

The Rodi Review

Winter 2006

LETTER FROM THE EDITOR

We hope you and your families had a happy and healthy holiday season!

Welcome to the Winter 2006 issue of the Rodi Review. In this issue, we return to our estate planning roots, with articles by Bradley Marsh, about the use of irrevocable life insurance trusts as a still-valuable estate planning tool, and Tom Curtiss, who discusses the impact of new California legislation affecting registered domestic partners.



Jean M. Beasley

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LEGAL UPDATE: NEW LIMITS FOR RETIREMENT AND ESTATE PLANS

by Jean M. Beasley and John D. Pettker

With the advent of 2006, increased limits retirement account funding, annual gift exclusions and lifetime exclusions from the federal estate tax have become effective:

IRAs

The 2006 maximum allowable contribution for traditional and Roth IRAs is **\$4,000**. Individuals over age 50 may now contribute an additional **\$1,000**.

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THE IRREVOCABLE LIFE INSURANCE TRUST: ALIVE AND WELL IN THE CHANGING ESTATE TAX ERA

by Bradley R. Marsh

Without proper planning, federal gift and estate taxes can still consume, even in this era of lower marginal estate tax brackets and higher exemption equivalents, nearly half of an individual's estate. A properly drafted and funded irrevocable life insurance trust ("ILIT") can help shelter transfers beyond the current \$1 million gift tax exemption and the \$1.5 million estate tax exemption and can provide tax-free dollars for payment of estate liabilities in the insured's estate.

The ILIT is a complex document, the terms of which are driven in large

part by the tax law to avoid gift and estate tax liabilities. The scope of this article is therefore to provide a conceptual overview, not to offer a primer for establishing such a trust.



INSURANCE AS A VALUABLE ESTATE PLANNING TOOL

Historically, the most common use of life insurance has been to provide for family members and loved ones in the event of an unexpected death. Individuals who have insufficient liquid assets in their estates to meet their families' ongoing

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WHAT HATH SACRAMENTO WROUGHT?

by Thomas Curtiss, Jr.

The gay and lesbian community in California has long advocated legal parity with married couples for gay and lesbian life partners. In response, the California state legislature passed AB 205, effective as of January 1, 2005, which has conferred upon registered domestic partners (a class which includes not only gay and lesbian couples but also heterosexual couples where at least one party in the relationship is over age 62) almost all of the same rights, obligations and privileges of a married couple.

The statute is well meaning, but has predictably raised nearly as many questions as answers, generating an entirely new legal sub-specialty in one fell swoop. Only couples who have registered with the California Secretary of State are affected by the legislation. Therefore, an unmarried couple who qualifies for RDP status will ask one of two equally important questions:

1. Should we register?
2. Because we have been registered since before January 1, 2005, what should and can we do now?

WEIGHING THE PROS AND CONS OF REGISTERED STATUS

The first question is the easier of the two: Before registering, the partners can first weigh the benefits and offsetting disadvantages. To be sure, significant benefits can attach to registering as RDP's, such as the ability to inherit in the absence of a Will, priority to serve as Conservator or Administrator of a partner's intestate estate, adoption rights and many more. The new law essentially gives RDP's the same legal rights (except for income and estate tax purposes) that married couples enjoy.

A couple considering formal registration can therefore inspect the panoply of obligations and benefits and define their commitment accordingly.

The desire of the parties to adopt, the need for one partner to be on the group medical insurance policy of the other or



The snake pit seems to be the community property accrual provision, which, in its present application, makes no sense.

even the need of one partner to file a disability claim for the other may be the crucial concern.

THE RETROACTIVE ACCRUAL OF COMMUNITY PROPERTY FOR PARTNERS REGISTERED PRIOR TO JANUARY 1, 2005

The snake pit seems to be the community property accrual provision, which, in its present application, makes no sense. The legislation has sought to give parity to RDP's in sharing their lives in the same manner as married Californians. The problem is that the

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statute has enacted an automatic retroactive accumulation formula for those who were registered as RDP's before January 1, 2005, unless they chose to opt out of the community property regime prior to June 20, 2005. The result in some cases can potentially create a significant transfer of wealth.

An anecdotal example is instructive: RDP clients prepared through our office

separate estate plans in about 2000 that provided for each other, but also ultimately benefited separately their own families or charitable organizations. At the time, the older partner was retired, and his estate consisted of rental properties, in California and elsewhere, with an approximate value of \$6 million. His younger partner was struggling with a start-up company. By the fall of 2004, the value of the younger partner's enterprise, as a direct result of his efforts, was estimated to be \$10 million.

Absent an agreement to the contrary, the older partner would have acquired from his younger partner's efforts as much as \$5 million in assets to fund his own estate plan, and the younger partner would have lost a like amount.

Furthermore, upon the death of the older partner, those community assets would ultimately have passed to his chosen beneficiaries; potentially forcing the younger partner into a business arrangement with partners not of his choosing. This result was not their intention, and they entered into a timely agreement that reversed that result.

The Legislature must have established the January through June window period to allow RDP's to opt out of the community property accumulation tax-free, and it is unlikely that any RDP's who did so will encounter tax difficulties. These difficulties will visit themselves upon RDP's whose personal financial arrangements are not so well ordered and any such arrangements entered into after the window period.

THE ACCUMULATION OF COMMUNITY PROPERTY AS A POTENTIAL GIFT TAX LIABILITY

The potential problem arises where a great disparity exists in the partners' earning capacities, and the parties' earnings have accumulated as a result. The more highly compensated partner has in

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needs in the event of their premature death often rely on term life insurance to provide their families with financial security if they die prematurely.

High net worth individuals can structure whole life (but not term) policies to provide life insurance proceeds for payment of estate taxes at their death, or even at the surviving spouse's later death, with *tax-free* dollars. An ILIT is the most popular vehicle for doing so.

The main objective of the ILIT is to avoid inclusion of the life insurance proceeds in the insured's — and the surviving spouse's — taxable estate. If the insured is married and pays the premiums out of his or her separate property resources, the insurance proceeds, if paid to the trust at the insured's death, can then be available to support the surviving spouse and still pass tax-free to the children at his or her later death.

For married couples, the insurance industry has developed a joint insured policy that only pays the proceeds upon the death of the survivor, which, because of the marital deduction, is typically when any estate tax will be due. If the survivor does not require the insurance proceeds for support after the death of his or her spouse, this policy can provide the necessary liquidity for that purpose. Furthermore, the policy premiums will be significantly lower because a policy insuring two lives creates an actuarially lower risk.

FUNDING THE TRUST

Existing life insurance policies can fund the trust. The insured simply assigns the ownership of the policy to the Trustee of the ILIT. This funding arrangement will require that the insured live for three years after the policy trans-

fer in order to avoid estate tax inclusion.

Alternatively, the Trustee can instead purchase a new policy for the trust, using cash the insured has transferred to the trust for that purpose. The three year survival rule does not apply when the Trustee purchases the policy directly.

PAYING THE PREMIUMS

In order to exclude the policy proceeds from the estate, the Trustee must be responsible for paying the premiums on the policy, although the insured will typically contribute the actual cash resources. If the policy is a joint policy on the lives of both spouses, then neither spouse can serve as Trustee because a

The main objective of the ILIT is to avoid inclusion of the life insurance proceeds in the insured's — and the surviving spouse's — taxable estate.

Trustee/insured is considered the "owner" of the policy for estate tax purposes. Even where only one of the spouses is the insured, it is unwise for the other spouse to serve as Trustee in order to avoid possible ownership issues arising out of community contributions.

GIFT TAX CONSEQUENCES

Unless properly structured, any cash contribution to an ILIT will be a reportable gift to the beneficiaries of the trust for gift tax purposes. That tax liability is avoidable only if the beneficiary has the limited right to draw down the gifted contribution. If this right is limited to the greater of (a) the first \$5,000 contributed to the ILIT in each calendar year, or (b) 5% of the value of the ILIT value in that year, then the gifted contribution is tax-free to the beneficiaries.

If the policy premium amounts exceed this annual ceiling, the trust will typically confer upon the beneficiaries a limited withdrawal right, known as *Crummey* power (up to \$12,000 per spouse each year), which will then qual-

ify the contribution for the present interest exclusion and avoid a reportable gift. Under this structure, during a brief interim period after the insured has made the cash gift to pay the premium, the beneficiary has the right to draw the gift down. The beneficiary's failure to do so will then cause the right to lapse and make the contribution available to pay the gift. Of course, if the *Crummey* power holder elects to draw down the contribution, the entire plan to fund the insurance premiums is frustrated.

As a corollary, if the *Crummey* contribution amount is higher than the "5 or 5" ceiling referenced above, a portion of the proceeds would be "owned" by the beneficiaries at the death of the insured or second insured. Because the beneficiary is not the deceased party, however, no federal or estate tax consequences would arise.

GENERATION-SKIPPING TRANSFER TAX

It is possible to structure the ILIT to remain in existence for the lifetimes of the insured's children and grandchildren. By allocating a portion of the insured's generation-skipping transfer tax exemption to the trust, it is possible to leverage the ILIT to pass significant amounts of wealth to future generations. Generally, however, the purpose of an ILIT is to pay the estate tax on the second death, and then the trust terminates.

USING AN ILIT AS AN ONGOING ESTATE PLANNING TOOL

As stated above, the ILIT has not entirely lost its usefulness in the planning of large estates. As Congress continues to tinker with the concept of estate tax repeal, you may wish to consult your estate planning advisors as to whether an ILIT meets your needs.

WHAT HATH SACRAMENTO WROUGHT?

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effect made a transfer to the other to the extent of one-half of the accumulated community property. Because the Internal Revenue Service has not yet recognized this new form of community property, it is even possible that the Service will assert that this transfer from the more highly compensated RDP generates a gift tax liability.

The gift problem disappears if both partners have essentially the same income. Furthermore, even if one partner has been earning significantly more than the other, the actual community property accumulations could still be minimal if the partners have been spending all of their earnings on living expenses. Under California Law, living expenses are first chargeable to community earnings, which may in effect draw down all or most of the community accumulations and obviate the problem.

TERMINATION OF REGISTRATION AS A SOLUTION MAY INVOLVE A FORMAL DISSOLUTION PROCEEDING

One option that would appear to be logical is probably not practical – terminating the partners' registered status. Unless the RDP's financial history is

very modest (in which event terminating the status should not be a priority), the RDP's must subject themselves to the same dissolution Court formalities as heterosexual couples who are dissolving their marriage. With separate representation, aggressive "tracing" of community accumulations and the involvement of the Court in every step of the process, the RDP's could find

Where two partners have disparate income expectations, they must decide whether this kind of wealth transfer is acceptable.

themselves in a very expensive and acrimonious proceeding even though their personal relationship is still intact.

PLANNING PRIOR TO REGISTRATION

Leaving aside the pre-existing RDP's, what legal steps can prospective RDP's take to embrace the good and avoid the bad in the AB 2005 package? Where two partners have disparate income expectations, they must decide whether this kind of wealth transfer is acceptable. If not, they may want to avoid registration. If wealth transfer is a significant goal of registration, then the only peril in registering is if the IRS successfully asserts that one party made taxable gifts to the other.

Another possible option, as yet untested, is for partners to enter into a "Uniform Premarital Act" agreement. California Law expressly allows an engaged or married couple to enter into an agreement that alters the character of the property owned by each or later acquired from separate to community, or the reverse.

Because the law applies to agreements between heterosexual married couples, the same law should apply under AB 205 to RDP's as well. The IRS may, however, take the technically logical position that, because RDP's do not qualify for the marital deduction (which exempts inter-spousal gifts from gift tax), although the agreement is legal, a taxable transfer has occurred. If so, it may be more economical for the RDP's to revoke the agreement. Depending on how soon the RDP's learn of the gift tax consequences, the cost to them could be significant.

Estate planners have survived carry-over basis, the generation-skipping transfer tax and will likely survive AB 2005, with all of its attendant problems and the need for individual partners, for income tax purposes and community accumulation purposes, to maintain two sets of books. Our tax law is consistent in being inconsistent!

LEGAL UPDATE

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EMPLOYER-SPONSORED PLANS

The limit for employee contributions to 401(k) and similar plans is \$15,000. Employees over age 50 may contribute an additional \$5,000.

GIFTS

The IRS has announced that the annual gift exclusion amount has

increased to \$12,000. This amount is indexed for inflation, but will only increase in \$1,000 increments in the future.

LIFETIME EXCLUSION FROM ESTATE AND GENERATION-SKIPPING TRANSFER TAXES

This amount has increased as scheduled from \$1,500,000 to \$2,000,000, and under the current law will remain at that level until 2009. Repeal, or the more likely reform, of the estate tax

continues to be a hot topic on Capital Hill, and we predict that Congress will reform, but not repeal, the estate tax. Our source in Washington has projected that the final version will include a probable estate tax exempt amount of \$3 to \$5 million and a maximum tax rate in the range of 30 to 40%. When all is said and done, Congress will, as a practical matter, eliminate the estate tax for all but the wealthiest Americans.