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Re: Estate Planning Changes in the Law

To our valued clients:

You may have heard recent news about legislative fights in Congress over the fate of the estate tax law. Because it does not appear that Congress will meet a December 31, 2009 deadline to extend the current estate tax (and generation-skipping tax) laws, we wanted to let you know what will happen beginning January 1, 2010, and how it might affect your personal estate plan. We are also including in this letter some recent changes in California law that may affect your personal planning.

Please note that we do expect Congress to act sometime during 2010 and when Congress does act, its actions may be retroactive. As a result, some of the changes described in this letter may be further modified (and/or nullified) so that while we are giving you the most current information you should be aware of possible future changes.

A. Tax Changes.

1. One Year Repeal of the Estate Tax and Generation-Skipping Tax.

For persons dying during 2010, the existing law states that there will not be any estate tax or generation-skipping transfer tax. This means that a person who dies in 2010 may pass an unlimited amount of assets to any beneficiary without estate and generation-skipping transfer tax. However, for persons who die after 2010, the estate tax law comes back into effect with a vengeance—exempting only \$1,000,000 in assets from estate tax (compared to the \$3,500,000 exemption in effect in 2009) and imposing a maximum estate tax rate of 55% (60% for certain very large estates) compared to the current estate tax rate of 45%.

If someone dies in early 2010 (before Congress has a chance to act), his or her estate might be completely free of tax. Alternatively, when Congress acts, it may do so retroactively. There is much speculation (and difference of opinion) over whether retroactive legislation in this context would be upheld as constitutional.

2. Continuing Gift Tax. Even though the estate tax is scheduled to be repealed as of January 1, 2010, the gift tax is not being repealed. Therefore, the \$1,000,000 lifetime exemption amount and the \$13,000 annual exclusion amount for gift tax purposes will remain in effect. The gift tax rate will, however, decrease from 45% to 35% for the calendar year 2010 (and then go up to as much as 55% in 2011 unless Congress acts to reinstate the 45% rate in effect in 2009).

3. Carryover Basis versus Stepped-Up Basis. Under current law, assets receive a new income tax basis (for computing capital gain or loss) at the time of death, equal to their fair market value at that time. This is a big advantage for people who

own highly appreciated property at the time of death. However, during the period that there is no estate tax (currently the year 2010), the Internal Revenue Code provisions that allow a new basis at the time of death are also not effective. Instead, beginning January 1, 2010, at death a person's assets will receive a basis equal to the lesser of their historical basis (sometimes called "carryover" basis) or fair market value. In other words, the general rule will be that basis may be "stepped down" but will not be "stepped up."

That said, the current rules for 2010 allow an estate to increase the basis of assets by a total of \$1.3 million (for any recipients) and an additional \$3.0 million for a surviving spouse (but not beyond the fair market value of the property in question). The Executor would decide to which assets this increase in basis would be allocated.

This new "basis" regime potentially will require the beneficiaries of people who die in 2010 to keep records of the decedent's income tax basis in the assets inherited, even if those records go back many decades.

Please note that most commentators expect that the 2010 tax changes will end up being repealed (perhaps retroactively) sometime during 2010. While it is possible to amend a trust to plan with specificity exactly how the \$1.3 million and/or \$3.0 million of increase in basis might be allocated (if that held some importance), given that these new basis rules may only be in place a short time (and might be retroactively repealed in any case), for most clients the potential benefits of amendment probably would be outweighed by the cost.

4. Possible Estate Plan Revisions That Might Be Needed. Many married couples have estate plans that provide for setting aside the estate tax exemption amount (currently \$3,500,000) or the generation-skipping exemption amount (likewise \$3,500,000) in a separate trust, sometimes called a Bypass Trust or Exemption Trust, under a formula clause. That formula clause often refers to the maximum amount that can be allocated without generating a tax.

Beginning January 1, 2010, and until the law is revised, those formula clauses will result in 100% of the decedent's share of the joint assets ending up in the Bypass Trust. That may or may not be what is intended, and may or may not be a good thing. On the other hand, it might end up being the best estate planning possible, as it could result in the maximum amount possible ultimately passing on to your children or others without estate tax. Some clients who may have been comfortable with \$3.5 million being siphoned off into the Bypass Trust might not be comfortable with the first spouse's entire estate (all separate property and 50% of community property) being allocated to the Bypass Trust. Whether or not this is good estate planning for a client could depend on the extent to which the surviving spouse is a beneficiary of the Bypass Trust. Oftentimes, the Bypass Trust is written to provide that the surviving spouse receives all of its income and can invade principal for health, support and maintenance. Other times, distributions from the Bypass Trust to the surviving spouse are discretionary. In still other cases, the surviving spouse has no interest at all in the Bypass Trust, and it passes entirely to the children.

As a result of these issues, if your estate plan contains such a formula clause allocating assets to a Bypass, Exemption or other trust, we would encourage you to review your plan and determine if you would still be comfortable with its provisions, taking into account that the formula could result in 100% of the assets of the first spouse to die being allocated to a Bypass or Exemption Trust.

In this regard, you might keep in mind that the exemption amount is currently scheduled to reset from the unlimited amount to \$1,000,000 on January 1, 2011 (and actions by Congress may result in the exemption changing even before January 1, 2011 and may possibly include action to make the current \$3.5 million exemption amount permanent, or to raise the exemption amount to a somewhat higher figure such as \$5 million). If you would like us to review your estate plan to counsel you on how the new law would apply to it, please contact us at your earliest convenience.

B. No Contest Clauses. Many clients include clauses in their estate plans to discourage beneficiaries from challenging, or contesting, the plan after the client dies. These clauses, often referred to as no-contest or "in terrorem" clauses, threaten that if any beneficiary challenges the legality of the plan or any part of it, that person will receive nothing (i.e. forfeit the gift). Currently, the list of challenges that may cause a beneficiary to lose his or her inheritance can be quite broad. Beginning January 1, 2010, California law reduces this list in a way that limits the effectiveness of no-contest clauses. In general terms, the only types of challenges that will result in a beneficiary losing his or her gift are those that (i) are brought without probable cause and allege that the estate plan is invalid because documents were forged, were not properly executed, were signed when the client did not have legal capacity or was unduly influenced, or were the result of fraud, (ii) challenge a transfer of property on the grounds that the client did not actually own the property when it was transferred, or (iii) consist of pursuing a creditor's claim after it has been rejected by an Executor or Trustee. Please contact us if you would like us to counsel you on how the change in the law applies to your plan and what options are available to you to address the situation.

C. Gifts to Caregivers. Under California law, gifts made in a will or trust to "a caregiver" who is not a relative are presumed invalid (unless the presumption is rebutted by clear and convincing evidence). The purpose of this law is to protect elderly people from caregivers who procure gifts by fraud, undue influence, menace or duress. While this law has been in place for several years, the California Supreme Court has now interpreted this law so broadly that it often causes unexpected results. First, clients often assume that only professional care providers fall within the definition of "caregiver." Instead, any non-relative who provides health or social services to someone over age 64 may be considered a "caregiver" under this law. A "caregiver" may therefore include a person who helps with grocery shopping, meal preparation, assistance with personal needs, administration and application of medication, or assistance with financial and investment affairs. Second, the law voids gifts to "caregivers" even if the person making the gift had a pre-existing or long-term relationship with the caregiver and even if the person to whom a gift is made was not a caregiver at the time the trust or will was drafted. For example, a long term partner to

whom you are not married or with whom you have not registered as a domestic partner may be considered a "caregiver" under this law whose gift could be treated as invalid.

Please consider whether your estate plan includes gifts to any person who provides care or health services to you now or who may do so in the future. If it does, we recommend that you contact us to discuss steps that you can take to ensure that your intention to make the gift is honored. For example, we can arrange for you to obtain a "Certificate of Independent Review" confirming that the gift is valid or talk with you about assembling evidence in your file (including affidavits or other documentation) to enable a "caregiver" to rebut the presumption that the gift to him or her the result of fraud, undue influence, menace or duress.

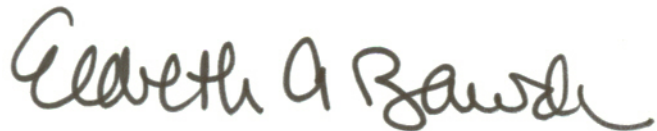
We realize that the issues discussed in the letter, as well as the conflicting and constantly changing news reports on these issues, may be quite confusing. We are available to confer with you at any time and appreciate the opportunity to be of assistance. Best wishes for a happy new year!

Very truly yours,

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