there may now be the opportunity to move beyond mere “tax planning” and focus on true estate planning. This is not to say that tax planning is not important – it is in fact crucial to an estate plan – but a truly successful estate plan requires something more.

I. Introductory Comments

At its most basic level, estate planning is about what you want to do with your assets when you pass away. Historically, after quickly determining who is to inherit (family, third parties, charities, etc.), most of the focus and energy has been on the legal issues, such as avoiding probate, minimizing taxes, asset protection, etc., and those legal issues have been the primary influence in determining how assets should be distributed (whether outright or in trust for some period of time, and/or charitable purposes). Yet this approach to estate planning has not really worked given that almost all of us have heard of the family conflicts that often arise upon the death of a family member. Why are family conflicts so prevalent in the administration of an estate or trust? What has been missing in the planning process that has caused so many estate plans to fail?

Research, and our own anecdotal evidence, shows that 60% of estate plan failures in a family are related to family dynamics and only about 10% are related to taxes and other legal reasons.¹ How then can the new Succession Laws help avoid the negative impact of family dynamics? While tax planning will remain a crucial part of any estate plan, the significantly increased estate and gift

¹ See Morris, Williams, Allen and Avila, *Correlates of Success in Family Business Transitions* (1997) 12 *Journal of Business Venturing*, at p. 391.

tax exclusions under the Act (see discussion below), will relieve some of the pressure associated with tax planning and facilitate the design of a truly successful estate plan – one that focuses not only on taxes and other legal issues but also on family dynamics.

Thus, given the implications of the new Succession Laws, we wanted to at least mention the kind of planning questions you may want to consider in the future.

II. Thoughtful Planning

With the new Succession Laws in place for at least two years (see below), you may want to revisit your estate plan by considering the following three questions:²

- What is really important to your family?
- What should you do to guide and support the life journey of each of your family members?
- Do you feel that you have a responsibility to society?

Answering the above questions can help lead your planning team to results that better reflect what is important to you and your family now that the tax laws may, in some cases, be of secondary importance.

III. The New Estate and Gift Tax Law: The Basics

1. The New Estate Tax Law

Beginning January 1, 2011, and continuing through December 31, 2012, the estate tax applicable exclusion amount will increase to \$5 million and will be inflation adjusted. Every dollar over the exclusion amount will be taxed at a rate of 35 percent. *Because the law is only effective for the next two years, even if you have an estate under \$5 million you should still consider advanced estate tax planning.*

In addition, spouses have the right, in 2011 and 2012, to aggregate their exclusion amounts in certain situations (known as “portability”). For example, if a husband dies and the value of his estate is \$3.5 million, then the unused \$1.5 million of his \$5 million exclusion amount can be transferred to his wife thus increasing her estate tax exclusion amount from \$5 million to \$6.5 million. However, remarrying will not allow the surviving spouse to stack up multiple unused exclusion amounts as the surviving spouse may only use the unused exclusion amount of the most recently deceased spouse.

² See Collier, *Wealth In Families* (2nd ed. 2006).

While estate planners generally view portability as a positive development, it does not solve all problems and in fact can cause a conundrum for a husband and wife, especially for those with assets worth less than \$10 million. A prominent benefit of portability is that it simplifies the manner in which each spouse's estate tax exclusion amount may be fully utilized. Under portability, the unused exclusion amount may pass to the surviving spouse by operation of law³ without the need to resort to the more complicated two-trust approach traditionally used by estate planners in the past.

Another advantage to portability is that the assets transferred to the surviving spouse will be included in the surviving spouse's estate and will receive what is commonly referred to as a "step-up in basis." A "step-up in basis" means that, for income tax purposes, the basis of most assets included in an individual's estate will "step up" to the fair market value of such assets as of the date of death.⁴ This basis adjustment can have a substantial impact on capital gains when assets are later sold.

There are, however, significant disadvantages to the surviving spouse receiving all of the family assets as a result of portability. For example, if all of the assets are owned by the surviving spouse, creditors of the surviving spouse may be able to take all of those assets if insurance does not cover any losses. In addition, any subsequent appreciation in those assets will be included in the surviving spouse's estate with the risk that such new values may push the estate over the \$10 million threshold, thereby resulting in estate taxes that could have been avoided. Also, the surviving spouse could change the beneficiaries of the entire estate and give those assets to other parties. In this regard, for fun, you may want to read www.stealanestate.com for how certain people can "work" a surviving spouse to the detriment of the family and the original estate plan. And, finally, remember that the laws governing portability can easily change as *the current law is only in effect for two years*.

What to do for the estates under \$10 million given this planning conundrum?⁵ We are in most instances (but not all) recommending that the family continue with the use of the two-trust estate plan but with the caveat that, if circumstances allow, we will need to review the plan when a death is imminent. This review will allow us to determine the appropriateness of using portability

³ Note: Certain forms must be filed with the IRS upon the death of the first spouse in order to take advantage of portability.

⁴ While often referred to as a "step-up" in basis, it is worth noting that in a down market the basis adjustment can go the other way and result in a "step-down" in basis, which can actually result in higher capital gains taxes.

⁵ From a purely tax perspective, estates over \$10 million should not change from their pre-2011 plans; however, such estates should still be reviewed to ensure that the testamentary intentions are being satisfied.

versus the two-trust estate plan and will include an analysis of any potential step-up in basis and the then-existing tax laws.⁶

2. The New Gift Tax Law

The new Succession Laws unify the gift and estate tax applicable exclusion amount, allowing taxpayers to gift up to \$5 million either during life or at death without incurring an estate or gift tax. Since 2002 (and prior to the new Succession Laws), taxpayers were able to give away only \$1 million during life without incurring a gift tax, even though the estate tax exemption was higher. If you have already used your lifetime gift tax exclusion, you now have another \$4 million available to use. We think this is an opportunity for our clients to make some large gifts today and take advantage of the new \$5 million exclusion amount. *Remember, this larger exclusion amount is currently only in effect for two years.*

3. Generation-Skipping Transfer Tax

The Act also increases the generation-skipping transfer (“GST”) exemption amount to \$5 million, which means clients with larger estates should talk to us about strategies designed to pass significant wealth to their grandchildren and beyond. It is important to note that a taxpayer’s unused GST exemption amount may not be transferred to a surviving spouse under the portability provisions. *And, as we have mentioned several times regarding other provisions of the Act, this increased GST exemption amount is currently only in effect for two years.*⁷

IV. What the New Tax Legislation Does Not Do

Leading up to the passage of the Act, there were a number of issues being discussed on Capitol Hill and in the news media regarding various estate planning strategies. A few received significant attention, but were not addressed in the new legislation.

1. Discounts

A number of proposals had been made in the last few years that called for the restriction of estate planning discounts in the valuation of family partnerships and LLCs. The Act includes no such restrictions, leading us to advise clients to continue to take advantage of discount planning where appropriate. When discount planning is combined with the substantial \$5 million gift tax exclusion, tremendous wealth can be shifted. Since the \$5 million exclusion is only assured for two

⁶ In an effort to build in flexibility, our trust documents are generally drafted to maximize the ability of the Special Trustee to make discretionary distributions. This discretionary authority can be a great benefit when important tax sensitive decisions need to be made.

⁷ Our trust documents are generally drafted to provide full utilization of the GST exemption regardless of the amount of such exemption.

years, the Act provides a new and unprecedented opportunity for our clients. This could apply not only to those clients with estates over \$10 million, but to anyone who wants to take advantage of discounted gifting and the larger exclusion before 2013 when the exclusion is scheduled to return to \$1 million.

2. Grantor Retained Annuity Trusts (GRATs)

Congress and the President were quite vocal over the past two years in their desire to substantially limit the use of GRATs, but the Act does not include any restrictions on GRATs. GRATs are particularly attractive in today's environment where both interest rates and asset values are low. With the possibility of a reduced estate and gift tax exclusion amount and higher tax and interest rates in 2013, clients should consider pursuing GRATs while they remain advantageous.

V. Title to Property

We always like to remind our clients how important it is that title to all of their property be titled correctly. If you intend that certain of your property be owned by your trust or partnership or LLC, please verify that this property is actually titled in the correct name. You need to be especially diligent about this if you have done any refinancing. Please save your loved ones the inconvenience and expense of transferring these assets after your passing.

VI. California Property Tax Developments

We also want to remind you that since January 1, 2010, we now have *mandatory property tax penalties* for not timely reporting a change in ownership or control of legal entities, which can happen upon a transfer of a partnership interest, LLC membership interest or corporate stock. The reporting must be made *within 45 days of a transfer (including within 45 days of a birth or death of a current income beneficiary of a trust) – and no extension is available!* For legal entities, 100% of the California real property is reassessed even if the interest transferred is small, perhaps 1%. So it is critical not to miss the reporting requirements after the fact, but more critical to plan ahead. You can access a chart of the various property tax reporting requirements in an article on our website, "Property Tax Reporting Requirements and the Consequences of Not Complying," which was published in *California Trusts and Estates Quarterly* last year.

Property tax treatment of life estates has been at issue in the courts for many years. The California Supreme Court addressed a pivotal question when it became the first court to define a "transfer" for property tax change in ownership purposes in the *Steinhart* case this year, but other important issues remain undecided, even after the recent *Phelps* decision in which we were co-counsel for petition for review to the Supreme Court. Currently, the position of most (probably all) assessors, BOE, and some courts is that every time a trust life beneficiary of current income dies (or when there is a class of beneficiaries and a new person is born into the class) there is a "change in ownership" for property tax purposes, and this is based on the position that an income beneficiary's interest under a trust is "substantially equal to the value of the fee" interest in the real property. Most taxpayers would not agree they are of the same value. *California Trusts and Estates Quarterly* is

also publishing our article discussing the history of this debate and showing why several aspects of the question have not yet been answered. The article is titled, "The Supreme Court Defines a 'Transfer' for Property Tax Change in Ownership Purposes in *Steinhart*," and should be out in early February. It will then also be posted on our website. (See the California Real Property Taxation page under our website "Resources" section.)

While the real estate market remains low, continue to check whether the property value may have fallen below its assessed value, and if so, you (or we) can request the Assessor to give a temporary reduction in tax assessment. Recall our March 2009 letter (also posted on our website) about strategies for making this temporary reduction in assessed value permanent so that future assessments will be limited to the 2% inflation cap, rather than returning to the prior assessed level when the market does.

Lastly, if keeping your property taxes low and avoiding non-reporting penalties is important to you, then there are two important steps to take: (1) Read through all of your trusts to make sure that they include an Article or Paragraph titled, "Special California Real Property Interest Provisions." It is a provision we have developed over the years which will prevent reassessment in instances where it can be avoided. This provision is not in some of the older trusts drafted by our office, so if it is not in any of your trusts, please contact us so that we can update your trust. (2) Contact us for a property tax review *before* sales or gifts of real property, or *before* transfer of real property to or from any legal entity; or *before* transfers of partnership, LLC or corporate interests in entities which own real property; or for any trust which owns real property or interests in legal entities, *before* there is a birth or death of any trust beneficiary. We will see if any steps can be taken to avoid a reassessment and, if not, take steps to timely comply with the reporting requirements so you can avoid penalties and interest.

VII. Thank You

Thank you for giving us the opportunity to serve you. We value your confidence in us and look forward to our continued relationship in 2011. If you would like to learn more about what this office has been doing over the last year or view a listing of our publications and seminars, please visit our website at www.taxlawsb.com.

The above information is general in nature and there will be different ramifications or applications for each person and each situation. Consequently, it is important that you review your estate plan to determine if any of the points discussed in this letter may impact your plan. We encourage you to contact us to discuss these issues.

Sincerely,

AMBRECHT & ASSOCIATES

John W. Ambrecht