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RE: Changes in Tax Law and its
Impact on Your Estate Plan

Dear Friends and Clients,

As I write this letter this morning, I am truly amazed with the U.S. Senate's inability to forge a resolution to the repeal of the estate and generation skipping tax which took effect on January 1st. I never really believed it could happen. Nor did any other competent estate planner throughout the country. But as of today, that is exactly what has happened. Effective January 1st, the federal estate tax and the generation skipping transfer tax has been repealed and we now have the introduction of carryover basis. The changes last for one year and then we go back to having a death tax in 2011 with only a \$1.0 million exemption per taxpayer. The real question we now face is whether Congress will pass legislation during 2010 which will be retroactive to January 1, 2010. We just don't know.

Background

In the 2001 Tax Act (known as EGTRRA), many changes were made to the transfer tax system, including increasing the estate and generation-skipping transfer (GST) exemptions gradually to \$3.5 million as of 2009, lowering the top rate for all three transfer tax systems to 45%, eliminating the state death tax credit and ultimately repealing the estate and GST taxes (but not the gift tax), and thereafter lowering the top gift tax rate to 35% and eliminating of the "step up" in basis under section 1014(a) of the Internal Revenue Code so a decedent's basis will "carryover" to those who inherit his or her property.

The 2001 Act, however, also included a "sunset" provision that eliminates all of the changes (including the transfer tax changes) at the end of 2010. Unless the Internal Revenue Code is changed, beginning in 2011, the estate tax will be reinstated, the estate tax exemption will decrease to \$1.0 million, the top estate, gift and GST tax rate will become 55% as it was before the 2001 Act (and it may even be 60% for some estate and gift tax transfers), the estate and gift tax system will again be "unified," the state death tax credit under section 2011

will be restored, and several other important provisions will again be as they were before EGTRRA.

The chart set forth below summarizes the essential changes in the estate tax arena:

2009 Rules [Old]

- \$3.5 million estate and GST exemption
- 45% maximum estate tax rate on estates in excess of \$3.5 million
- \$1.0 million lifetime gift tax exemption
- No state death tax credit
- Beneficiaries receive property from a decedent with an income tax basis stepped up to date of death values

2010 Rules [Current]

- Estate and GST tax repealed
- \$1.0 million lifetime gift tax exemption remains but the maximum rate on gifts is reduced from 45% to 35%
- Estate tax replaced with carryover basis for income tax purposes

2011 Rules [Future]

- Estate and GST tax reinstated
- \$1.0 million estate and GST tax exemption (indexed for inflation)
- 55% maximum estate tax rate
- State death tax credit reinstated
- Estate and gifts taxes are unified
- Carryover basis is eliminated.

These fundamental changes in the transfer tax laws present difficulties and complexity for planners, opportunities for some of our clients, and unknown potential dangers. There is a possibility Congress could pass legislation this year reinstating the transfer tax system as it existed in 2009 with such legislation retroactive to January 1, 2010. I personally believe that this is unlikely to occur but other commentators feel differently. There is also a significant risk that any action taken on the premise that either the estate or the GST tax will indeed be repealed for the entire year, or that the gift tax rate will be only 35%, could result in unintended consequences and unexpected transfer taxes if a tax is retroactively imposed. The longer we proceed into 2010, the risk of retroactive legislation decreased significantly.

Effect on Clients

Many of our clients have used what we commonly refer to as formula clauses to make gifts under their will or trust. For example, many married people divide their estates into two portions: one portion equal to the unused estate tax exemption (typically passing into a non-marital deduction trust often called the "family bypass trust" or "Trust B" for the benefit

of the surviving spouse and descendants or sometimes, in larger estates just to descendants) and the other portion passing outright to a spouse or to a marital deduction trust for the spouse's benefit. In some cases, the bequest intended to qualify for the marital deduction is phrased as "the lesser of the maximum marital deduction allowable in my estate or minimum amount necessary to reduce my federal estate tax to zero."

In other cases, an individual, whether or not married, will have a portion of his or her estate equal to his or her "unused GST exemption" pass in a way different from the balance of his or her estate, such as to a trust for the benefit of his or her grandchildren and more remote descendants.

Under pre-existing tax laws, these formulas are used because they produce what appears to be the optimal division or disposition of a decedent's property at the least possible transfer tax cost. **But they have no meaning if the concepts used to define them are no longer part of the tax law.**

For example, our firm has frequently used formula clause to minimize or eliminate federal estate taxes. But, what is the "minimum amount necessary to reduce my federal estate tax to zero" if there is no federal estate tax? The beneficiary of that gift will get nothing because that formula yields a gift worth \$0. That is clearly not what one may have had in mind when their documents were signed. Some beneficiaries (either your spouse, your children, your grandchildren or others) will be distraught if you die with these clauses in place because someone will not get a gift that you intended and others will get more than you intended. This will likely lead to costly and time consuming will contests and related legal proceedings.

Carryover Basis Considerations

The income tax basis of assets acquired from an individual who dies in 2010 will not equal their estate tax values. Instead, the basis of his or her assets will "carryover" to those who inherit the property. There are two "exceptions" to the 2010 carryover basis rule, which will provide some relief to the beneficiaries who receive these assets.

The first exception permits the decedent's executor (or personal representative) to allocate up to \$1.3 million to increase the basis of assets. This increase, however, may not increase the basis above the fair market value of the asset on the date of death. In addition to the \$1.3 million step-up in basis, the decedent's executor (or personal representative) can also allocate up to \$3.0 million to increase the basis of assets that the surviving spouse receives outright or through a QTIP trust (called "qualified spousal property").

If carryover basis is not repealed in 2010 (I expect that it will be), your wills (and it must be your will because it is only the executor who by law has the authority to allocate the basis increases) should have language to authorize the executor to allocate the basis increase, in the executor's sole and absolute discretion. This is true even for clients who do not have

formula clauses in their trusts (typically referred to as a trust passing property solely to the surviving spouse with a “disclaimer trust” option). Trusts and wills of our married clients should be revised to make a special bequest to either spouse or a QTIP trust to permit the use of the \$3.0 million basis increase for "qualified spouse property.

What do these changes mean to you?

If your personal estate is less than \$1.0 million excluding life insurance (or jointly \$2.0 million for community property estates), it is unlikely that your existing wills and trusts will need to be changed to reflect the possibility of there being no estate tax. However, because of the uncertain estate tax environment, you may still want to have your estate plan reviewed to make certain that your assets pass in accordance with your wishes, regardless of the level of exemption or rate of tax.

If your personal estate is valued at more than \$1.0 million dollars but is less than \$2.0 million dollars, you should likely have your plan reviewed. Asset protection planning will remain vital, as will planning for incapacity, disability or spendthrift issues. Planning for 2011 with only a \$1.0 million dollar exemption is important.

For our clients with estates valued at more than \$2.0 million dollars (and that is the vast majority of our clients), you absolutely should make an appointment to confer with us about necessary changes to your estate plan. This will allow us to customize your plan to fit your needs in this continuing uncertain transfer tax environment.

For our largest clients, extraordinary planning opportunities may exist for transferring wealth to grandchildren before Congress acts in 2010 to close numerous loopholes which have availed themselves.

Finally, clients with interests in businesses will still need to create business succession plans, while considering the associated tax consequences. Clients with relatively large retirement plans should consider converting at least a small portion of such plans to Roth IRA's. Clients who own homes or other real estate outside of California will still need to factor this complexity into the planning process. It will still be critical to plan for non-U.S. citizens and their spouses.

I believe it is prudent to meet with almost all of our clients to review their wills and revocable trust agreements as soon as possible in order to determine which, if any, of those documents need to be changed to reflect the repeal of the federal estate and GST tax. **This will not be easy and modifications may not be simple.** In many cases we will need to schedule appointments with you, some of which can be handled by telephone but many others which will require in-person meetings.

Due to the large number of estate planning clients our firm has, in order to appropriately manage these reviews, we will give expedited service to our oldest, most frail, and those who have been diagnosed with a terminal condition. Next, we will attempt to service our clients who may be impacted by these changes most significantly. Our firm's estate planning team will handle everyone who would like to meet with us for a review, but it may take us as much as 6 months or more to complete these conferences. Your patience will be appreciated.

Conclusion

In my opinion, the inaction on the part of Congress is inexcusable. Millions of Americans and their professional advisors have been placed in a quandary. No one expected Congress to do nothing. Now that they have done nothing, we must deal with these extraordinary events.

The beginning of 2010 is likely to be an enormously busy time for the estate planners at our firm. The elimination of the estate and GST taxes coupled with the introduction of carryover basis for those dying in 2010 is an unprecedented event. This development may open tremendous but temporary planning opportunities and can create many risks. What the future holds is most uncertain. However, inaction is inappropriate and potentially extremely costly to your family and intended beneficiaries.

While it is impossible to be at all certain about these matters, I can assure you we will do our absolute best to advise you on these critical changes after taking into account your particular circumstances and desires.

To summarize, we suggest the following order of priority as appropriate for purposes of scheduling a meeting:

- First, clients who are elderly or in poor health;
- Second, clients with estates in excess of \$10.0 million;
- Third, clients with wills or trusts that use formula clauses to make gifts;
- Fourth, clients whose estates, excluding life insurance, exceed \$1.0 million (or which jointly exceed \$2.0 million for community property); and
- Fifth, all other clients who wish to review their estate plans.

If you are uncertain whether you fall in one or more of the above categories, you should contact us to schedule a conference.

We look forward to hearing from you and meeting with you to review your estate plan.

Sincerely,
TEMMERMAN, CILLEY
& KOHLMANN, LLP

A handwritten signature in black ink, appearing to read "Robert E. Temmerman, Jr.", written in a cursive style.

Robert E. Temmerman, Jr.
Managing Partner