THE LAW OFFICES OF BORTON PETRINI, LLP

Spring 2006

Published By
The Law Offices of
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If you are interested in receiving the Estate Planning Quarterly Report, *or have someone to whom you would like it sent, call (661) 322-3051, ext. 170 or e-mail publish@bpclaw.com and leave your name, e-mail and/or mailing address to request a free copy.*

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Disinheriting the Internal Revenue Service

By John F. Petrini

Most people know who their heirs are. Generally, they are your spouse, children, parents, or siblings. Did you know that one of your heirs might be the IRS? Our objective is to disinherit the IRS. This article discusses how to do that.

Estates of a value in excess of the estate tax exclusion are required to file estate tax returns. Whether the estate has to pay an estate tax depends on how the estate is set up prior to death. It is entirely possible and legal to deprive the government of any estate taxes, even for those whose wealth at death is far in excess of the minimum level required to file an estate tax return.

For those decedents who died in 2005, the minimum level is $1.5 million. That jumped to $2 million in 2006, 2007 and 2008. In 2009, it goes to $3.5 million. Under current law, the estate tax is abolished for those who die in 2010. If Congress does not act before 2011, the estate tax scheme reverts to what it was in 2002, a $1 million exclusion.

The most common method of transferring assets from a decedent to surviving spouse and then to children without estate taxes for estates with a value in excess of the estate tax exclusion is the use of the an exemption trust, also known as a credit trust or a bypass trust. For decedents who die in 2006, 2007 or 2008, the value of the estate that qualifies for this technique is $2 million or more. While that may seem to exclude most persons, the property included in the estate of a decedent for estate tax purposes includes not only the obvious assets such as real estate (including the residence), cash in the bank or money market accounts, and securities, but also the value of qualified plans such as IRAs and 401(k)s and the amount of death benefit of life insurance. When you include all of those items, the value of the estate could easily exceed $2 million.

The use of the exemption trust takes advantage of not only both spouses' exclusions but also takes maximum advantage of the marital deduction. Many people do not realize that property inherited by a surviving spouse is exempt from estate taxes, regardless of the size of the estate. That means that when Bill Gates dies and if his wife inherits his entire estate, the estate will not owe any estate taxes. The best way to explain the use of an exemption trust is by way of example.

Assume that Betty and Bob have an estate worth $3 million at the time Bob dies in 2006. Bob's living trust provides that all of the property goes to Betty outright, meaning that his surviving spouse inherits the entire estate. There is no estate tax even though the value of the estate is more than $2 million because of the marital deduction; that is, all property inherited by a surviving spouse is exempt from estate taxes. On Bob's death, therefore, there is no estate tax, and Betty's estate is worth $3 million.

Betty is a shrewd investor and manages to grow the estate to $4 million by 2007 by investing the estate in development real estate in a hot market. Unfortunately, Betty dies unexpectedly in 2007.

Her living trust leaves all of her estate to their four children in equal shares. Since Betty did not leave a surviving spouse, the marital deduction does not apply, but Betty's $2 million exclusion does apply. Subtracting the $2 million exclusion from the $4 million value of her estate leaves a taxable estate of $2 million. The estate tax on $2 million is $900,000, leaving a net estate of $3,100,000 to the children ($2 million exclusion plus $1,100,000 of the remaining estate after payment of taxes).

Recapping then, Betty's $4 million estate is divided as follows: $900,000 to the IRS and $775,000 to each of the four children. **THROUGH CARELESS ESTATE PLANNING, THE IRS HAS BECOME THE LARGEST HEIR OF BETTY'S ESTATE.**

How could proper estate planning disinherited the IRS in this example?

The proper use of the exemption trust would have eliminated any estate taxes to both Bob's and Betty's estate. While Bob was alive, he and Betty should have arranged their estate plan in such a way that the $2 million estate tax exclusion would apply to Bob's estate as well as the marital deduction. Bob and Betty's

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CHOOSING YOUR RETIREMENT PLAN BENEFICIARY

By John F. Petrini

One of the top three questions we hear is who should I pick for the beneficiary of my IRA/401(k)/pension plan. There are some very good ways to do this and some very poor ways. The favored beneficiaries are very favorable and the not favored beneficiaries are very not favored. We will explore the various possibilities and discuss why some are better than others.

There are six possibilities for designating a beneficiary for your qualified retirement plan. Those are a young individual, your surviving spouse, a charity, an older individual, your trust for the surviving spouse, and your estate.

Young Individual: This is a highly favored designation. The payout rules provided that the IRA payout may be made over a period of years based on the beneficiary's life expectancy. For instance, if your beneficiary at the time of death is a new born child with a life expectancy of 80 years, then the first year's payout would be 1/80th of the principal amount, the second year 1/79th, the third year 1/78th and so on. As you can plainly see, the younger the person, the more favorable the payout period. Of course, parents are concerned that when this young child turns 18, he/she will take a full payout and fritter away their hard earned savings. The solution is to create a see-through trust for the child that can accept the payout and restrict the child's ability to collect until he/she reaches a responsible age.

Surviving Spouse: Designating your surviving spouse as the beneficiary of a qualified retirement is the most favorable way to handle your designation. In fact, the treatment is so favorable that you are really forced to do so. The surviving spouse can transfer all of the funds from your IRA and deposit them into his/her own rollover IRA or elect to treat your IRA as his/hers. The spouse can then defer the distribution until he/she reaches age 70 ½, as opposed to required withdrawals at the end of the year after the year of your death. At that time, he/she is obligated to start taking a minimum required distribution (MRD) based on his/her life expectancy as set forth in the Uniform Lifetime Table, much more favorable life expectancy than the standard life expectancy tables. Additionally, his/her life expectancy is recalculated every year, allowing your spouse to take withdraws for a period much longer than his/her normal life expectancy. If your spouse is more than 10 years younger than you, he/she can take smaller MRDs if he/she is named as the sole beneficiary.

Charity: Naming a charity as your beneficiary has two advantages: first, there is no income tax on the distribution from the plan or IRA because a donation to a charity is generally income-tax exempt and second, there are no estate taxes because of the estate tax charitable deduction. You can also get this advantage by designating your beneficiary as a charitable remainder unitrust or a charitable remainder annuity trust. The distribution of the plan is to a trust. The trust should provide that all the income is distributed to a named individual or individuals and the principal is distributed to the charity upon the death those who receive the income.

Older Individual: Contrary to naming a young individual as a beneficiary, designating an older individual is not favorable because the minimum required distributions are made over the life expectancy of the individual. The shorter the life expectancy, the faster the distributions and the faster the IRS collects income tax. Instead of naming the individual as the beneficiary, naming a charitable remainder unitrust or annuity trust can both benefit the older individual and the charity.

Trust for Surviving Spouse: There may be non-tax reasons for designating such a trust as the qualified plan beneficiary, but they come at a price. Such a trust does not receive the favorable income tax deferral treatment that a surviving spouse receives. The trust must generally start making distributions the year after your death, not when the surviving spouse reached age 70 ½, and must take the MRDs over the spouse's single life expectancy instead of using the Uniform Lifetime Table. The trust cannot designate another beneficiary and keep the deferral going after the survivor dies. Further, distributions paid to a trust are generally taxed at a higher rate than benefits paid to an individual.

Your Estate: The worst. Distributions from a qualified plan to your estate are not eligible for a rollover or a stretched out withdrawal because an estate has no life expectancy. Therefore, there is an immediate income tax liability and possible estate tax liability, depending on the size of the taxable estate. These taxes have the potential of sending up to 75% of the funds in the plan to the IRS and state taxing authority.

The moral of the story: think carefully about how you designate your beneficiary because the consequences can be either very favorable or disastrous.

Summarizing as follows:

FAVORED	UNFAVORED
Young Individual	Older Individual
Surviving Spouse	Trust for Surviving Spouse
Charity	Your Estate

DISINHERITING THE INTERNAL REVENUE SERVICE *continued from Page 1*

estate plan should have created a trust upon Bob's death and all property up to a value of $2 million would be distributed to that trust. The trust should provide that all of the income of the trust is for the benefit of Betty and that she can use the principal of the trust for her health, support, maintenance and education. It could also provide that upon Betty's death, the principal of the trust is to be distributed to their four children in equal shares. There is no estate tax on the amount distributed to this trust even though the marital deduction does not apply [since it is not distributed to Betty] because we apply the $2 million exclusion and the net taxable amount to the trust is zero. Betty should inherit the remaining property worth $1 million. The marital deduction applies, so this property passes to her without estate tax. Therefore, we have the same result as we had in the first part of the example. There is no estate tax at the time of Bob's death.

JOINT TENANCY: THE GOOD, THE BAD & THE UGLY

By Grant Peters

Many people have used a joint tenancy form of ownership as a substitute for more formal estate planning, such as a will or a living trust. Although joint tenancy is appropriately used in some situations, it has inherent dangers that need to be considered before property is transferred to joint tenancy.

Joint tenancy is a form of ownership in which two or more people share ownership of property so that when one owner dies, his or her interest passes to the other joint owner or owners by operation of law. With a joint tenancy, each joint tenant's interest must be created by the same instrument, each interest must be equal and each tenant must have the same rights and obligations respecting the property. Joint tenancy includes a right of survivorship so that upon the death of a joint tenant, the property transfer to the surviving joint tenant or tenants occurs without probate administration.

One of the most common problems with joint tenancy arises from the requirement that each owner have an equal interest in the property. This requires agreement between all of the owners in order to take many actions regarding the property.

A second and larger disadvantage of a joint tenancy is that the property can be taken by the creditors of any one of the joint tenants. For example, a parent may desire a particular piece of property to be passed on to their child. By adding the child's name as a joint tenant to the property, the property is at risk for any liabilities that the child may incur. Even through the parent may not have intended to give the child ownership rights over the property, once someone's name is on the deed as a joint tenant, they share ownership rights to the property. In one case, a single mother added her son as a joint tenant on her home. The son got behind on his child support payments and a lien was attached to the house for the debts. Although the mother had not intended to give her son present ownership rights over the property, that occurred simply by virtue of the house being held in joint tenancy.

Is there any way out of an ill-advised joint tenancy? Some individuals recognizing the liability risk of joint tenancy ask their joint tenant to deed the property back to them. The new joint tenant, however, cannot be forced to return title once it has been conferred. Creating a joint tenancy often constitutes a taxable gift. Depending upon the value of the gift, a gift tax return may be due. In the situation where mom (1) adds son as a joint tenant to her home, (2) then realizes the mistake, and (3) asks son to deed his interest back to mom, there would most likely be a gift from mother to son and a second gift from son to mother. Unfortunately, the gifts do not cancel out for gift tax purposes.

There are other tax problems with joint tenancy. Generally, the sale of property held in a joint tenancy after the death of a joint tenant may result in greater capital gains taxes than if the property had passed through a living trust or will.

Another feature of joint tenancy is that upon the death of one joint tenant, the property passes equally to the other joint tenants. The property does not go through probate and the property is not subject to any instructions in the decedent's will or trust. For example, mom might add her son as a joint tenant to the property simply for convenience, intending that the property be divided between both son and daughter. Upon mom's death, however, the son receives the entire interest in the property. If son desires to honor mom's wishes, the transfer of an interest in the property from son to his sister will be considered a taxable gift and a gift tax return could be required.

The automatic passage to joint tenancy property also makes it impossible to disclaim part of the property to keep it out of the joint tenants' taxable estate. Any provisions in the living trust to reduce the impact of estate taxes will not apply to the joint tenancy property. The carefully crafted tax avoidance program of the living trust may be thwarted.

In summary, joint tenancy is suitable and can be used in certain circumstances, however, it is not a substitute for proper estate planning. In most cases, it is better to hold property in a living trust than in joint tenancy. Although there are up front costs in establishing and maintaining a living trust, they can avoid significant taxes and the unwanted liability risks inherent in the joint tenancy form of ownership. Anyone considering holding property in joint tenancy would be well advised to review his or her situation with his or her attorney to determine if, indeed, joint tenancy is the best option.

Grant W. Peters

Grant W. Peters is an attorney in the Bakersfield office of Borton Petrini, LLP. He received his undergraduate degree in Chemistry and his M.D. from Loma Linda University. He earned his J.D. at University of California, Berkeley, Boalt Hall School of Law. Grant also holds an M.S.A. in Health care Administration.

Grant's primary areas of emphasis at Borton Petrini, LLP are health care law, business organizations and estate planning.

Grant's estate planning practice focuses on helping individuals and families develop a realistic plan for their assets that benefits the people and causes that are important to them. Many plans include asset protection and tax reduction strategies; others simply assure that assets are passed to the designated family members at the appropriate time. An important part of each plan is planning for the possibility of infirmity, ill health, or accidental injury.

DISINHERITING THE INTERNAL REVENUE SERVICE
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If we assume that Betty shrewdly invests her $1 million inheritance and it grows rapidly by $1 million, then the total value of her estate at the time of her death in 2004 is $2 million. Her estate plan provides that the property in her estate passes to their 4 children in equal shares. We apply the $2 million exclusion to her estate, so her taxable estate is zero, and, of course, no tax is due on her estate. Therefore, the entire $2 million passes to the 4 children and each receive $500,000.

The $2 million in the exemption trust also passes equally to the 4 children, so they end up with $500,000 each from the trust. There is no estate tax on the property that passes to them from the trust because it was property of the trust, not property of Betty's estate.

Therefore, the children get $1 million each instead of $775,000 each, and the IRS is disinherited and gets **NOTHING!**

This is just one of several ways to disinherit the IRS.

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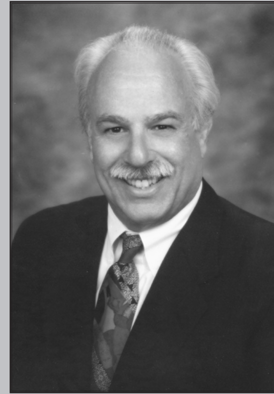

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Mr. Petrini served as President of the Kern County Bar Association (1987), and sits on the board of the Petroleum Club of Bakersfield and the Southern San Joaquin Emmaus Group.

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