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TRUST AND ESTATE

ADVISOR REPORT

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Message From The Firm

Few events in life are as difficult as dealing with a loved one who is displaying signs of weakening mental capacity. Estate planners have historically provided for methods of transferring financial control in these situations, to trusted family members or advisors. These financial controls can affect a client's business, business transition, investment portfolio, and personal support and care. As explained in Kalyani Chirra's article, recent changes in Federal law render much of this planning obsolete, and clients must be carefully advised on how to deal with this transfer of financial control under the new law.

We are also pleased to report on a new financial and estate planning technique developed by the Firm, and ratified by the Internal Revenue Service, in dealing with the often difficult problem of asset division and support in connection with a divorce. In the article by Brad Cohen and Kyle Neal, the authors explain how unique and creative solutions can be developed to satisfy the specific financial needs faced in a particular situation. The Firm has a long tradition of developing unique and innovative solutions for our clients, in estate planning, business planning, tax and employee benefits, and this article reflects the Firm's most recent efforts.

As always, if you have a question about an article in this newsletter, please contact the author or me.

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Medical Privacy Rules and Estate Planning

By Kalyani Chirra (KalyaniChirra@Reish.com)

Problem: Your client is starting to lose his memory and is not able to manage his assets but is unwilling to resign as trustee of his living trust or allow anyone to act as his agent under a financial power of attorney. You and the beneficiaries of the client's living trust think it would be best if client were removed as trustee of his living trust. After reviewing the provisions of the living trust, you determine that the triggering device for removing a trustee is a physician's certification that the trustee is no longer able to administer the trust because of physical or mental incapacity. You approach client's doctor, explain the situation to her and ask that she certify client as incapacitated. She responds that unless you have a valid written authorization from client or are named as client's current health care agent she cannot release client's medical information to you or provide you with a certification, because to do so would be in violation of client's privacy rights under the Health Insurance Portability and Accountability Act (HIPAA) and California's long-standing Confidentiality of Medical Information Act (CMIA).

Solution: Many trusts are drafted so that the trigger for removing a trustee is a physician's certification of the trustee's incapacity, as in the example above. Financial powers of attorney are often drafted such that an agent may only take over a person's financial affairs if the principal is deemed incapacitated by a physician's certification. Estate planners are now having to rethink the way trusts and powers of attorney are drafted.

Under HIPAA and CMIA, in general, a health care provider may only disclose a patient's "protected health information" to the patient, anyone whom the patient authorizes in a written authorization form meeting specific requirements, or to a patient's agent under a currently effective Advanced Health Care Directive.

If any estate planning document contains a requirement for a physician's certification of the principal's physical or mental inability to act, the principal should either execute an authorization for disclosure of protected health information, as a separate document, or execute an Advance Health Care Directive that makes the health care agent's powers currently effective and not springing upon incapacity. Similarly, a financial power of attorney can be made currently effective. However, extreme caution should be exercised in doing so.

There are some drawbacks to giving another person, even a spouse, power to access medical information. In one unfortunate case a couple had named each other as currently effective health care

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Medical Privacy

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agents under their Advance Health Care Directives. The couple subsequently separated and was in the middle of a custody dispute when the wife used her power as health care agent to obtain her husband's medical records. Unfortunately, the husband's medical records provided evidence that he had previously had a cocaine addiction. Clearly, caution should be used before giving any person the power to obtain another's protected health information.

Another alternative is to draft trusts and powers of attorney to change the mechanism by which a trustee can be removed or an agent's powers can become effective. There is no requirement that a physician's certification be obtained. This has been the standard for many years because many clients believe that such certifications are the most dependable evidence of unfitness to serve. One alternative is for the settlor of the trust to name one or more trusted individuals who would have the power to remove a trustee if they determined that the trustee was unfit to serve. Another alternative would be to give the beneficiaries this power. However, one would have to worry if the beneficiaries are acting in self-interest in removing a trustee, particularly if the trustee controls distributions to such beneficiaries.

Individuals are advised to review their estate plans to determine if a physician's certification will be required to remove a trustee or to make a power of attorney effective. If a physician's certification is required, we recommend that the document be amended to provide for an alternate trigger to remove the trustee or make the agent's power effective. Alternatively if the client is willing to name someone as health care agent and make this power currently effective instead of springing, the client should execute a new Advance Health Care Directive. ❖

Unique Estate Planning Opportunities Available in Divorce

By Brad Cohen (BradCohen@Reish.com) and Kyle Neal (KyleNeal@Reish.com)

In PLR 200408015, the IRS blessed a creative solution in a divorce settlement with positive income, gift and estate tax advantages for the spouses and their children.

A husband and wife entered into a divorce settlement that required the husband to set up a trust that would pay to the wife a fixed monthly amount to the wife for her life. The payments to the wife from the trust were required to be income tax-free to the wife.

The husband set up an irrevocable trust to pay the wife a fixed monthly annuity, and upon her death to distribute the remaining trust assets to the couple's children. The trust was set up as a "grantor trust" for income tax purposes, so that any income not distributed to the wife would be taxable to the husband.

Income Tax

The trust was required to invest solely in municipal bonds. This met the requirement that there would be no taxable income to the wife. (If the trustee had been allowed to invest in taxable investments, the wife would have been taxable under Internal Revenue Code Section 682 on the income payable to her, and the husband would have been taxable on the balance of the income, even though he would not have received it).

Gift Tax

The wife received her annuity interest in the trust pursuant to divorce, so her interest was not considered a taxable gift. The present value of the remainder interest passing to the children was a taxable gift. The value of the gift to the children was calculated using the interest rates under Internal Revenue Code Section 7520. In a time of low interest rates, the value of the spouse's annuity is higher, and therefore the value of the children's remainder interest is lower. A planner could design the amount of the annuity payable to the spouse to in effect "zero out" the value of the remainder passing to the children and therefore eliminate any taxable gift to the children. The ability to do so will depend on the amount of the monthly annuity, the wife's life expectancy, and the amount of the agreed original contribution.

If the trust's investments outperformed the Section 7520 rate used to value the annuities, the excess value passing to the children would pass to the children free of gift or estate tax. For example, if at the time the trust was established the value of the children's remainder interest was calculated (under Section 7520) as 1x, but at the date of the wife's death the actual asset value was 2x, the children would receive the 2x with no additional death tax.

Estate Tax

The husband retained no rights to any of the assets in the trust and he retained no rights to change the trust in any way. Therefore, the trust assets would not be includible in his estate. Neither would the trust assets be includible in the wife's estate, because the trust was not the type of "QTIP marital trust" that results in inclusion in a donee spouse's estate. If the husband had instead gifted the municipal bonds outright to the spouse, any remaining assets would be taxed in the spouse's estate and only the net after tax value would pass to the children. ❖

Around the Firm

Brad Cohen presented an “Income Tax Update” seminar in December to the Business Managers Committee of the Los Angeles Chapter California Society of CPAs. Kyle Neal spoke on the "New Domestic Partnership Law and Its Estate Planning Implications" to the Valley Estate Planning Council in December. In November, David Schwartz gave two presentations to brokers on “Basic Estate Planning.” Brad and David co-presented a seminar for business managers in November on the New Tax Act and Estate Planning.

Bruce Ashton and Robin Gilden co-authored the feature article for the American Society of Pension Professionals and Actuaries (ASPPA) November 23rd newsletter on "New Tax Shelter Rules Under AJCA: Advisors Beware."

The firm is a sponsor of the USC Law School 2005 Tax Institute, being held in Los Angeles on January 24-26. The Institute is a leading tax law conference that addresses legislation, critical issues and strategies that impact corporate, partnership, individual, real estate, and trust and estate planning.

Our attorneys frequently give presentations on a variety or business, tax and estate planning topics to business managers, accountants and investment advisors. If your firm needs continuing education hours, please contact Traci Mortimer in our office at (310) 478-5656 ext. 231 to schedule a presentation.

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