Recent Estate Planning Developments

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A Summary Provided by the:

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WE'VE MOVED!

SEE THE ENCLOSED MAP FOR OUR NEW LOCATION

STATUS OF FEDERAL ESTATE TAX LEGISLATION CHANGE OF EMPHASIS: FROM REPEAL TO REFORM

2001 Tax Act. We have previously reported to you, both in our newsletter and on our website, about the 2001 Tax Act and how it affects the transfer tax aspects of estate planning. Under this tax act, the applicable exclusion amount (the amount that you can transfer tax-free at death) is $2,000,000 in 2006 and increases to $3,500,000 in 2009. In 2010, the federal estate tax is repealed for one year, and in 2011 the applicable exclusion amount is reduced to $1,000,000 and the estate tax comes back into effect. This is the so-called "sunset" aspect of the 2001 Tax Act.

Emphasis Has Shifted From Repeal to Reform. In our past newsletters, we have described how Congress has attempted to make the 2001 Tax Act "permanent" by replacing the one-year repeal of the estate tax (2010) with permanent repeal. Since 2001, the House of Representatives has voted a number of times in favor of permanent repeal. However, the key has been obtaining Senate approval. In order to obtain Senate approval, 60 senators need to vote in favor of the legislation. The issue of permanent repeal has been brought up in the Senate (directly or indirectly) a number of times since 2001. Each time, the Senate has failed to obtain the necessary 60 votes.

As a result, in 2006 Congress changed its emphasis from repeal to reform of the estate tax. The proposed reform would increase the applicable credit amount and decrease the estate tax rate. (At the present time, each person has a tax credit which protects $2,000,000 of transfers from federal gift and estate tax. We can use up to $1,000,000 during our lifetime and the balance at our death.)

This reform approach was passed by the House of Representatives this summer and was sent to the Senate. The applicable credit amount would have increased, in annual $250,000 increments, to $5,000,000 by 2015. The maximum estate tax rate would have been phased down to 30% by 2015. However, on August 3, 2006, this reform legislation failed to obtain the necessary 60 votes in the Senate (the vote was 56 to 42). The Administration has stated that it will continue to attempt to obtain a compromise on this reform approach during 2006. Whether Congress will be successful, and what the compromise approach will produce in the way of increased applicable credit and reduced rates, we will have to wait and see. If Congress is successful in passing estate tax legislation, we will immediately post it on our web page and report to you in a future newsletter.

ALASKA'S 2006 NEW ESTATE AND TRUST LEGISLATION

Our firm has continued to work with other estate planning attorneys and trust officers to provide suggestions to the Alaska Legislature for improvement of Alaska's trust and estate statutes. In the 2006 legislative session, the Alaska Legislature accepted our suggestions and enacted a number of new provisions, which include the following:

1. Divorce: Protection of Beneficiary's Interest in Trust. Many estate planners have assumed that a beneficiary's interest in a third-party created trust would be protected from the beneficiary's creditors, including a divorcing spouse. However, recent court decisions interpreting various state statutes and commentators' analyses have raised questions about this assumption. Pursuant to these cases and theories, a beneficiary's interest in a trust has been or may be invaded or considered when the divorce court divides up the couple's property. Often the theories of the courts are based upon an interpretation of the applicable state statutes' concept of "property" which may be divided or considered upon divorce.

Alaska's divorce statute provides the court with authority to divide the parties' property, whether joint or separate, acquired during marriage, or acquired before marriage, when the balancing of the equities between the parties requires it. If Alaska courts were in the future to determine that "property" included a spouse's interest as a beneficiary in a third-party trust, or as a beneficiary in a self-settled discretionary spendthrift trust created before marriage, then that interest could either be invaded or at least considered by the divorce court when equitably dividing the couple's property. Such an invasion or consideration of the beneficiary's interest will likely frustrate the intent of the person who created the trust.

For example, consider the situation where parents create a trust for the benefit of their child or grandchild. Most often the parents would want the trust assets to be used for the benefit of the designated child or grandchild and not invaded and distributed to the beneficiary's ex-spouse, or considered by the court in a way that allows the ex-spouse to obtain more of the beneficiary's other property.

This is an area that is driven by state law. The Alaska Legislature decided to expressly protect beneficial interests in trusts from invasion or consideration in a beneficiary's divorce property division. This protection applies whether the trust is a third-party trust or a self-settled discretionary spendthrift trust created prior to marriage. This new subsection (m) of Alaska Statute 34.40.110 provides:

> (m) If a trust has a transfer restriction allowed under (a) of this section, in the event of the divorce or dissolution of the marriage of a beneficiary of the trust, the beneficiary's interest in the trust is not considered property subject to division under AS 25.24.160 or 25.24.230 or a part of a property division under AS 25.24.160 or 25.24.230. Unless otherwise agreed to in writing by the parties to the marriage, this subsection does not apply to a settlor's interest in a self-settled trust with respect to assets transferred to the trust;
>
> (1) after the settlor's marriage; or
>
> (2) within 30 days before the settlor's marriage unless the settlor gives written notice to the other party to the marriage of the transfer.

Alaska may be the first state to directly address this subject, and to expressly prohibit the divorce court's invasion or consideration of trust interests in divorce property divisions.

2. Revocable Trusts: New Claims Procedure. If a decedent has used a will as the primary vehicle for his or her estate planning, then the Uniform Probate Code provides an expedient claims procedure during the probate process. If the personal representative has provided notice to creditors, either by personal service on known creditors or by publication, then creditors must file a claim within four months of the date of the first publication or their claims will be barred.

However, in many states, including Alaska, revocable trusts are often used as the central vehicle for estate planning. There may be no need to open a probate and appoint a personal representative. If the fiduciary desires to cut off creditors' claims as quickly as possible, often a probate is opened and the claims procedure followed. Then the question arises whether this claims procedure only applies to assets in the probate estate (often minimal) or also to the assets of the revocable trust.

In an effort to solve the above-described procedural problem, Alaska has enacted new provisions which state that if a probate is opened and a personal representative appointed, and if the personal representative follows the claims procedure, then claims that are allowed or barred against the decedent's estate shall also be allowed or barred against the assets of the revocable trust. If a probate is not opened, or if the personal representative fails to follow the claims procedures, then the trustee of the revocable trust may file a petition with the court for a determination of claims and follow the general claims procedure of the Uniform Probate Code. Then claims against the revocable trust and against the decedent's estate shall be allowed or barred under those procedures.

3. Trust Decanting: Expansion of Statutory Authority. Webster tells us that "decanting" is pouring wine from one glass to another. New York enacted a "decanting" statute, which allowed a trustee, who has absolute distribution discretion, to make distributions of trust assets from one trust to a new trust. Subsequently, Alaska, Delaware, and Tennessee have enacted similar provisions. This decanting authority may be used to achieve a variety of goals, including: dealing with changed circumstances; modifying administrative provisions; altering trusteeship provisions; extending the termination date of trusts (for non-tax reasons); correcting drafting errors; converting a trust to a grantor trust or back; changing the governing law; dividing trust property to create separate trusts; and reducing potential liability. Alaska's new amendments allow decanting not only by a trustee who has absolute discretion but also by a trustee whose authority is limited by an ascertainable standard.

4. Proceedings Against Trustees: Shorter Statutes of Limitations. Alaska has again amended its statute which specifies the limitations periods applicable to trustees. Alaska's approach adopts some of the provisions of the Uniform Trust Code but then adds substantial changes. The most significant change shortens the claim period from twenty-four months to six months.

The new amendments to Alaska Statute 13.36.100 give a trustee three different methods to bar claims against the trustee.

a. If the trustee issues a report without adequate disclosure of potential claims, and informs the beneficiary of the location and availability of records for examination by the beneficiary, then all claims against the trustee are barred unless a proceeding to assert a claim is commenced within three years after the beneficiary's receipt of the report.

b. If the trustee serves a report on a beneficiary that adequately discloses the existence of a potential claim and the trustee informs the beneficiary that a proceeding to assert any claim must be commenced by the beneficiary within six months, and the beneficiary fails to so assert a claim against the trustee, then all claims of the beneficiary are barred.

c. If the trustee petitions a court for an order approving a report that adequately discloses the existence of a potential claim, serves the report on the beneficiary, gives the beneficiary at least 60 days notice of the court proceeding, and notifies the beneficiary that a claim must be begun within 45 days after notice of the court proceeding, then all claims against the trustee will be barred unless the claims are served on the trustee and filed with the court within 45 days after the beneficiary is served with notice.

The report of a trustee is considered to provide adequate notice to the beneficiary that there is a time limitation for filing claims if the report contains certain language specified by the new statute.

FAMILY LIMITED PARTNERSHIPS AND FAMILY LIMITED LIABILITY COMPANIES SHOULD BE REVIEWED

Family limited partnerships and family limited liability companies (both referred to here as FLPs) have been a popular estate planning technique used by many of us. These entities have facilitated the transferring of interests to the next generation and have provided significant asset protection. As we have previously written to you, the IRS has been more and more aggressive about attacking the tax savings when FLP or FLLC interests are discounted.

The IRS has challenged some of these entities asserting both legal and valuation arguments. Most of the valuation cases have been resolved through negotiated settlement by the parties. The IRS' early legal challenges generally failed.

However, in recent years, the IRS has asserted a new legal challenge, based on I.R.C. § 2036. This statute includes assets in the decedent's estate if the decedent retained the income or enjoyment of the assets during his or her lifetime. The IRS has been focusing closely on the operation of the FLP since its formation. A number of new cases have considered this I.R.C. § 2036 challenge and have held in favor of the government. As a result, all of the FLP assets (even though the decedent had given away part or all of the FLP ownership interest during the decedent's lifetime) have been included back in the decedent's gross estate and taxed under the federal estate tax.

These cases involved improper operation of the FLP. Also, the courts have also focused on the decedent retaining too much control, either directly, or implicitly through family members and their conduct.

If you are using an FLP or FLLC for your estate planning, we strongly recommend that you schedule a conference with us so that we may review the entity's operation. If there are problems with the manner in which you are operating your FLP or FLLC, often they can be cured by additional planning.

As we have discussed with you before, the tax law is a moving target. Our job is to assist you in making adjustments to your planning so that it will be successful.

ALASKA RESIDENCE TRUSTS SAVE ESTATE TAXES: ASSET PROTECTION FOR YOUR RESIDENCE

An Alaska qualified personal residence trust is an excellent way to reduce your federal estate tax dramatically and also provide full asset protection for your Alaska residence.

For example, let us assume that you own, in your individual name, an Alaska residence with a fair market value of $400,000. Assume you are 60 years of age and that the residence appreciates 4% per year until your death at age 81 [your actuarial life expectancy].

Estate Taxes. Without using a residence trust, at the date of death, the residence will be worth $925,253. At today’s estate tax rate (46%), the federal estate tax will be $425,617.

Creditors. Also, assume that at some time in the future you have a bad commercial transaction, or a professional negligence situation, or a personal injury accident, or a divorce after a recent marriage. Without a residence trust, your future creditor will be able to force a sale of your residence, give you the first $67,500 and keep the remainder of the sale proceeds to satisfy the judgment.

Form an Alaska Residence Trust. What if, instead, you place your Alaska residence in an Alaska qualified personal residence trust? This is a trust that you form and then direct that you are retaining the use of the residence for a certain number of years. At the end of that time, the residence will then be held in trust for the benefit of your family (for example, your spouse and children).

Gift. Let's assume that you decide to retain the use of the residence for 15 years. You will be making a gift under the federal gift tax. However, this gift is only of the value of the interest that passes to the family after the15 year period. In addition, this gift will also be discounted for the risk that you may die during the 15 year period. If the federal interest rate that applies is 6%, then this gift would be $117,952. Your gift can be offset by part of the tax credit that each of us has in order to protect against a certain amount of transfers. Therefore, you will probably not have to pay any gift tax.

Estate Tax. Once you have made this gift, and if you live for the period of years you select, then the residence will no longer be included in your estate for federal estate tax purposes. This means that you can get your residence out of your estate, for federal estate tax purposes, for a gift of only $117,952. Compare this to the $925,253 value that would be taxed at your death if you kept the residence.

Tax Savings Bottom Line: In our example, you will save $371,359 in estate tax because you used an Alaska residence trust.

Asset Protection. In addition, and equally important, Alaska state law provides that an Alaska residence that has been placed in an Alaska qualified personal residence trust is fully protected against your future creditors. This rule applies no matter how large the value of the residence.

Asset Protection Bottom Line: An Alaska residence trust provides excellent asset protection for perhaps your most important asset, your home. Very few other states provide this type of asset protection for residences.

Flexibility. If you decide to sell your residence during the period of time when you have retained its use, you have two years within which to roll over the proceeds into the purchase of a new residence. If instead, you decide not to purchase a new residence, then you will be paid an annuity for the rest of the period of time that you otherwise would have retained the use of the residence.

AN UPDATE OF ESTATE PLANNING TECHNIQUES WHICH YOU SHOULD CONSIDER AND MAINTENANCE REMINDERS

We have previously discussed that periodically it is important to review your estate planning. Changes in assets, net worth, and family situations often dictate that adjustments or new planning should be implemented. We have updated our handout which lists many of these planning techniques and maintenance reminders. **A copy of that update has been included with this newsletter.** We hope that you will find it helpful in thinking about your estate planning and, if necessary, bringing it up to date.

WE'VE MOVED !

For the last ten and one-half years our office has been in the Atwood Building (previously called the Hunt Building and then the Ensearch Center). As many of you know, several years ago the State of Alaska purchased the building from Equitable Life Assurance Company. As private tenant leases expired, the State of Alaska refused to renew the leases in order to obtain more space for state agencies. We were the next to the last private tenant to move from our old home.

On June 1, 2006, we moved to our new office, which is located at 1029 West Third Avenue, Suite 600. We are very pleased with our new office as we have more room and spectacular views of the inlet. We hope that when you are downtown that you will drop in for a visit and a tour of our new office.

We have included a map along with this newsletter. The map pinpoints our location, as well as easy parking locations. Our building has a dedicated parking lot at the end of Second Avenue with free visitor parking available. Alternatively, you may park in either metered spaces on Third Avenue or in the Dimond Parking lot, which is one-half block away.

OUR STAFF'S ACTIVITIES

Our attorneys recently prepared and presented a full-day seminar entitled, "**Sophisticated Estate Planning in Alaska**". The seminar was very well attended by clients, local estate planning attorneys and accountants. We enjoyed the presentations and the input from the participants.

Larry Biskowski has prepared and presented seminars to the Fairbanks Estate Planning Council and here in Anchorage regarding Alaska's qualified personal residence trusts.

In September 2006, **Chuck Schuetze** will participate in an Anchorage seminar sponsored by the National Business Institute. Chuck will lecture on "Limited Liability Companies."

In November 2006, **Dave** will chair and participate in the Alaska Bar Association's seminar entitled "Alaska's Special Estate Planning Techniques for You and Your Clients," which will be presented to members of the Alaska Bar Association.

In February, **Dave** will lecture at the American Law Institute–American Bar Association Conference in Maui. Dave's topics will include Alaska trusts and defined value clauses.

Bhree is back!

Bhree Roumagoux took a sabbatical during 2005-06 to obtain her LL.M. degree in taxation at the University of Washington Law School. She arrived back in Anchorage in August and is working full-time. Now our firm has three attorneys who have specialized degrees in tax law.

Suzanne's baby arrived! Suzanne McVicker had a baby boy, Aidan, weighing 8 lbs., 5 oz. Suzanne is back in the office working on trust and estate administration.

OUR WEB SITE

You may refer to our website for a variety of information:

1. A "what's new" discussion of developing estate planning subjects;
2. New federal and state legislation affecting estate planning;
3. A "checklist" for evaluation of your estate planning;
4. Discussion of a number of relevant estate planning techniques;
5. Our past newsletters;
6. Key Alaska estate planning statutes; and
7. Many articles which we have written about Alaska estate planning techniques.

We hope you will visit our web page at your convenience.

Please e-mail us at <**info@shaftellaw.com**> with your estate planning questions or topics which you would like to see discussed on our web site.

We hope the above information is helpful to you. We remain available to help you maintain your estate plan and to add appropriate new techniques when you so desire. If you would like to meet with one of our staff to discuss any of the above subjects, please call.

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