MEMORANDUM REGARDING BASIC ESTATE PLANNING

This memorandum summarizes the general rules of estate planning and is not meant to be an exhaustive treatment of every practical and tax aspect of estate planning. It is our attempt to highlight some of the important issues but does not take account of any personal or family needs, goals or obligations. There are many important aspects of each subject which are not discussed here and on which the law is constantly changing. You should not take any significant actions without first consulting an attorney.

1. Disposition of Property and Death Taxes. The manner in which and the persons to whom property will pass at death depends upon the character of the property, the nature of the property interest and the manner in which title to the property is held. Each of these factors is discussed more fully below.

In addition, two taxes may be imposed at death, the federal estate tax, possibly a state tax, usually incurred if one own real estate outside of California. California is prohibited constitutionally from having a state estate tax. The amount of the federal estate tax is computed in general on the basis of the fair market value of the assets owned by the decedent at the time of death and the persons to whom the decedent's property passes. The net worth of the decedent subject to that tax depends in part upon the character of the property and the manner in which title to the property is held.

An estate plan will coordinate all of these factors to pass a person's property to his or her beneficiaries in accordance with his or her wishes and with the minimum costs for taxes and other expenses. However, almost every alternative has both advantages and disadvantages which can only be evaluated by the individual.

A. Character of Property. Property in California may have, in general, three characters: separate property, community property and quasi-community property. Each spouse has the right to dispose of his or her separate property, one-half of the community property, and one-half of his or her quasi-community property.

Separate property includes property owned before marriage and property acquired after marriage by gift or inheritance and the income from that separate property and any appreciation of that separate property.

Community property is (1) virtually all other property acquired while married and domiciled in California and (2) property acquired while married and while domiciled in a state, other than California, that has community property rules or an equivalent, and that community property's income and appreciation.

Quasi-community property is property acquired while married and while domiciled in a state, other than California, which does not have community property rules or an equivalent, and which would have been community property if acquired while domiciled in California.

A change in the form of property will not change its character. For example, the sale of an asset and reinvestment in a new asset will not change the character of property; the new asset will have the same character as the asset sold. However, character may be changed, but only by a written agreement between spouses called a "transmutation agreement," or by failing to keep property clearly identified. Such changes are generally to be made only after careful consideration because of the alteration of ownership in the event of divorce and control at death.

The federal estate tax will be imposed on all of the decedent's separate property, the decedent's one-half of the community property and all of the decedent's quasi-community property.

B. Nature of Property and Title. A decedent's Will may not control the disposition of all property owned by a decedent. The manner in which title is held and the nature of the property interest may control the disposition of the asset. Typical examples of such situations are assets held in joint tenancy, life insurance contracts, employee benefit plans, annuity contracts and assets held in a trust.

(1) Joint Tenancy. Property held in joint tenancy is a form of separate property with the additional characteristic that it will pass at death to the surviving joint tenant without regard to the Will of the deceased joint tenant.

The federal estate tax on joint tenancy property is complex. Except when a husband and wife are the only joint tenants, all of a joint tenancy asset will be taxed in the estate of the first joint tenant to die, except for the portion that the surviving joint tenant can prove was contributed by that surviving joint tenant from his or her own property, other than property originally received as a gift from the deceased joint tenant. If a husband and wife are the only joint tenants, only one-half of the joint tenancy property is subject to tax.

The primary disadvantage of joint tenancy property is that only the portion of the joint tenancy property subject to tax in the decedent's estate receives a new basis at death; the surviving joint tenant's basis is not changed. That new basis is generally the fair market value for federal estate tax purposes. On the other hand, property held as community property between husband and wife receives a new basis for both the decedent's one-half interest and the surviving spouse's one-half interest. If property which has appreciated in value were sold after the death of the first joint tenant/spouse to die, but before the death of the surviving joint tenant/spouse, the joint tenancy property would incur a greater capital gains tax than would community property.

(2) Community Property With Right of Survivorship. Property may be held by a husband and wife as community property with right of survivorship. Such property is community property, but passes at death in manner similar to joint tenancy property. The primary advantage is the step-up in basis on the death of the first spouse to die of both the decedent's one-half and the surviving spouse's one-half of the property. However, as discussed more fully below, transfer of assets from a deceased spouse entirely to a surviving spouse may incur avoidable estate taxes for the family on the death of the surviving spouse.

(3) Life Insurance, Employee Benefit Plans and Annuities. Proceeds of life insurance policies pass to the beneficiary designated in the policy's Beneficiary Designation form without regard to the provisions of the policy owner's Will; pension and profit sharing plans pass to the beneficiary designated by the plan participant on the Beneficiary Designation form without regard to the participant's Will; and annuity contracts are paid in accordance with the terms of the contract without regard to the contract holder's Will.

The federal estate tax on the proceeds of life insurance depends upon who has the "incidents of ownership" at death and is more fully discussed below. Pension and profit sharing plans are generally subject to federal estate tax. Annuity contracts may or may not be subject to federal estate tax depending upon whether further payments are due after death.

(4) Trusts. Property held in a trust, whether a revocable or irrevocable trust, will pass at death in accordance with the terms of the trust and without regard to the deceased Trustor's Will. A Totten Trust is an example of a revocable trust; it is a bank account in the name of a decedent, as Trustor, for a beneficiary. The Totten Trust passes at the decedent/Trustor's death to the beneficiary without regard to the terms of the decedent/Trustor's Will.

Revocable trusts are subject to federal estate tax at death to the extent of the decedent's interest in the trust assets. The federal estate tax on irrevocable trusts is complex and depends upon the interests and powers of the decedent in the trust.

2. Wills Only or Pour-Over Wills and Revocable Trust. The most common estate planning document is a Will. Any property that passes under the terms of a Will is subject to probate administration and the supervision of the probate court, unless (A) the estate is very small, in which case it can sometimes be collected by a declaration without probate administration, or (B) the estate passes entirely to a surviving spouse, in which case no administration is necessary or a shortcut method of confirmation of property passing to the spouse may be elected.

An often used alternative is a combination of the pour-over Will and a funded revocable trust. There are no income tax advantages and no estate tax advantages to a revocable trust that cannot be obtained through a Will. The advantages of a revocable trust are (A) avoidance of probate administration and a reduction of the costs and administrative burdens thereof, (B) privacy, and (C) avoidance of a conservatorship of the estate if a person becomes unable to manage his or her property. The disadvantages of a revocable trust are (A) additional costs to establish the trust and transfer title of assets to the trustee, (B) lack of prior court supervision of the trustee's actions, and (C) some small additional administrative burden in operating the trust.

Whether Wills only or pour-over Wills and a funded revocable trust are used, the dispositive schemes discussed below may be used.

3. Provisions For Spouse. Understanding the options for a surviving spouse in an estate plan first requires a review of how those provisions can affect the amount of the federal estate tax.

A. Basic Estate Tax Rules. The estate tax rules vary depending upon whether the surviving spouse is a U.S. citizen or not.

(1) If the Surviving Spouse if a U.S. Citizen. If the surviving spouse is a U.S. citizen, the federal estate tax may be described as a computation on two separate parts of the decedent's net worth. The first part consists of property which passes to the surviving spouse in such a way that it will be subject to tax on the surviving spouse's death. The first part is typically eligible for the marital deduction for federal estate tax purposes and is free of federal estate tax. A similar deduction is available for property passing to a qualified charity. The second part consists of the estate exemption, which is the amount which can be passed to any persons, including the spouse, free of estate tax. The federal estate tax exempt amount is currently $3,500,000 until Congress takes action, probably in late 2009. Any excess of the tax exemption amount payable to anyone other than a surviving spouse is subject to tax at a rate of 45% in 2009.

(i) All to Spouse Plan. A common estate plan is for one spouse to leave all of his or her property to the survivor. Such a scheme will generally eliminate the federal estate tax in the estate of the first spouse to die. However, the property included in the estate of the first spouse to die is then part of the estate of the surviving spouse and may be subject to an avoidable tax on the survivor's death. If the surviving spouse spends the estate before death or if the combined estates would not be large enough to be subject to federal estate tax, an "all to spouse" estate plan would not have a significant adverse death tax consequence but may still not be the appropriate plan for family goals.

(ii) Tax Exempt Portion to Decedent's Exclusion Trust or Descendants. However, in many cases the combined estate, especially when insurance proceeds are added, are greater than the tax exempt amount and therefore is large enough to result in a federal estate tax on the surviving spouse's death. A method to avoid this tax on the surviving spouse's death is the Decedent's Exclusion Trust, also known as the "B" Trust, Exemption Trust, Credit Shelter Trust, By-Pass Trust and by other names.

Rather than giving the estate of the first spouse to die outright to the surviving spouse, the first spouse to die gives the surviving spouse only as much of the estate as is necessary to eliminate all federal estate taxes and gives the remainder of the estate (the tax exempt amount) to a Decedent's Exclusion Trust.

The Decedent's Exclusion Trust can have all of the following characteristics:

(a) The trustee may be the surviving spouse with management control of the trust assets, subject to certain minor limitations;

(b) All income of the trust may be paid to the surviving spouse or may be paid by an independent trustee in discretionary amounts so unneeded amounts can grow tax free for other beneficiaries;

(c) Principal may be distributed to the surviving spouse as needed for his or her health, maintenance, support and education;

(d) The surviving spouse may have a limited power of appointment allowing the surviving spouse to reallocate the assets among the children and further descendants or other beneficiaries to take account of changed circumstances;

(e) If the limited power of appointment is not used, the trust property will pass on the death of the surviving spouse to the spouses' descendants or other beneficiaries; and

(f) Children can be included for discretionary distributions of income or principal subject to some minor limitations on both.

On the death of the surviving spouse, the trust is not subject to federal estate tax in the estate of the surviving spouse. The trust along with any appreciation that may have occurred since the death of the first spouse passes free of estate tax to the spouses' descendants or other beneficiaries.

If the surviving spouse's estate is so large that a Decedent's Exclusion Trust is not needed to provide for the surviving spouse, then the tax exempt portion may be given outright or in trust to the descendants of the first spouse to die or to other beneficiaries without incurring estate tax.

(iii) Marital Deduction Portion. The property passing to the surviving spouse may be given in three different ways and still qualify for the marital deduction: (1) outright; (2) in a standard Marital Deduction Trust, or (3) in Qualified Terminable Interest Property Trust ("QTIP" Trust).

An outright gift is the simplest and gives the surviving spouse full control of the property.

A standard Marital Deduction Trust must provide that the surviving spouse receive all of the income and have a general power of appointment of the trust, that is, the right to designate who will receive the property at the death of the surviving spouse. Such a trust is useful when the spouses wish to use the trust as a means of conveniently segregating property, as when there has been a second marriage and both agree certain property should return to the family of the first spouse to die, and is also useful when the surviving spouse desires or requires professional management of the property.

A QTIP Trust must also provide that the surviving spouse receive all of the income, but unlike the standard Marital Deduction Trust, the first spouse to die may control to whom the property passes after the surviving spouse's death. In addition, no one but the surviving spouse may be a beneficiary of the trust during that surviving spouse's lifetime. Such a trust is useful when one or both spouses have children from prior marriages, want to provide for the surviving spouse, and want to obtain the tax benefits of the marital deduction, but also want to be certain that the trust property passes to those children of a prior marriage after the surviving spouse's death. The QTIP is appropriate when the decedent does not want the property to go to a second spouse before it goes to the decedent's children or other beneficiaries.

(iv) Summary of Alternatives. In summary, the option for the provisions for the surviving spouse are as follows:

(a) All outright to spouse;

(b) All to a standard Marital Deduction Trust, a QTIP Trust, or a Decedent's Exclusion Trust, and then to descendants or other beneficiaries.

(2) If the Surviving Spouse is Not a U.S. Citizen. If the surviving spouse is not a U.S. citizen, the estate tax rules are substantially different.

(i) Tax Exempt Portion. The tax exempt portion of the deceased spouse's estate (currently $3,500,000) is still free of estate tax and may be given to anyone, including a non-citizen spouse or a Decedent's Exclusion Trust or descendants, without estate tax on the death of the first spouse to die.

(ii) Excess Over Tax Exempt Amount. However, the value of the portion of the deceased spouse's estate in excess of the tax exempt amount will be subject to estate tax unless the property is placed in a Qualified Domestic Trust ("QDOT"). A QDOT must require that at least one of the trustees be a U.S. citizen or domestic corporation, and that no distribution may be made without the approval of such a trustee. In addition, the trust must meet certain other requirements that the Secretary of the Treasury has established.

Any distribution of principal from the trust during the lifetime of the surviving spouse, with certain exceptions, is taxable as though it had been subject to tax in the deceased citizen spouse's estate. Upon the death of the surviving spouse the entire trust is subject to tax at the rate which would have been imposed on the death of the first spouse to die if the QDOT had not been used.

4. Provisions for Children and Further Descendants. The typical estate plan for married couples after the death of both spouses is to leave their property to their descendants. Often the property is given outright to the descendants, so that each takes his or her share of the estate. If all of the beneficiaries are mature adults, this is a simple and effective plan. However, if any of the beneficiaries are minors, a guardianship will have to be established for such minor's estate, requiring court accountings filed every two years, and the guardianship property will be distributed to the minor at age 18 – an expensive, time consuming, intrusive court proceeding avoided generally by a trust.

Two trust arrangements are commonly used as alternatives to outright distribution to minors: the Family Pot Trust and Separate Share Trust.

The Family Pot Trust provides that all of the property shall be held in a single trust until the youngest child reaches a mature age, such as 21 or 25. The trustee is given the power to distribute income and principal to the beneficiaries as needed for their health, maintenance, support and education, with the power to provide more benefits to one beneficiary than another. After the youngest child reaches the designated age the trust is divided into as many shares as there are living children and deceased children leaving grandchildren, and the shares are either distributed outright to the beneficiaries or contributed to be held as a Separate Share Trusts until a later age. Usually, there is no "evening-up" of any unequal distribution during the terms of the trust. Therefore, the Family Pot Trust may raise issues in the relationships of siblings among each other.

The Separate Share Trust simply provides that any share of the parents' property, whether distributed after death or after the termination of the Family Pot Trust, will be held in trust until the beneficiary reaches a designated age. Until at least age 21 or generally some later age the income and principal may be paid by the trustee for the health, maintenance, support and education of the beneficiary. After a specified age (we usually recommend age 30), all of the income is generally paid to the beneficiary along with so much principal as is needed, usually, but not always, limited to support, health care and educational expenses. The beneficiary can also be given a general or limited power of appointment over the property exercisable by his or her Will in the event the beneficiary should die before full distribution of the trust. If a power of appointment is given to the beneficiary, the determination of limited or general power of appointment will depend substantially on the generation skipping tax consequences and occasionally estate tax consequences.

As mentioned above, a Decedent's Exclusion Trust will not be taxed on the death of the surviving spouse even though that surviving spouse is a beneficiary of the trust.

Before the Tax Reform Act of 1976, similar Decedent's Exclusion Trusts were established to successively by-pass the estates of children and grandchildren, thereby avoiding federal estate taxes for several generations.

To prevent such by-passing estate tax for multiple generations, a new tax was created in 1976 called the "generation skipping trust tax," but in 1986 that tax was repealed retroactively and replaced by a similar tax called the "generation skipping transfer tax."

The purpose of the generation skipping transfer tax is to tax the transfer of property at each generational level. The combined estate tax and generation skipping tax can in certain circumstances approach a 75% tax rate.

The generation skipping tax is generally minimized by (A) placing the property in a Generation Skipping Trust that is exempt from the generation skipping tax or (B) causing any property held in a trust for a beneficiary to be taxed in the beneficiary's estate for estate tax purposes. The first solution is limited to $3,500,000 for each decedent. The second solution requires the beneficiary to have a general power of appointment over the trust property, that is, a right to give the trust property on their death to anyone the beneficiary chooses.

The Generation Skipping Trust typically provides that the income will be accumulated and added to principal but the income may be directed to be paid to any of your descendants. The trustee, usually but not always, is authorized to distribute the accumulated income and principal for the child's health, maintenance, support and education. The trustee can be the child when he or she reaches a mature age. The child may have a special power of appointment allowing him or her to alter the distribution of the remainder among his or her descendants or other designated beneficiaries. On the death of a child, if the special power of appointment was not used, the remainder of the Generation Skipping Trust is typically distributed to the child's descendants, if any, and if none, to other designated beneficiaries, such as siblings or nieces and nephews.

The advantage of this scheme is that none of the assets of the Generation Skipping Trust are includable in the estate of the child on his or her death and pass free of estate tax and generation skipping tax to the grandchildren or more remote descendants.

5. <u>Life Insurance</u>. There are three significant elements to an insurance policy for estate planning purposes: (A) the insured upon whose death the proceeds are payable, (B) the owner, who generally pays the premiums and has all rights to the policy, and (C) the beneficiary, who receives the proceeds.

The proceeds of life insurance are taxed in accordance with the incidents of ownership in the policy, that is, who the owner of the policy is. If the premiums are paid from community property, the policy and the policy proceeds normally will be community property and one-half will be included in the estate of the deceased insured owner. If the policy is owned by the non-insured spouse as his or her separate property, no part of the proceeds will generally be included in the estate of the insured spouse.

If you select to own the policies between spouses, it may still be advantageous to do planning. For example, if the non-insured spouse dies first and gives the policy to a trust, the proceeds may escape federal estate tax on the insured's later death. Thus, assignment of the insurance to the non-insured spouse in certain circumstances may have tax advantages. Similarly, a transfer of a life insurance policy from the U.S. citizen spouse to the non-citizen spouse may remove the proceeds from federal estate tax, thereby giving the non-citizen spouse tax free use of the insurance proceeds. Outright distribution is appropriate if the spouses want the proceeds for the sole purpose of protecting the surviving spouse. Otherwise, there are more tax efficient ways to handle life insurance.

A common error is to name minor children as direct beneficiaries even if they are contingent beneficiaries. The insurance company will usually require a court appointed guardian in order to pay over the proceeds. As mentioned above, guardianship in most instances is not the best way to handle money for minors. The beneficiary designation should specifically refer to the trust to be established upon the decedent's death for the benefit of the minor, and the same may be equally applicable to young adults depending on the circumstances.

Insurance can similarly be removed from the estate of both spouses by transferring the policy to an Irrevocable Life Insurance Trust ("ILIT"). Under certain conditions the non-insured spouse and the spouses' children can be made the beneficiaries of that trust. The trust requires a few hours of annual attention but the rules must be followed to achieve tax free insurance proceeds. Such a trust can provide liquidity to both estates without adverse tax consequences.

To complete a transfer of a policy three documents are required: (A) an assignment form, also known as a change of ownership form, (B) a beneficiary designation form to conform the beneficiary designation to the estate plan, and (C) an agreement between the spouses that the policy is separate property of the non-insured spouse or the property of the trustee of a life insurance trust and that if premiums are paid from community funds, the payment is intended to be a gift from the insured spouse to the uninsured spouse to the extent of the insured spouse's community property interest.

Whether or not an assignment of the ownership of your insurance policies is made, the beneficiary designation should be reviewed and, if necessary, revised to conform to the estate plan.

6. Gift Giving. One method of reducing an estate is to transfer assets to your intended beneficiaries during lifetime by gifts. However, lifetime transfers are subject to federal gift tax.

A donor may give an unlimited amount to a spouse who is a U.S. citizen and no gift tax will be imposed. However, there is a limit to the amount a donor may give to a non-citizen spouse. The tax-free amount in 2009 is $128,000 per year to a non-citizen spouse. Any amount in excess of that limit will require the filing of a gift tax return and is a taxable gift.

A donor may also give up to $13,000 for federal gift tax purposes in 2009 to any number of donees without the necessity of filing a gift tax return and without any gift tax as long as the gift is of a "present interest" in the property. The recipient of a present interest has control over the gift immediately. Gifts of future interests and of present interests in excess of $13,000 per year to any donee will require filing of a gift tax return and are taxable gifts.

The first $1,000,000 of taxable gifts are exempt from gift tax in a manner identical to the estate tax, but any use of that $1,000,000 during lifetime reduces the amount that is exempt from estate tax at death by an equivalent amount. In other words, there is one $1,000,000 exemption amount which may be used for gifts either during lifetime or at death. Unlike the estate tax, this exemption is fixed indefinitely at $1,000,000.

The typical gift is outright to an adult beneficiary and qualifies as a present interest. The gift may be of cash or property, such as securities or real property, including fractional interests. However, an outright gift to a minor beneficiary may require the establishment of a guardianship for the gifted property and court supervision of the guardianship. Alternatively, the property may be transferred to a custodian for the minor under the Uniform Transfers to Minors Act, but if the donor/parent acts as custodian and dies before the donee/child reaches age 18, the gifted property will be taxed in the donor's/parent's estate despite the gifts. Also, custodianship assets must be given to the child at age 18, which may not be appropriate for a number of reasons.

If substantial gifts, including annual exclusion gifts over a number of years are to be made to a minor, it is generally preferable to make them to an irrevocable trust containing a "Crummey" withdrawal right for 30 days which will qualify the gift for the $13,000 annual exclusion. The Crummey power authorizes the donee/beneficiary to withdraw the gift from the trust for a specified time period during the year in which the gift is made. If the donee/beneficiary is a minor, a custodian other than the donor or donor's spouse named in the trust usually holds the power. If the power to withdraw is not exercised before the end of the withdrawal period, the power to withdraw lapses and the gift remains in the trust until later distribution in accordance with the terms of the trust.

Such a trust usually requires a third party co-trustee to act with the donor/parents to prevent the property from being included in the donor's/parents' estates. The trust property may be held until the donee/child reaches a mature age selected by the donor/parent.