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HALES, HALES & GEORGE

ATTORNEYS AT LAW

N E W S L E T T E R

Devoted to Estate and Business Planning Law and Trust Administration Since 1972

THE FUTURE OF FEDERAL ESTATE TAX

by Robert E. Hales

As part of his first federal budget, President George W, Bush presented his much touted $1.6 trillion tax cut package. Of much interest to our clients is the proposal within this legislation to abolish the estate tax. Support for the abolishment has waxed and waned on Capitol Hill, as many small business advocacy groups have kept the pressure on Congress to scrap the tax while others have expressed concern that repeal will in effect create a permanent aristocratic class of wealthy Americans. As the debate continues, with no resolution likely until this summer, we feel our clients should be aware of the following.

Would Abolishment Eliminate the Need for Estate Planning?

The federal estate tax is not the primary reason why clients need an estate plan. The primary purpose of estate planning is to ensure that your estate is ultimately distributed to the individuals you intend, in the manner you intended. By using a living trust, this goal can be accomplished, while eliminating the unnecessary and tedious legal process known as probate.

In fact, abolishment of the estate tax may increase the importance of having an estate plan, as for many of our clients, the size of their inheritable estate will increase dramatically.

What is the Bush Plan Comprised Of?

The bill presented by President Bush calls for a gradual reduction in the estate tax brackets over an eight-year period, with the top rate of 55% incrementally dropping a few percentage points each year, and settling at 39% by year eight. Then, in year nine, the estate tax is completely repealed. The problem I see with this plan is that during these eight years there will be two presidential elections, four congressional elections and possible fluctuations in the economy affecting the forecasted budget surplus. The best case scenario for a total abolishment is that the economy remains strong and Republicans maintain political control for the next nine years. However, if a different party gains control, or the economic situation changes negatively, it is reasonable to believe the Bush Plan will be permanently "frozen" prior to year nine, and abolishment will thus never be reached. Therefore, the Bush Plan calls for both optimism and scepticism.

Is the Estate Tax Really a Bargaining Chip to Win Other Concessions?

The consensus in our profession indicates that, most likely, elimination of the estate tax will be used as a bargaining chip to win approval of other parts of the Bush Plan, in particular, cutting the marginal income tax rates. After thirty years of practicing law, and, in particular, following tax legislation through Congress, I have found that a compromised tax bill is eventually needed to gain the approval of the House, the Senate and the President. As the federal income tax has an immediate effect on the voter and the economy, and the estate tax has little effect on either, I think the "compromisable" component of the tax cut package is obvious.

The Bottom Line

While disagreement exists on whether to repeal the estate tax, most people do agree that the current estate tax system is in need of reform. Hopefully we will see some meaningful leg-

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IMPORTANT CHANGES FOR YOUR IRA AND RETIREMENT PLANS

I. QTIP Retirement Plan Trust

Important changes exist in estate planning for IRA's and retirement plans. The I.R.S. has relaxed its requirements, and will now allow a married individual to designate a "QTIP Retirement Plan Trust" as the beneficiary of their IRA and retirement plan, while allowing for both deferral of income and estate taxes. Prior to this change in I.R.S. policy, absent special circumstances, an IRA or retirement plan left in trust for one's spouse resulted in immediate recognition of

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IS YOUR ESTATE PLAN CURRENT?

A summary of important estate planning considerations is provided below:

I. Health Care Directives

The law regarding the Health Care Durable Power of Attorney has changed as of July, 2000 and allows more specificity about your desires if you are incapacitated. The new documents are called Advance Health Care Directives, and allow you to designate the people you would like to make health care decisions if you are incapacitated. Additionally, the documents provide several pages of instructions to your agent which you complete as appropriate about your specific wishes regarding health care. If you have a Health Care Durable Power of Attorney executed prior to July, 2000 we should talk.

II. Periodic Review of Estate Plan is Necessary

A periodic review of your estate plan with an attorney in our office is necessary especially when major changes occur in your life. Of course, regardless of whether any of the below changes have happened, you should still make an appointment to visit our offices if a substantial amount of time has elapsed since our last meeting, or if you have any questions about your estate plan. We have detailed some of the examples of occurrences that necessitate a review of your estate plan below:

- Divorce
- Remarriage
- New Children/Grandchildren born
- Children have attained adulthood
- Children have drug/alcohol problems
- You desire Generation Skipping advantages
- Durable Powers of Attorney executed before 1989 must be re-executed
- Death of a Settlor, Trustee, and/or Beneficiary
- Changes in financial net worth
- Purchase of new real property
- Execution of Living Trust prior to 1982
- Purchase of Life Insurance

III. The Emergence of the Limited Liability Company (LLC)

If you own any investment real estate either alone or with a partner and want to limit your liability, the LLC is a unique business entity that is becoming increasingly popular in California. An LLC provides owners with the limited liability protection of a corporation, and, if properly structured, the flow-through federal income taxation benefits of a partnership. However, unlike a corporation, an LLC eliminates the requirements of strict adherence to corporate formalities. And, unlike a limited partnership, all members are

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NEW ATTORNEYS AT HALES, HALES, & GEORGE

Mary Pryce has been an associate with Hales Hales & George since 1999. Ms. Pryce's practice emphasizes estate planning, probate, and trust administration in which she has worked for over twenty years. Ms. Pryce received her Juris Doctorate from Santa Clara University School of Law. She is a member of the Santa Clara County Bar Association Probate and Estate Planning Section, the California Bar Association Estate Planning, Trust and Probate Law Section, the American Bar Association Real Property, Probate and Trust Law Section, the National Academy of Elder Law Attorneys, and the Silicon Valley Bar Association. Ms. Pryce has lectured on estate tax reduction, asset preservation, and probate avoidance.

Patrick A. Kohlmann joined Hales, Hales and George as an associate attorney in 2000. His legal practice emphasizes estate and business planning. Mr. Kohlmann clerked at the Firm for two years before becoming an associate, having worked primarily with Robert Hales. Prior to pursuing a legal career, he practiced business and tax planning as a C.P.A., beginning his career in public accounting in 1993. Mr. Kohlmann is a graduate of Santa Clara University, where he received his Juris Doctorate and was distinguished by being listed in Who's Who of American Law Students. He is a member of the Santa Clara County Bar Association (Member, Estate Planning Section and Business Law Section), the Silicon Valley Bar Association, the State Bar of California (Member, Estate Planning, Probate and Trust Section, Real Property Section and Business Law Section), the American Bar Association (Business Law Section and Real Property Section), the State of California Certified Public Accountants (Licensed Member) and the California Society of CPA's (Member).

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islation in the near future. However, the most important thing about the future of the federal estate tax is not whether or not there is one. Even if there are no taxes when I die, I am still primarily concerned that when my wife and I are both deceased, my children and eventually my grandchildren will inherit my estate (rather than "Honolulu Bill", my wife's next husband whom she has already picked out!). We will keep our clients posted of any new tax legislation, and what effect it will have on your existing estate plan.

IMPORTANT CHANGES FOR YOUR IRA AND RETIREMENT PLANS

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all deferred income taxes at the first spouse's death. This change in position allows for important estate planning with your Living Trust.

Prior to this recent change, married couples were forced to designate their spouses as beneficiaries of their qualified retirement plan or IRA in order to defer recognition of income tax. This strategy had legitimate concerns, as illustrated by the following example.

Bill and Hillary, a married couple with one child, Chelsea, named each other as their IRA beneficiary in order to defer income taxes at the first death, and trusted that the survivor would accordingly leave the IRA to Chelsea. Neither Bill nor Hillary named their Living Trust as their IRA beneficiary, as such a transfer would have resulted in all deferred income taxes becoming due at the first death.

Hillary died first. Bill, as beneficiary, was transferred her IRA. Bill then named Chelsea as the designated IRA beneficiary at his death.

However, several years later Bill married Monica. As the years passed, Bill became concerned with his second wife's financial well being should he predecease her. So, he changed the designated IRA beneficiary from Chelsea to Monica. As Bill, and not Hillary's Living Trust, was the owner of Hillary's IRA, Bill had the unconditional right to do so.

In effect, at Bill's death Hillary's IRA was inherited by a total stranger.

However, I.R.S Revenue Ruling 2000-2 now allows one to name a trust as the beneficiary of both an IRA and qualified plan assets, while deferring income tax recognition and still qualifying for the marital deduction. This "QTIP Retirement Plan Trust", incorporated into your Living Trust, requires all income received from an IRA account be paid at least annually to the decedent's surviving spouse. However, upon the surviving spouse's death, the decedent's IRA or qualified plan assets pass to the decedent's intended beneficiaries as designated in his or her Living Trust.

We at Hales, Hales, and George believe the principle reason for performing estate planning is to ensure that your estate is inherited by those whom you intend. This change in I.R.S. position opens the door for important IRA or qualified retirement plan planning to ensure accomplishment of such a goal. We encourage all of our clients to carefully consider the advantages of including a QTIP Retirement Plan Trust within their Living Trust.

II. Designated Beneficiary Trust

Individuals who intend to ultimately leave their IRA's to their children should consider the advantages of a Designated Beneficiary Trust ("DBT"). A DBT is a separate, unfunded irrevocable trust that designates the Settlor's children as its beneficiaries.

The advantage of a DBT is that it requires payments from an IRA after the death of the last surviving parent to be made over either the combined life expectancies of that parent and his or her child, or, effective in 2002, over the life expectancy of the child alone.

"By stretching the payout period over such an extended period, a parent can ensure continued tax-deferred compounding of the plan even after their death, and prevent a child from emptying the plan via a lump sum distribution."

This approach may even save income taxes, as trusts take better advantage of certain deductions (e.g., the I.R.D. deduction for estate taxes).

If you are interested in discussing the advantages of a QTIP Retirement Plan Trust or Designated Beneficiary Trust with one of our attorneys, please contact Hales, Hales, and George to set up an appointment.

IS YOUR ESTATE PLAN CURRENT?

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extended limited liability protection. Thus, in essence an LLC combines only the best aspects of a corporation and a partnership.

An LLC may also be used to gift assets to children, thus shifting appreciating assets out of the donor's taxable estate.

IV. No Contest Clause

A no contest clause provides that any person who contests a Will or Trust shall forfeit all interests they would have received thereunder.

Prior to this year the Courts decided whether a person's attack on a Will, Trust, or other assets would violate the no contest clause. This led to case by case litigation on what constituted a "contest." In an attempt to minimize litigation and avoid unanticipated forfeitures of bequests under Wills and Trusts, the California Legislature has enacted a new law.

Effective January 1, 2001, Trusts, Wills and Codicils to Wills executed after that date must "expressly identify' specific enumerated actions constituting a contest to trigger the no contest clause. No longer will a generic no contest clause in Wills and Trusts protect an estate plan or assets outside the Will or Trust from attack. As a result, the new law requiring no contest clauses enumerate actions must be tailored to each client's needs. While there is no requirement to revise an existing no contest clause, it may be wise to do so. In addition to a Will and Trust, assets vulnerable to attack include joint tenancy, beneficiary designated assets, such as life insurance, pension plans, annuities, contracts, agreements, etc.

If your estate plan is vulnerable to attack and you wish to put more teeth into an existing no contest clause, a Codicil to your Will and Amendment to your Trust is recommended.

HALES, HALES & GEORGE, a family-owned law firm with offices in Saratoga and San Francisco, California, specializes in Estate and Business Planning as well as Probate and Trust Administration. Each partner of Hales, Hales & George is a member of the State Bar of California, the Santa Clara Bar Association, and the Santa Clara County Estate Planning Council. This issue of the Hales, Hales & George Newsletter was written & edited by attorneys Robert E. Hales, Jan Marie Hales, William P. George, Mary E. Pryce and Patrick Kohlmann. Any questions raised by these articles can be addressed by simply writing the law firm at 19040 Cox Avenue, Suite 3, Saratoga, CA 95070 attention: HH&G Newsletter. This newsletter is intended to be a source of information for our clients and associates and should not be considered personal legal advice. Laws can change frequently and rapidly. Please consult your attorney before relying on any information contained in this publication. (408) 255-6292, Fax - (408) 865-1904, e-mail: postmaster@haleshalesgeorge.com

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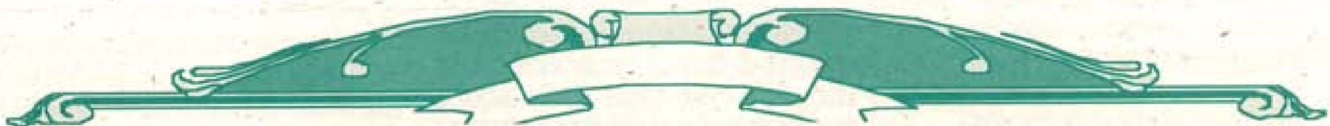

Estate Plan Up-Date Certificate

As a service to our existing clients who have received this NEWSLETTER, this certificate entitles you to a meeting with an attorney from HALES, HALES & GEORGE to review your estate plan and the impact of current tax laws for a fee of $150 per year. This meeting will be a review of all your estate planning documents including your Exhibit "A". If any additional documents or changes to existing documents are required, an additional fee will be quoted during your scheduled appointment.

Please complete the information below and return this certificate with a check for $150 payable to HALES, HALES & GEORGE. Upon receipt, we will call you to arrange a convenient time to meet with us or please feel free to call us at (408) 255-6292 to schedule an appointment.

NAME:______________________________

ADDRESS:______________________________

DAYTIME PHONE:________________ HOME PHONE:________________