Law Changes:
Is It Time for Your Estate Planning Checkup?

SIGNIFICANT RECENT CHANGES IN ESTATE PLANNING LAWS

In 2001, there were very important changes made to the law, as well as other developments that have significantly affected estate planning. Almost everyone who created an estate plan prior to these changes will find that their plan needs to be reviewed in light of the new and more demanding requirements.

The estate planning law firm of Morris, Hall & Kinghorn, has been working closely with the American Academy of Estate Planning Attorneys and other lawyers to improve estate planning documents and to respond to the significant changes in the law. The following are some of the recent developments that have necessitated revisions to existing documents:

THE ECONOMIC GROWTH AND TAX RECONCILIATION RELIEF ACT OF 2001

In June of 2001, President Bush signed the Economic Growth and Tax Reconciliation Relief Act of 2001 into law. Among other things, the Act dramatically changed the federal estate tax. One of the primary changes is the increase in the applicable credit equivalent, which is the amount a decedent is permitted to pass to his or her heirs without paying any federal estate tax. The chart below shows how this increase is scheduled to be implemented:

Applicable Credit Equivalent	Year
$2,000,000	2008
$3,500,000	2009
Unlimited	2010
$1,000,000	2011

An important, and often overlooked, provision of the new tax law is its "sunset provision." Although the new law made significant changes, all of those changes will be automatically repealed beginning January 1, 2011, and the old law will become effective again. This means that the increase in the Applicable Credit Equivalent will vanish and again any estate over $1,000,000 will be subject to estate taxes at rates from 37% to 55%.

Prior to the enactment of the relief act, Arizona was one of 40 states that had no inheritance tax. We had what was called "a sponge tax" or "piggy-back tax." If there was a federal estate tax, the state got the first portion of the tax. Under the 2001 Tax Act, the sponge tax was phased out over a period of four years. Most of the states have "decoupled" from the sponge tax, creating a state inheritance tax. In the situation of a married couple, there is now a possibility of a state inheritance tax on the first death. Provisions can and should be added to your trust which allow for the creation

of a special State QTIP Trust in order to avoid any state death taxes upon the death of the first spouse.

DISTRIBUTION RULES FOR IRAS AND OTHER RETIREMENT PLANS

New rules for distributions of IRAs, 401(k)s, 403(b)s and other qualified plans make it easier for clients to take advantage of the "stretch IRA" concept. The tax rules for many years have permitted the long-term tax-deferred payout of retirement benefits to younger generation beneficiaries after the death of the original owner. However, the old rules made it difficult, and sometimes impossible, for some individuals to achieve that result. Under the new rules, whoever you designate as your beneficiary can enjoy a deferred payout of the retirement plans over his or her life expectancy, regardless of when you named him or her as your beneficiary and no matter when you pass away.

A trust may be the beneficiary of a retirement plan without causing a loss of most of the income deferral opportunities, but only if the trust is a qualified trust. This means that the trust must comply with the complicated and sometimes obscure rules for the treatment of the retirement plans after the death of the owner. If the trust meets these requirements, it is a qualified trust, and the trust beneficiaries are considered to be the beneficiaries of the retirement plan and are entitled to stretch the payments tax deferred over their lifetimes.

Recent changes by the Internal Revenue Service have altered the requirements for a qualified trust. A trust must comply with code section 401(a)(9) and Treasury regulations to be deemed a "qualified trust." If a trust is not qualified and if it is the beneficiary of an IRA, 401k, 403b or other qualified retirement plan, receipt by the trust will trigger a recognition of income, even though there has been no actual distribution, and will result in increased income taxes and loss of protection for the beneficiaries. Given the changes in the requirements under 401(a)(9), any trust that was written prior to 2002 must be amended to assure its status as a qualified trust. As a cautionary note, literally every trust should be reviewed to make sure it qualifies under 401(a)(9). Sadly, the vast majority of trusts that are written even today are not qualified.

MEDICAID PLANNING

Nursing home and other long-term care costs can be very expensive and are not covered by Medicare or other health insurance policies. The average cost for such care is in excess of $50,000 annually. Because Medicare and health insurance do not cover most long-term care costs, they are generally paid for in one of three ways: 1) directly from your income and assets (self-insured); 2) long-term care insurance; or 3) Medicaid and other public or private assistance programs.

If you need long-term care and do not have required provisions in place, you will have to spend down all you own except for $2,000, with few exceptions, before the government will assist you. This is tragic because you have worked hard all your life to save what you have and to pass it to your beneficiaries, and you have paid for Medicaid all your life.

A properly drafted trust and power of attorney should contain special provisions to allow the trustee of your trust and your power of attorney agent to engage in certain planning strategies to allow you to qualify for Medicaid and other assistance programs without depleting all of your assets. These

provisions are commonly referred to as "Medicaid triggers" and include the ability to transfer ownership of assets from your estate to your loved ones and avoid the three or five year "look-back" period. You can also transfer assets to your spouse, convert assets to exempt property or purchase certain kinds of special annuities. If the trust is drafted properly and a trustor becomes incapacitated, a great portion of his or her assets can be protected against the spend-down. For married couples, upon the death of one spouse, up to one-half of the combined assets, plus the entire value of the residence, can be protected, and the surviving spouse will not have to spend these assets down. Without these Medicaid triggers, you and your family would be unable to engage in many of these planning strategies that can save tens of thousands of dollars.

These Medicaid triggers, however, cannot guarantee that you will qualify for Medicaid. For many people, long-term care insurance is the best alternative for taking care of these costs and should be seriously considered.

DIVORCE AND CREDITOR PROTECTION

With the recent proliferation of lawsuits and the divorce rate at about 50%, more often parents are leaving inheritances in trust for their children and grandchildren. The advantages of leaving an inheritance in trust are many:

1. Lawsuit protection, if the trust is properly structured.
2. Protection from a divorcing spouse of the beneficiary.
3. A potential reduction in estate and generation-skipping transfer taxes at your death and the death of future generations through the use of generation skipping trust provisions.
4. In the case of a "spendthrift" beneficiary, or one who is prone to drug, alcohol, or gambling addictions, the ability to have a third party manage the inheritance for the beneficiary.
5. In the case of a "special needs" beneficiary, the ability to avoid disqualifying the special needs beneficiary from receiving valuable government benefits such as Medicaid or SSI, while at the same time making inheritance funds available for their supplemental needs.

An inheritance is held in a trust does not mean that it cannot be used to help the beneficiary buy a house, start a business or invest for retirement. The trustee of the beneficiary's trust can invest in these types of assets — the only difference is that the title to the asset, such as the house, business, or retirement savings, will be in the name of the beneficiary's trust as opposed to the name of the individual beneficiary. Although this difference in how title is held seems small, it can make all the difference between losing the house, business or retirement assets or being able to continue to use those assets and passing them on to the beneficiary's heirs upon his or her death.

COMMUNITY PROPERTY AGREEMENT

Every trust written by a married couple in Arizona should be accompanied by a community property agreement. Arizona is one of eight community property states, and the laws of community property offer significant tax advantages. It is important that there be an agreement, separate from the trust that converts all jointly held property to community property. If this is properly implemented, upon the death of the first spouse, community property will get a step up in cost basis, and the surviving spouse can sell assets without having to pay capital gains taxes.

Until recently, it was not possible to designate a qualified retirement asset, such as IRA, 401(k) or, 403(b) as community property. Qualified assets are a function of the federal law, and there is no community property under federal law. However, recent court decisions have made it possible for qualified funds to be converted to community property. This allows the surviving spouse the greatest flexibility in allocating the qualified funds between the survivor's trust and the decedent's trust. Ideally, as much as the qualified funds as possible will go into the survivor's trust. This will offer much greater protection against federal taxes, state taxes, spend-down for long term care, and attachment by creditors. Only a properly drafted community property agreement, which is much more sophisticated than older versions, offers this protection and flexibility.

UNIFORM PRINCIPLE AND INCOME ACT

Arizona recently enacted the Uniform Principle and Income Act. The provisions of this act can have a very significant effect upon the survivor after the death of the first spouse. The survivor is typically at liberty to do anything he or she desires with the assets in the survivor's trust, but has an investment burden as to assets in the decedent's trust. There are also income tax consequences as to distributions made or withheld from the trust. Properly applying the principles of the Uniform Principle and Income Act, and the related Uniform Prudent Investor Act, the survivor has much greater flexibility with permitted investments, paying less income taxes on distributions from the decedent's trust, and avoiding many of the conflicts that arise with the remainder beneficiaries.

SPECIAL CO-TRUSTEE

Upon the death of the first spouse, the decedent's trust becomes irrevocable. Because this trust is irrevocable, it provides protection against creditors, taxes, the spend-down for long-term care, and against other contingencies. Almost every married couple should choose to have an A/B Trust (survivor's/decedent's), even if there is not a potential taxable estate. This is to provide the protections that are set forth above, and also protections against poor decisions if the survivor ceases to function well and is inclined to make poor choices.

Most trusts provide that upon the death of the first spouse, the decedent's trust is irrevocable and unamendable. However, subsequent changes in the law or other circumstances could significantly affect the assets in the decedent's trust and the protection for and distributions to the beneficiaries. It is possible for the surviving spouse, or a successor trustee, to appoint a special co-trustee in the event of a change in the law or change in circumstances to address such changes. The special co-trustee cannot alter the Trustor's intent or overall distribution, but can bring some flexibility to what was heretofore unamendable.

NEW HIPAA LAWS

Last year the U.S. Department of Health and Human Services issued final regulations regarding the privacy provisions of the Health Insurance Portability and Accountability Act, commonly known as "HIPAA." The new regulations have caused turmoil throughout the medical industry, as doctors, hospitals, nursing home facilities and other entities are now subject to sanctions, monetary fines, and even imprisonment for the unauthorized disclosure of private health information. Fearing the heavy hand of the government, health care providers have clamped down on the release of medical records and other health care information to anyone other than the patient. This means that if you are

hospitalized, even your closest family members and clergy may not be able to receive information about the status of your condition or even your room number! You can avoid this by executing a proper HIPAA authorization form.

TAKE ACTION

These important changes can have a profound impact upon your estate plan. Reviewing your plan every three years or so always makes sense. But when there have been changes as dramatic as those we have seen in the past three years, it becomes even more critical to make sure your plan has kept pace with these important developments. If your plan has not been reviewed in the past two years, or if you are not certain that all of the above changes have been addressed, it is time to do something about it — for your peace of mind, and for the protection of your family and other beneficiaries.

This communication may not be used and is not intended or written to be used and cannot be used, by you for the purpose of avoiding penalties that may be imposed on you by the Internal Revenue Service.

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A Premier Estate Planning Law Firm

For over forty years, the attorneys at Morris, Hall and Kinghorn, P.L.LC. have been providing quality estate planning documents for our clients. Helping our clients protect their assets for those that they love has been our goal from the very beginning. We are recognized throughout the Southwest for our expertise in educating individuals about the importance of proper estate planning. We do this through various speaking engagements and seminars; and further, we keep our clients up-to-date through constant communication, complimentary reviews and phone calls and more advanced seminars.

At MHK, we focus on protecting families from the expense and delay of probate, providing long-term care planning options and minimizing tax consequences. We also implement the basic and advanced estate planning strategies for clients and assist in administering clients' estates upon death or disability. As we do no other law other than estate planning, our focused practice allows us to answer the complex questions and concerns consumers have about estate planning.

Morris, Hall, and Kinghorn is staffed with experienced attorneys and paralegals, trained in the complex areas of probate, trust, elder law, life care planning and tax law. The aim of our law firm is to help you, our client, understand the basic principles of estate planning, its importance and why each individual needs a plan. We have helped thousands of individuals secure their assets and eased the mind of them and the families left behind. By taking advantage of the services that MHK has to offer, you can be assured that your legacy and your family will be protected.

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