

January 2010

2010 Forecast and Planning Guide

Uncertainty Regarding the Estate Tax and a Possible Window of Opportunity to Reduce Tax Exposure Require a Commitment to Reviewing Your Own Estate Plans and Asset Protection Posture.

As we enter a new year *and new decade* and celebrate our firm's 120th anniversary, we find ourselves thinking once again about the **VALUE OF COMMITMENT** – one of our guiding principles. A vigilant commitment to delivering value to ScottHulse clients is what has enabled us to sustain our heritage of service to the Borderplex community and our friends and neighbors.

In view of our commitment, we want to bring to your attention certain estate planning and wealth preservation issues surrounding the federal tax code that require your thought and consideration to protect and sustain your estate, wealth, and financial legacy. This is a timely opportunity for you to renew your commitment to review your asset protection postures and your estate plans from both tax and non-tax perspectives on a continual basis.

This year may prove to be one of the most disruptive years in recent history for estate planning clients (and those of us who serve them), but it might also provide some unique opportunities for estate planning strategies to reduce exposure to taxation unlike any year before or in the future.

To help you begin thinking about your own situation and needs, we are providing the following summary of the current status of the death tax and pending legislative activity. We also are providing a list of action items you should seriously consider.

Congress Has Focused on Financial Bailouts, Economic Stimulus, and Healthcare Legislation and Has Failed to Address the Sudden Reappearance of the Death Tax in 2011.

In 2001, Congress amended the tax code to repeal, over time, the estate tax (also known as the “death tax”) and the even more draconian generation-skipping transfer tax (“GSTT”). The amendment accomplished the repeal by gradually increasing the exemption from both taxes from \$1,000,000 per person in 2001 to \$3,500,000 in 2009 and finally remove both taxes altogether in 2010. At the same time and as part of a compromise, however, the amendment's repeal of the estate tax and the GSTT was to last only one year.

In 2011, both the estate tax and the generation-skipping transfer tax are scheduled to come back with a vengeance. For deaths beginning January 1, 2011, the estate tax and the GSTT exemptions will be only \$1,000,000. Because of the effect of inflation, the result will be an even greater exposure to the estate tax than existed ten years ago. According to The Inflation Calculator, \$1,000,000 in 2008 is equivalent in purchasing power to only \$820,334 in 2001, representing a 21.9% increase in exposure to the tax based on value over only a portion of the period.

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The 2001 amendment also effectively did away with state inheritance taxes in many states, because of the way in which those states historically drafted their inheritance tax laws. The 2001 amendment, however, also will effectively cause the inheritance tax in those same states to be reinstated beginning in 2011. For example, in both Texas and New Mexico where most of our clients reside, if an estate is subject to the federal estate tax, it also will be subject to state inheritance taxes. The net result, however, should not change, because the estate will receive a credit for the taxes paid to the state.

Not surprisingly, Congress played another trick at the same time it repealed the estate tax and the GSTT. All of us are keenly aware of the capital gains tax, which taxes as income the gains one recognizes from the sale of an asset. The capital gains tax is calculated as a percentage of the difference between the sales price and the seller's "basis" in the property. In simple terms, the basis is the price at which the property was originally acquired. Historically and in the context of the death of an owner, the heirs have received a step-up (or down) in basis to the fair market value of the property as of the date of death. One can imagine the capital gains tax savings the step up in basis provides for property that has appreciated in value over the years.

The Congressional trick was to give with one hand and take with the other. For deaths in 2010, there is no step up in basis. Instead, the heirs receive the same basis in the property that the decedent had. This means that if the decedent had a very low basis, capital gains tax likely will be due if the heirs sell the property (where no or little tax would be due in most situations under the historical scheme). Fortunately, there is an exemption of sorts equal to \$3,000,000 for transfers to spouses and an additional \$1,300,000 for transfers to other persons.

Commentators estimate, however, that the net effect of the change in the capital gains tax will be to cause taxation in many more estates than would have been subject to the estate tax with the \$3,500,000 exemption in place. While this tax reporting fiasco waiting to happen will go away after only one year, establishing entitlement to the exemptions and the basis in the property should prove to be difficult indeed.

For several years now, the pundits in the estate planning profession have been forecasting that Congress simply would not, by any stretch of the imagination, allow the 2001 legislation to stand this long. Something was going to be passed, either a permanent repeal of the taxes or a permanent exemption level of at least \$3,500,000. The result would simply depend on which political party could muster the most votes. Well, the unimaginable has happened. The financial bailouts, stimulus and health care took center stage and Congress failed to act.

Current Law and the Unanswerable Million Dollar Question

For persons who have a \$3.0 million estate and who will likely survive until January 1, 2011, the question of what Congress will do is worth a literal \$1,000,000.

Summary of Current Law and Tax Rates				
Year of Death or Transfer	Estate Tax	GSTT	Gift Tax	TX & NM Inheritance Tax
2010	No tax	No tax	\$1,000,000 exemption, 35% maximum rate	No tax
2011 and beyond	\$1,000,000 exemption, 55% maximum rate, with 5% surcharge on certain large estates over \$10,000,000	\$1,000,000 exemption (indexed for inflation), 55% flat rate	\$1,000,000 exemption, 55% maximum rate, with 5% surcharge for certain large gifts	Tax equal to available credit on federal estate taxes

While we can no longer pretend to know what will happen, we do know that Congress has not yet given up on making changes to existing law. The million-dollar question is what will be the result. **Possible** scenarios are:

- **Congress will do nothing and allow the status quo to go forward.** While allowing no estate tax in 2010 certainly will go against the grain of those lawmakers who believe in “progressive” taxation, they will reap a huge reward in 2011. And they cannot be accused of voting for a tax increase to boot. Most observers do not think this scenario will play out.
- **Congress will pass a permanent \$3.5 million exemption on a prospective basis.** While Republicans are happy with the repeal, they are not happy with \$1 million exemption in 2011. Most members of Congress also are subject to the tax themselves (especially at the \$1 million exemption level). Also, the House passed this very bill late in 2009. Democratic leadership in the Senate has vowed to do the same in 2010. Most observers expect this compromise to be the ultimate result.
- **Congress will pass a permanent \$3.5 million exemption retroactively to January 1, 2010.** Democratic leadership also has floated the retroactive balloon for consideration. Retroactivity, however, raises significant constitutionality concerns.
- **Congress will do something else.**

...but exactly what Congress will do is anybody's guess.

Take Action. A “Wait and See” Approach Could Be Costly.

The current status of the law raises several issues that go beyond the question of whether your estate will be subject to taxation. Most tax planned estate documents are based on formulas that refer to tax code provisions related to the estate tax and GSTT. Reliance on such references may render the formulas nonsensical given the current status of the law. Further, some estate plans make gifts depending on the effect of the estate tax. That there is no estate tax in 2010 (at least for now), may result in unintentionally leaving someone out of your plan. The result in some plans could be so drastic as to leave the surviving spouse with nothing from the decedent's estate.

If the \$1 million exemption comes into play in 2011, many of our clients who did not previously have an estate tax issue, suddenly will have one, especially if the client has a significant life insurance policy (the proceeds of which are included in the calculations). The risk of a wait and see approach is that the client might not have the opportunity to make necessary changes because of incapacity or an untimely death.

We recommend the following:

- **REVIEW YOUR ESTATE PLAN NOW.** This is a good time for you to ensure that the fiduciaries you have named (executors, personal representatives, trustees and agents) are still appropriate. You also should review the disposition of your estate to ensure it comports with your wishes. Consider how your family has changed since your last review. If you have minor children, consider whether you have appointed appropriate guardians if they are left orphans. Consider whether a trust might be appropriate for your surviving spouse or children (trusts are very important for minors). Regardless of whether you have an estate tax issue, trusts can provide significant protection for your loved ones from creditor claims (including divorcing spouses) and prevent loss of governmental benefits for

disabled and incapacitated loved ones. Also consider whether a charitable bequest might be appropriate.

- **REVIEW YOUR BENEFICIARY DESIGNATIONS.** Retirement accounts, annuities and life insurance are not controlled by your will or living trust. Rather, they are controlled by beneficiary designations. Make sure those designations are still appropriate.
- **REVIEW THE TITLE OF YOUR ASSETS.** Many times, bank and securities accounts are held as joint tenants with rights of survivorship. Stock certificates and real estate also may be held in the same fashion. In New Mexico, real estate owned by a husband and wife almost always is held as “joint tenants”, which also means “with rights of survivorship”. Property also may be held as “pay on death” or “transfer on death”. Property held in any of these fashions bypasses your will or living trust. Except in rare circumstances, we recommend that you hold property as “tenants in common” if you have a will based plan, and as Trustee if you have a living trust based plan.
- **REVIEW FUNDING OF YOUR LIVING TRUST.** If you have an estate plan based on a living trust, you should ensure that you have fully funded the trust. Review your bank accounts, CDs, securities accounts, and other financial assets to ensure you own them as Trustee of your trust. You also should review any stock certificates, small business interests and real estate holdings to ensure you own each as Trustee. Failure to transfer these assets should not defeat your plan if you have a will, but will require probate (one of the things we try to avoid with living trusts). Historically, we recommended that Texas residents not transfer their homesteads into the trust. The federal courts were taking the position that a homeowner who transferred the home to a living trust lost the homestead exemption from creditor claims. In September 2009, Texas law was changed to remove this concern. We now advise that Texas residents do transfer their homesteads to their revocable trusts.
- **REVIEW YOUR LIFETIME PLANNING DOCUMENTS.** No estate plan is complete unless you have appointed agents to act on your behalf if you become incapacitated or are otherwise unable to act yourself. *Texas residents should have at least three documents current within three years: (1) a Durable Power of Attorney (for financial decisions); (2) a Medical Power of Attorney (for medical and personal care decisions); and (3) a Directive to Physicians (for end of life decisions). New Mexico residents should have two: (1) a Durable Power of Attorney (for financial decisions); and (2) a Health Care Directive (a combined document for both medical and personal care decisions and for end of life decisions).* Other documents we suggest include those that appoint guardians and/or conservators and give your health care providers permission to share information about your medical condition with loved ones. For parents of minor children, we also suggest a power of attorney appointing an agent to make medical decisions for the child if the parent cannot.
- **REVIEW YOUR CURRENT FINANCIAL STATUS.** If you have not done so recently, you should create a current financial statement. The financial statement should include the face value of the death benefits of any life insurance you may own as that value will be included in your estate. Note that the assessed value

2010 ACTION PLAN CHECKLIST

- ✓ Review your estate plan now.
- ✓ Review your beneficiary designations.
- ✓ Review the title of your assets.
- ✓ Review funding of your living trust.
- ✓ Review your lifetime planning documents
- ✓ Review your current financial status.
- ✓ Review your insurance coverage and liquidity.
- ✓ Consider your risk from lawsuits and creditors' claims.
- ✓ Review the status of business entity documentation and practice.
- ✓ Review the succession plan for your business.

LET US REVIEW YOUR PLAN. CALL US WITH YOUR QUESTIONS.

of real estate for property tax purposes really is not helpful in the analysis. You should use your best estimate of its fair market value. The same holds true for any closely held businesses and other assets (like assessed value, book value typically is not very helpful). You also should account for any separate property you might have as compared to community property. Do not forget liabilities, as well.

- **REVIEW YOUR INSURANCE COVERAGE AND LIQUIDITY.** Especially if you have a taxable estate, life insurance is an important planning tool. Life insurance can provide liquidity to pay expenses and taxes and avoid fire sales of property. Before you purchase new insurance, consider whether an irrevocable life insurance trust would be appropriate. You also should consider whether long term care insurance is appropriate. With the rising costs of both home health care and nursing home care, preparing to fund this type of care is extremely important. Failure to consider long-term care insurance means that you have chosen to self insure by default.
- **CONSIDER YOUR RISK FROM LAWSUITS AND CREDITOR CLAIMS.** Are you operating a business as a partnership or a sole proprietorship? Are you part of a joint venture? Are you the general partner of a limited partnership? Do you own rental property? Do you own raw land or recreational property? Are you a professional (especially the type who lawyers love to sue)? Are you simply concerned about protecting your assets? *All of these issues, and more, should cause you to review whether your assets are exempt or otherwise insulated from creditor claims.* The first line of defense is adequate liability insurance coverage. Accordingly, you should visit with your insurance agent for a coverage review. But you also should consider whether a business entity such as a limited liability company might be appropriate. Certain types of assets also are automatically exempt from creditor claims. Several strategies are available for reducing your risk. Keep in mind, however, that transfers of assets in the face of a threatened or existing claim are considered to be fraudulent and will be reversed.
- **REVIEW THE STATUS OF BUSINESS ENTITY DOCUMENTATION AND PRACTICE.** If you have established a legal entity such as a corporation, limited liability company, limited partnership or professional association, consider whether you are respecting the legal entity form. *These legal entities insulate the owners from the creditors of the entity but only if the owners treat the company as a separate entity from themselves.* Owners who pay personal expenses from company bank accounts and otherwise abuse the form are at risk for personal liability.
- **REVIEW THE SUCCESSION PLAN FOR YOUR SMALL BUSINESS.** The failure of business owners to consider what happens when the person or persons who started the business or key players leave the business because of death, disability or retirement is one of the major causes of business failure. Do you have a Buy-Sell Agreement in place? Do you have life insurance or other funding with which to fund the requirements of the Buy-Sell Agreement? What effect does the agreement have on your estate tax exposure? Have you addressed liquidity to pay potential taxes at the death of the owner? Have you addressed disability in the agreement? Have you considered how to pass ownership of the business to the next generation? Are all members of the next generation interested in the business, or only a few? How can you give the business to those who are interested, but adequately provide for those who are not? As you can see, there are many significant legal and practical issues to address.
- **AUTHORIZE US TO REVIEW YOUR ESTATE PLAN.** With your authorization, we will review your extant planning documents for potential problems caused by the issues raised above and provide you with written recommendations. Giving us a current financial statement will greatly enhance our ability to provide the right advice.

- **IF YOUR ESTATE LIKELY WILL BE SUBJECT TO THE ESTATE TAX REGARDLESS OF WHAT CONGRESS DOES, VISIT WITH US.** *There are many strategies that may be appropriate for your unique situation that will reduce your exposure to the tax. The historically low fair market values of many types of assets together with low interest rates provide several opportunities to transfer wealth to lower generations at significantly reduced tax costs.*
- **CALL US IF YOU HAVE ANY QUESTIONS OR CONCERNS** about your plan or any other legal issues. We want to be of assistance.

A Window of Opportunity to Review Your Situation and the Implications of Pending Changes to Tax Codes.

Although the uncertainty is unnerving and the list of action items may seem daunting, we hope you will view the current status of the law as an opportunity to review and reconsider your current situation. Let us know how we can help, and have a great year – and new decade.

Sincerely,

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This Information is Provided as a Courtesy – Not as Legal Advice.

We are making you aware of these issues as a courtesy and for informational purposes only. This letter is not intended to be legal advice, nor should you consider it as such. This letter simply cannot replace a substantive legal review of your particular circumstances and you should not take any action simply on the basis of this letter. Further, we will take no action unless you have requested that we do so. The firm has always limited its scope of representation of clients to specific matters or tasks. Once we have completed a matter, the attorney-client relationship ceases. However, the nature of estate planning and asset protection requires constant review and adjustment and you should never consider your planning to be complete. If you wish to have us review your plan with you and assist you with possible changes, we would be honored for you to engage us to serve you.

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