

**AN OVERVIEW OF THE FEDERAL TRANSFER
TAX SYSTEM AND ESTATE PLANNING**

BY

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I. INTRODUCTION

The Estate Planning Department at FERRARI OTTOBONI LLP provides legal services relating to family wealth transfers, including pre-mortem and post-mortem tax planning to minimize the effect of transfer taxes to the estate and beneficiaries. Our practice involves special emphasis in areas relating to family business control and estate administration. The following are our general areas of expertise:

1. Inter Vivos Trusts
2. Wills and Durable Powers of Attorney
3. Advance Health Care Directives
4. Generation Skipping Transfers
5. Family Partnerships
6. Irrevocable Trusts
7. Charitable Planning
8. Post-Mortem Trust Administration
9. Probate Administration
10. Tax Litigation

11. Family Business Succession Planning

This document is intended to provide you with a general understanding of what estate planning is and what services we can provide to you to help you in the estate planning process. Please note that we do provide estate planning services which are much more complex than what is explained in this document should the need arise in any particular situation.

Basically, we will help you to plan your estate so that your assets get to whom you want, when you want in such a way as to minimize taxes, while at the same time, providing for yourself and your loved ones.

II. WHAT IS ESTATE PLANNING?

Estate planning is a process that begins during your life and can continue far after death. It is a process whereby you develop a plan to take care of yourself during your lifetime and to transfer your wealth to whom you want and when you want, in a cost efficient manner, while minimizing taxes upon your death.

III. TAX PROVISIONS RELATING TO ESTATE PLANNING

A. Federal Estate Tax

Historically, the Federal Estate Tax arose to redistribute the wealth held by a few to allow more people to own and share available wealth. Now it is imposed to raise revenue.

The Federal Estate Tax is the United States Government's death tax. It is a tax levied against the "right to transfer" property on your death. It is a tax on everything you own at your death, with certain exceptions, and it is paid to the federal government before your beneficiaries receive their share. Prior to 2002, the rates were progressive, beginning at 37% to a maximum of 60%, including the 5% surtax levied on estates valued at over \$10,000,000. In 2002, the rates range from 41% on estates valued in excess of \$1 million to a maximum of 50% on estates valued in excess of \$2.5 million. The maximum rate for any calendar year after 2002 and before 2010 will be 49% in 2003, 48% in 2004, 47% in 2005, 46% in 2006 and 45% in 2007, 2008 and 2009. The tax is based on the fair market value of the property owned by you on the date of your death and must be paid in nine (9) months after your death. The estate tax will be fully repealed for just one calendar year, 2010, before the repeal "sunset" and the estate tax rules in effect prior to 2002 return. Thus, in 2011 the top rate would return to 60% and the exemption amount would revert to \$1 million.

There are two (2) major tax exemptions from the Federal Estate Tax which are frequently used estate planning devices:

1. Currently, the Federal Estate Tax only applies to estates valued in excess of \$1,500,000. Therefore, if you die this year and own less than \$1,500,000 no estate tax will be due. The good news is that this individual estate tax exemption will gradually increase over the next several years to \$2,000,000 in 2006, \$3,500,000 in 2009 and will be repealed in 2010 (although in 2011 the estate tax rates in effect prior to 2002 return) and;

2. Spouses are able to leave property to their spouses free of Federal Estate Tax.

B. Federal Gift Tax

Like the Federal Estate Tax, the Federal Gift Tax is a tax on the privilege of transferring property during your lifetime. The manner in which the transfer is made determines whether a gift has been made.

Generally, a gift is defined as any transfer of property for which the donor receives less than the full property value in return. The rates are the same as the estate tax rates.

There is also an exclusion from gift tax that is used frequently in estate planning. You are allowed to give away \$11,000 to as many persons as you desire each year without incurring a gift tax. If you are married, you and your spouse together can gift \$22,000 per person each year. Because of this exclusion, annual gift planning is an important estate planning tool which enables you to reduce the size of your taxable estate tax free. Transfers in excess of \$11,000 (\$22,000 for a married couple) are subject to gift tax although each person may gift up to \$1,000,000 during their lifetimes free of gift tax.

C. Federal Generation Skipping Transfer Tax (GSTT)

The GSTT is imposed on all transfers of property from an individual in one generation to an individual in two generations below the generation of the transferor. The simplest form is a gift from grandparent to grandchild during life or upon death. The current rate of tax is 48% of the value of the transfer.

Each person has a \$1,500,000 exemption; therefore, you can give to your grandchild \$1,500,000 without incurring the GSTT and so could your spouse. The exemption is indexed for inflation.

The GSTT is aimed at individuals who wish to pass a substantial amount of property to younger family members without paying federal estate tax when intervening generations of family members die. While this tax has made it more difficult to skip generations, some methods still exist to maximize the amount that can pass from grandparent to grandchild or great grandchild.

IV. TITLE: HOW DO YOU OWN PROPERTY?

In order to understand how estate planning works, you need to understand how you own your property, i.e. how title to your property is held. There are four (4) often used methods by which an adult takes ownership of property:

- (1) fee simple
- (2) tenancy in common
- (3) joint tenancy
- (4) community property

A. Fee Simple

If you own something in "fee simple" then you are the sole and absolute owner of the property. Therefore, you can dispose of it during your life or upon your death such as by will.

B. Tenancy in Common

Property owned as a tenant in common is owned with one or more persons. For example, if you and your spouse own a book as tenants in common, each of you owns 50% of the book (i.e. you each own 50 pages). Therefore, each of you may give away during your lifetime or upon your death, 50 pages to anyone.

C. Joint Tenancy with Right of Survivorship

Assume again that you and your spouse own the same 100 page book as joint tenants with the right of

survivorship. As a joint tenant, you each own 100% of that book for purposes of holding title (it is different for tax purposes). The survivorship feature means if you die then your spouse, the surviving joint tenant, owns the entire property. The survivorship feature is significant in that you cannot dispose of your interest in the property at your death. The survivorship feature overrides any disposition which you make in your will or otherwise to transfer the property when you die. It automatically goes to the surviving joint tenant. Because of this, the property will not go through probate until the surviving joint tenant dies. However, holding title in

this form severely limits your control and estate planning options and also has certain tax disadvantages which will be discussed below.

You can, during your lifetime, give away or sell your interest. It is only at death that you are prevented from doing so.

D. Community Property (available for married persons only)

California allows a husband and wife to hold title to property as community property. As so held, each spouse owns 50% of the property and can give away his or her own share during each of their respective lives or upon death.

Community property is generally property acquired during your marriage as distinguished from separate property. Separate property is property acquired before marriage, given to one spouse by gift, or inherited by one spouse. Although, the property in question may not be community property, spouses are free to change the status of their property and acquire title as community property. There is a major tax advantage to doing so which will be discussed below.

V. TAX BASIS - EFFECT AT DEATH

A. Joint Tenancy and Tenancy In Common

Although you are considered to own 100% of the property as a joint tenant for title purposes (see section IV.C.), for tax basis purposes, you are deemed to own 50% if title is held in joint tenancy or tenancy in common. Generally, your tax basis in your property is whatever you paid for it. When you die, your 50% of the property gets a step up in basis equal to its fair market value.

Example: Assume you paid \$100,000 for an asset that is worth at your death \$300,000. You own this property as a joint tenant or tenant in common with your spouse. Only your half receives a step-up in basis equal to one-half (1/2) of the property's fair market value.

Surviving Spouse Decedent

Fair Market Value: \$150,000 \$150,000

Basis: \$ 50,000 \$150,000

Surviving Spouse's New Basis - \$200,000. Therefore, if the surviving spouse sold the property today, he/she would have \$100,000 of gain.

B. Community Property

If you and your spouse held title to the property as community property, then both the surviving spouse's one-

half (1/2) and the decedent's one-half (1/2) of the property receive a new stepped-up basis after the first death equal to its fair market value.

Surviving Spouse Decedent

Fair Market Value: \$150,000 \$150,000

Basis: \$150,000 \$150,000

Surviving spouse's new basis: \$300,000. Therefore, if the surviving spouse sold the property today, he/she will have no gain. All gain is forgiven at the death of the first spouse.

C. New Income Tax Basis Rules in 2010

The favorable tax treatment of basis remains the same until 2010 when the estate tax repeal is scheduled to be fully implemented. Thereafter, only the first \$1.3 million of any estate will receive the step-up in basis; however, a married person will be allowed to leave an additional \$3 million to a spouse with the favorable tax treatment. For amounts over those limits, heirs will be required to determine how much was invested in a stock or other asset by the decedent in order to determine the capital gain when the asset is sold. That can be difficult. Congress tried such a system in the mid-1970s by eliminating the step-up in basis for inherited assets, but the experiment did not last long. After two years it was repealed retroactively as unworkable.

Keeping track of basis over many years--or several lifetimes if the assets are inherited more than once--could be a nightmare. Those who fail to keep good records may end up paying more in taxes. Families who are unable to prove the cost of improvements over time on a house, for example, may be required to use the home's original purchase price as their tax basis and thus face higher capital gains taxes.

VI. WHAT HAPPENS IF YOU DIE WITHOUT A WILL?

A. Introduction

If you die without a will, then you lose control over what assets you want to go where and when and for whom you want to provide for after your death. In addition, you may pay a substantial amount of tax which could have otherwise been avoided. Without an estate plan, the State determines to whom and when your assets will be transferred. Most likely, this will be done in a way much different than you desire.

B. Intestacy

If you die without a will you have died intestate. Your estate will be probated and distributed to your heirs under the laws of intestate succession in the State of California.

Your estate will most likely be probated unless the assets are held as community property or in joint tenancy, or inside a revocable living trust, or if the assets are less than \$100,000 in value.

According to the California laws of intestate succession, if you own separate property (vs. community property) and you leave a spouse and one child, then one-half of the separate property will pass to your surviving spouse and one-half will pass to your child. Your surviving spouse will get all of the community property. If you leave a surviving spouse and two or more children, then one-third of the separate property will pass to your surviving spouse and two-thirds will pass to your children. Your surviving spouse will get all of the community property. If you leave a surviving spouse but not children, then one-half of the separate property will pass to your surviving spouse and one-half will pass to your parents, if they are alive, or if not, then one-

half will pass to your siblings. Again, the surviving spouse will get all of the community property. If you have no spouse, then upon your death your property will pass to your heirs. If none of your heirs can be found, your estate will be distributed to the State of California.

Furthermore, if you are single and you have a child under the age of 18, a guardian will be appointed by the court (and may very well be someone you do not know) to take care of your child and his or her finances.

Likewise, an administrator will be appointed by the court to settle your estate and will very likely not be someone you would have chosen.

C. Conclusion

Dying without a Will causes you to lose control as to who will get what, who will take care of your children, and who will handle your estate.

VII. DYING WITH A SIMPLE WILL

Dying with a simple will permits you to decide where you want your assets to go, who will administer your estate and who will take care of your minor children instead of the State of California.

Whether you die with a will or without a will, your estate will most likely require a probate administration. (See VI, B)

VIII. PROBATE - WHAT IS IT?

A. In General

Probate is a court supervised process of passing ownership of property from deceased persons to others. It involves the collection of assets and the passage of title to beneficiaries under the control and supervision of a probate judge. This process can be extremely time consuming and expensive.

The average length of time for the probate of an estate is approximately 9 months. However, this is assuming there are no complications, such as will contests or other litigation.

B. Statutory Probate Commissions and Fees

The California Probate Code provides for statutory commissions to be paid to the personal representative (executor or administrator) of the decedent's estate and for fees to the attorney for the personal representative.

Statutory commissions and fees are based on the gross fair market value of the estate and, accordingly, the fee computation does not reflect mortgages and other debts the decedent may have. The fee is four percent (4%) of the first \$100,000; three percent (3%) of the next \$100,000; two percent (2%) of the next \$800,000, and one percent (1%) of the next \$9,000,000 and one-half percent (%) thereafter. Therefore, the total commission to the personal representative for an estate of \$1,000,000 would be \$23,000 and the attorney would be entitled to receive the same amount. The attorney may also charge extra fees for extraordinary services, such as the sale of property.

IX. THE REVOCABLE LIVING TRUST

A. What is it?

A revocable living trust is a trust which is set up during the lifetime of the individual or couple. It allows the person(s) who establish it to maintain control of their assets until they die and is basically a receptacle for your assets. During their lifetimes, the trust is revocable, alterable and amendable. A living trust, if fully funded (i.e. title to all of your assets is in the name of the trust), will avoid probate thereby allowing the surviving family members to deal with the assets of the trust freely without having to obtain court approval and supervision.

B. Benefits

The following is a long list of the benefits that can be derived from the use of a revocable living trust:

1. You can give what you want to whom you want and when you want subsequent to your death through the use of a revocable living trust.
2. As the trust maker, you can specify your distribution terms and requirements as to how your property will pass after your death.
3. A revocable living trust can control, coordinate, and distribute all your property interests while you are alive as well as on your death.
4. You can arrange for your well-being under your terms as you advance in years, become ill, or become mentally incompetent.
5. It assures that your plans and affairs will remain private, rather than being made public, on your death or incapacity.
6. It is easy to create and maintain during your lifetime.
7. It is not difficult for you to change or amend.
8. There are no adverse lifetime income tax consequences that result from its use.
9. Property included in the trust does not pass through probate.
10. All opportunities of death tax planning available through a will are equally available.
11. It is legal in every state.

Furthermore, the trust is set up to make use of all the estate and generation skipping tax exemptions discussed above so as to effectively eliminate any estate tax which would otherwise be due after the death of the first spouse. For example, Mike and Karen are married and together have a net estate of \$3 million. They are both U.S. Citizens, they both die in the year 2004, and they have not depleted their respective individual estate tax exemptions during their lifetimes. Mike dies first and using the marital deduction, leaves everything to Karen estate tax free. Assuming they did not plan their estate to capture Mike's individual estate tax exemption at his death, when Karen dies, her estate of \$3 million can claim her \$1,500,000 exemption, but the estate tax bill on the remaining \$1,500,000 is \$705,000. When Mike left everything to Karen without a plan to capture his exemption, it is completely wasted.

However, if they established a revocable living trust with properly drafted tax planning provisions, they could have used both of their exemptions and saved \$705,000 in estate taxes. The trust terms would split their combined \$3 million estate into two trusts of \$1,500,000 each. When Mike dies, his trust captures his \$1,500,000 exemption, and when Karen dies, her exemption is applied to her \$1,500,000 trust. The result is that their taxable estates are both reduced to \$0, so the full \$3 million can go to their loved ones.

C. Trust Funding

A revocable living trust is an "empty basket" which can only provide the previously-described benefits if it is properly funded with your assets. To properly fund the trust, we first prepare a detailed trust schedule which lists each of your assets and their identifying characteristics, such as account numbers, parcel numbers, or certificate numbers. We then help you change the title of your assets so that they are titled in your name as trustee of the trust. Only then will the trust "basket" be full. After your death, trust assets which are not properly titled will have to be confirmed as trust assets by the probate court with corresponding costs and time delay.

We will also counsel you on how to properly designate beneficiaries on your retirement and pension plans (IRAs, 401(k) plans, etc.) and your life insurance policies so that they will be distributed according to your wishes.

X. THE DURABLE POWER OF ATTORNEY

A Power of Attorney is a very important legal tool. If you become mentally or physically disabled to a point where you cannot manage your own affairs, your spouse or child does not automatically have the right to sign your name to any document or to make decisions which would legally bind you. In order that they may act on your behalf, they must request the court to appoint them as conservator of your person and estate. Avoiding the expensive and time-consuming legal process and court mechanisms of a formal conservatorship is a worthwhile goal. A properly drafted, signed and notarized Power of Attorney can solve the conservatorship problem.

You can, by signing a properly drafted Power of Attorney, appoint some other person to legally act for you. When you empower a person to act for you, you are known as the "principal" of the power. The person who you appoint is known as your "agent" or your "attorney in fact." This agent is a fiduciary and strictly accountable to you the donor for his or her acts.

Legislation has greatly enhanced the effectiveness of a Power of Attorney. Prior law made it impossible for the agent to use the power if the donor was incompetent. To overcome this deficiency in the law, California enacted legislation allowing the principal to make the power "durable" and not have it affected by his or her incompetency.

Donors typically create two types of Durable Powers of Attorney, a California Form Durable Power of Attorney and a Durable Power of Attorney for Health Care. Unless otherwise stated, a Power of Attorney is valid as soon as you sign it and continues until revoked by you.

A. California Form Durable Power of Attorney

You can create a California Form Durable Power of Attorney to designate an agent or several agents to manage your property and personal affairs. The agent can make decisions that legally bind you and can sign on your behalf. We typically draft such documents so that the agent only has authority to act if two people named by you in the document declare in writing that you are incapacitated. The California Form Durable Power of Attorney may only be revoked in writing and with notification to the agent.

B. Advance Health Care Directive

You can create an Advance Health Care Directive to designate an agent or several agents to make health care decisions on your behalf when you are not able to make them. Physicians, hospitals and other health care providers are bound to accept and consider such health care decisions as if they were personally made by you. Such decisions could involve both giving certain treatment and withholding treatment. The withholding of treatment in terminal illness situations can only be done with the concurrence of the treating physician, but the "living will" provisions contained in the document can be persuasive evidence of your intent to have a dignified natural death. It should be noted that the agent cannot commit the principal or to a mental care facility, consent to "shock" treatment, psychosurgery, sterilization, or abortion. The Advance Health Care Directive is valid until revoked by the principal in writing or orally.

XI. CONCLUSION

We know of no average or representative estate planning situation that could be used as an example or illustration to summarize all the estate planning principles and techniques that we have discussed. In our experience, people have individual estates requiring individual planning techniques.

There are also several more complicated areas that we have not discussed, such as retirement planning, charitable giving, etc., which are valuable estate planning tools.

Estate planning is an area in which you should rely on trained professionals to advise you of the estate planning options which are most beneficial to you and which will achieve your desires.

We will be happy to discuss with you your estate planning desires and options and any questions that you might have. We hope this information has been helpful.