

# Trusts & Estates newsletter

## Letter from the President

I have the great pleasure to introduce our first Trusts and Estates Newsletter. We plan to publish at least two editions a year and hope to select topics of interest to you. I have asked Jean Beasley, who recently joined us as a trusts and estates lawyer and was the editor of a similar Newsletter at her prior firm, to edit the Newsletter. Thank you, Jean!

*Jack Pettker*  
**Jack Pettker**

**PRESIDENT,  
RODI, POLLOCK, PETTKER, GALBRAITH & CAHILL  
A LAW CORPORATION**

## SUPPORTING THE ESTATE PLANNING NEEDS OF PARTNERS AND PRINCIPALS: SHOULD THE FIRM UNDERWRITE THE COSTS?

by Jack Pettker and Tom Curtiss

In a variation of the old adage "The shoemaker's children have no shoes," lawyers (who should know better) are notorious for failing to arrange their personal affairs before incapacity or death. Similarly, doctors, architects and other professionals become so absorbed in their practices that they neglect to see the need for personal and firm planning to account for death or incapacity.

If a professional dies or becomes incapacitated while still an owner in his or her professional partnership or corporation, the firm can incur unnecessary expense, embarrassment and even litigation if the professional and the firm have not properly planned to deal with these events. If the professional is unmarried, estranged from his or her spouse or has minor children as the only family, disputes can arise concerning who is entitled to inherit the value of the firm interest.



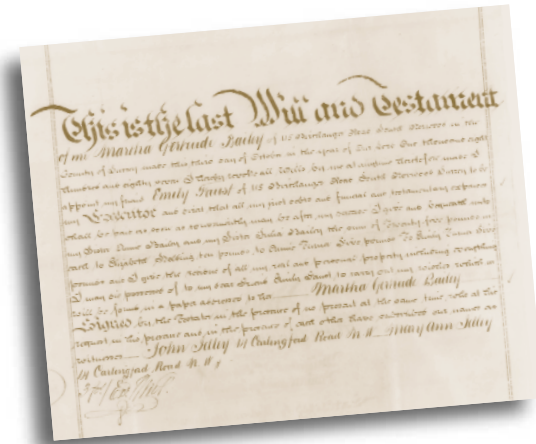
Although many larger companies offer estate-planning packages as a perquisite to their senior executives, historically professional firms have not. One reason may be that management is reluctant to involve itself in the members' personal affairs. In addition, underwriting the costs of establishing a plan is not perceived as a productive use of firm resources.

Perhaps the time has come for those professional firms to re-think the benefits of assisting their members in putting their affairs in order. This article may be instructive.

### UNDERSTANDING THE FIRM'S PLAN

A professional firm is usually organized as either a corporation or partnership. The form of the professional enterprise usually results from choices made by its members as to how they wish the firm to be treated for income tax purposes and to what extent they wish to insulate themselves from personal liability for the acts and obligations of the enterprise.

**Our T&E Team**  
Jack Pettker • Tom Curtiss  
Bill Christian • Elizabeth Blakely  
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The members own a capital interest in the professional firm. Some professional firms deal with a member's capital interest when he or she becomes incapacitated or dies by relying on negotiations by the parties at the time; in others, the members may adopt elaborate agreements that require a purchase of the capital interest of the incapacitated or deceased member by the other members or the firm. In the absence of a prearranged formula, costly litigation can result as the parties argue over the value of the capital interest and the terms of the payout.

Determining whether payments will be treated as ordinary income or as a return of capital will be important both to the firm and the terminating member, his or her family or his or her estate. Proper planning can usually establish the income tax consequences. Otherwise the

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## REVERSE MORTGAGES: PROVIDING LIQUIDITY FOR THE RETIRED HOMEOWNER

by Jean Beasley

Many of us have watched the decline in the stock market over the past three years, accompanied by the lowest interest rates in recent history, with considerable dismay. While working individuals may still have time to recover their losses, retired individuals may not be able to do so, and worry that they will have insufficient resources to meet their economic needs.



In contrast to the stock market, California real estate has continued to increase in value. Many retired individuals own valuable residences unencumbered by debt, and those residences can provide them with the cash flow they need.

This article will provide an overview of the reverse mortgage product. Because reverse mortgages are more complex than conventional mortgages, interested readers should contact their financial advisors for further details.

### HOW REVERSE MORTGAGES WORK

Under a conventional mortgage, a home purchaser borrows a sum of money and repays the loan in a series of monthly payments that include principal and interest. If the borrower survives the term of the loan, he or she will then own the house outright.

Under a reverse mortgage, the lender advances a sum of money to the borrower in a lump sum, periodic payments or a line of credit. No repayment is due until the borrower dies or moves out of the residence for more than twelve consecutive months or until a fixed period of time has elapsed. At that time, the loan must be paid in a lump sum, including the original principal amount and all of the accrued interest. If the loan is repaid at death, repayment will reduce the estate inherited by the borrower's heirs or beneficiaries.

A reverse mortgage is also “non-recourse”, that is, the repayment amount cannot exceed the value of the home on the maturity date of the loan. Given the conservative lending limits established by most providers (see below), it is unlikely that a reverse mortgage made in California would ever be “under water.”

*No repayment is due until the borrower dies or moves out of the residence for more than twelve consecutive months or until a fixed period of time has elapsed*

The Internal Revenue Service does not treat the proceeds from a reverse mortgage as income. Accordingly, whether the funds are disbursed in a lump sum or by periodic payments, the borrower has no reportable income. On the flip side, however, because interest accrues until the loan matures, interest is generally not deductible.

### QUALIFYING FOR A REVERSE MORTGAGE

Reverse mortgages are available to individuals 62 years and older. The amount available depends upon the individual's age and the value of the house and is subject to limits discussed below. The older the individual, the greater the amount of money available to him or her. Because no payments are required during the life of the loan, there are no income requirements.

In order to qualify, the residence must be the borrower's primary residence and be unencumbered by an existing mortgage or have only a minimal balance outstanding. Any encumbrances must be paid off at funding.

### TYPES OF REVERSE MORTGAGES

Three major types of reverse mortgage products are available, offered by FHA/HUD, Fannie Mae and Financial Freedom Senior Funding Program Corporation. Although all three offer the general product described above, differences in lending limits and available insurance may be important considerations in choosing one over the other.

The HUD program, called the Home Equity Conversion Mortgage (“HECM”), can be obtained from a HUD-approved private lender. Only single family residences and

apartment buildings of up to four units, one of which must be occupied by the borrower, qualify as collateral. HECM loans are insured by the federal government. Therefore, if the lender fails to advance funds as promised, the government will do so (and if the amount of the loan is greater than the value of the house at maturity, the government will make the lender whole). The maximum amount available under the HECM program is \$280,749.

The Fannie Mae Program is called HomeKeeper. This product is similar to HECM, but the lending limits differ slightly. Fannie Mae loans are also federally insured, and the maximum loan amount is \$322,700.

The Financial Freedom Plan is a privately owned proprietary product and offers larger loan amounts than either the HECM or the HomeKeeper, with no maximum amount. Because this product is entirely private, however, the loans are uninsured.

The chart below sets forth the estimated amount available under each program to homeowners aged 69, 77 and 85 (the numbers are derived from the Financial Freedom website). The analysis is based on a home in Rancho Palos Verdes with a value of \$1,300,000.

Age	FHA/ HUD	Fannie Mae	Financial Freedom
69	\$169,923	\$92,979	\$277,846
72	\$185,417	\$132,829	\$406,839
85	\$206,324	\$178,442	\$578,216

### OTHER CONSIDERATIONS

Because older citizens are the market for reverse mortgages, the law requires that a prospective borrower receive counselling before completing a loan application. This requirement arose from abuses early in the program by unscrupulous lenders, who attempted to incorporate other products, such as annuities, into the loans, and to ensure the accuracy of advice given by well-meaning but frequently inept lenders. Potential borrowers should examine their loan documents carefully, and should not enter into any transaction with which they are not comfortable.

Before selecting a reverse mortgage, the homeowner must consider a variety of factors. For example, in many instances, at the death of the homeowner, the home will be sold to pay off the loan. Therefore, if a home has been in the family for many years, the homeowner or other family members should first explore other alternatives. If, however, the homeowner is without other resources, the reverse mortgage may prove to be the best or even the only option.

Further information can be obtained from the following websites:

<http://www.fanniemae.com/homebuyers/findamortgage/reverse/index.jhtml>

<http://www.financialfreedom.com/>

<http://www.hud.gov/progdesc/hecm-df.cf>

## SUPPORTING THE ESTATE PLANNING NEEDS ...

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Internal Revenue Code will determine the tax consequences, often to the chagrin of the firm, the terminating party or both.

The professional firm should plan and institute how the capital interest of a terminating member will be valued, paid and taxed. Then each member of the firm must understand how the formula will work, and its financial and tax consequences, whether that member is the first to leave the firm or the last member standing.

### The Capital Interest as an Estate Asset

A professional's capital interest in the firm is often one of his or her larger investments. The interest (or some portion) may be "pre-tax," taxable as ordinary income when distributed, or the interest or some portion may be "post-tax" because the professional paid tax on the contributions when made, and therefore tax-free when distributed later.

The pre-tax or post-tax nature of the interest can materially affect to whom and how the disposition of the interest is made. For example, if a pre-tax distribution will immediately trigger an income tax, planning for an incremental payout will postpone the tax, and, if the payout is made to a spouse, will avoid the double estate and income taxation.

Most corporate or partnership organizational plans expressly direct that, upon the death of a member, the capital interest be paid to the member's estate. This approach takes no account of the member's personal estate plan, which in California typically includes a trust designed to avoid the necessity of a probate proceeding.

Therefore, if the member's capital interest exceeds \$100,000 (\$200,000 if the interest is community property), California law requires a formal probate to move the interest into the member's trust. If the firm instead opts to make an informal distribution, the firm can subject itself to liability from the members' creditors, or even beneficiaries whose interests may have been inadvertently prejudiced or diluted.

Although a Will can implement the same plan as a trust, several aspects of probate may be less than appealing:

1. If the capital interest is a probate asset, a public appraisal of its value is required, which the firm may prefer not to publish in a Court proceeding.
2. Furthermore, the value of that interest, if substantial, could significantly increase the statutory compensation to which the executor of the estate and the executor's attorneys are automatically entitled.
3. Finally, if the interest is funded with pre-tax dollars, the distribution of the account in lump sum through a Will could trigger an immediate and onerous income tax.

A deliberate firm policy to address these tax and dispositive issues, if coordinated with a member's estate plan, can minimize the negative consequences. The firm and its members will not address these issues unless the firm adopts a subsidized program to do so. In the long run, the benefits will far outweigh the costs.

## SOLUTIONS FOR A PROFESSIONAL PARTNERSHIP

The actual experience of a firm law partnership that in three consecutive years lost three active equity members with substantial capital interests illustrates three approaches that can avoid a formal probate. Like many firms, the members had never addressed the nuances of an early death in their partnership

agreement. The agreement merely directed that the capital interest be paid to the member's estate upon a pre-arranged formula.

### The "Wink and A Nod" Approach

When the first member died, the firm informally agreed to distribute the capital interest to the surviving wife, because she was the primary beneficiary under his estate plan, and creditors' problems were negligible. As a rule, however, such informality is extremely risky because transferring the deceased member's interest without following the technical legal requirements can expose the firm to liability to third party creditors for debts left unsatisfied by the deceased member's estate.

*Perhaps the time has come for those professional firms to re-think the benefits of assisting their members in putting their affairs in order*

### Outright Bequest to Surviving Spouse

Before the second member (also married) died after a long illness, estate planning counsel solved the probate problem by including in the member's Will a bequest of the account to the surviving wife, thereby qualifying the account for the abbreviated spousal set aside proceeding of the Probate Court. Under this procedure, a Court Order confirmed the transfer to the widow and at the same time protected creditors' rights in claims against the estate, thus relieving the firm from any prospective liability.

Although this confirmation process was quick and inexpensive, many firms feel that capital interest information is sensitive and that its public disclosure is to be avoided if at all possible. Furthermore, if the deceased member is unmarried, this option is not even available.

### The Beneficiary Designation

Before the third member died, the partnership amended its partnership agreement to allow each member to designate a "beneficiary" of his or her interest in much the same manner as insurance policies. This solution had great merit because (1) the member could direct the payment of the interest in any manner he or she wished, whether to a spouse, children, friends or his or her personal trust, and (2) any creditors' rights against the interest might actually be unenforceable.

## OWNERSHIP OF THE CAPITAL INTEREST BY THE MEMBER'S LIVING TRUST

California law generally prohibits the ownership of an interest in a professional corporation or partnership by anyone other than a professional. For example, a trust cannot practice medicine. It appears, however, that the doctor's revocable trust may hold his or her shareholder interest in a professional corporation so long as (1) the doctor is the only trustee of the professional interest during his or her lifetime and (2) that interest is transferred out of the trust to a qualified professional within six months after death.

The trust instrument can include language that easily satisfies these requirements, but the corporation's bylaws must authorize, or at least not prohibit, such trust ownership of the corporate interest. In that respect, the corporation becomes an indispensable party to the efforts by members to arrange their affairs.

By contrast, a trust cannot own an interest in a professional partnership. Professional partnerships should therefore adopt a beneficiary designation procedure for the capital interest.

## OTHER ESTATE PLANNING TOOLS THAT BENEFIT BOTH THE FIRM AND ITS MEMBERS

Wills or trusts are *sine qua non* components to a smooth estate settlement both for the member's beneficiaries and the firm. Other related, but ancillary planning can, however, be important as well.

### Nomination Of Conservator

Formally naming a conservator may not be necessary if the person with priority by law to serve as conservator is the member's logical choice. The spouse, or the adult children if the member is divorced or widowed, will be first entitled to serve, and if the member finds that priority acceptable, no issue arises. If, however, the member is separated but not divorced, or has multiple children, a family bloodletting could erupt in the Probate Court.

If the member is unmarried but is in a non-traditional relationship (Gay, Lesbian or unmarried heterosexual), he or she will

wish to name his or her life partner to act as conservator. Otherwise, the family members with legal priority could swoop in, assume control of the member's affairs and do great emotional and economic harm to both the member's interests and those of his or her life partner. In the process, the firm could become a reluctant party to the resulting litigation.

*If a member wishes to provide for children from a prior marriage, he or she must earmark assets to fund a separate trust for the lifetime use of the new spouse*

Choosing a responsible and qualified individual or institution to serve in those instances could well avoid, for the individual, the individual's family and the firm, significant and costly friction.

Implementing this choice can only be accomplished by a Nomination of Conservator document.

### Advance Health Care Directive

The power of attorney for health care decisions generally will not impact the firm of an incapacitated or terminal member. In rare instances, however, it is possible that decisions relating to the treatment of the member, perhaps involving a dispute with the group medical carrier, will be facilitated if the member has designated an agent to make those decisions. Particularly in instances where the member has no spouse or adult children or is in a non-traditional relationship, an authorized health care agent may avoid unnecessary involvement of firm personnel in a member's care, treatment and insurance support.

### Power of Attorney for Assets and Financial Decisions

A fully funded trust and a named successor trustee can reduce the need to confer a general financial power of attorney. A trustee may not, however, always have the requisite authority to act, and the designation of an agent under a power of attorney will be useful. Authorizing someone to sign the member's income tax returns and to make decisions with respect to the member's group insurance, pension plan and capi-

tal interest beneficiary designations, particularly where the firm is changing carriers, can avoid possible disputes and even court action.

### Beneficiary Designations

A professional firm will typically leave to its members the decision concerning who should be the beneficiary of the member's group life policy and any pension, deferred compensation or other retirement benefits. Without professional guidance, however, the member may make a designation that can generate needless taxes, expense, friction and even litigation.

For example, if a married member wishes to designate children from a prior marriage as the beneficiary of the member's firm group life insurance proceeds or his or her capital interest, the surviving spouse's community contribution claim can frustrate this goal. The member needs therefore to know the parameters of his or her legal right to dispose of those benefits.

If a member wishes to provide for children from a prior marriage, he or she must earmark assets to fund a separate trust for the lifetime use of the new spouse. At the spouse's later death, the trust assets can then pass to the children of the predeceased member.

Often, however, the family home and the pension account are the primary accumulated assets of the member, and those typically will pass to the surviving spouse. Therefore, the member must carve out a portion of his or her insurance or capital interest to fund that exempt amount. Only through the guidance of an estate planning professional can the member shape a plan that meets the member's needs and those of his or her entire family.

## ESTATE PLANNING AS A JOINT BENEFIT

The bottom line is that even though estate planning is by definition very personal to professionals, the firm of the professional has a significant stake in the soundness of that planning. Accordingly, the firm should encourage and even subsidize the planning process. No longer can the children of the cobbler be without shoes.