Recommended Update of Community Property Agreement

Now Included in HIPAA Update Package **Effective 7/1/2000**

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The AB Trust *type* is the favored Revocable Living Trust among estate planners for married couples and is the foundation estate planning document for most. I specify, AB Trust *"type"* because there are several types of AB Trusts. Regardless of type, these trusts have two major functions: to keep your estate out of probate during your lifetime and at death, and to guarantee the use of both spouse's federal estate tax exemptions (hereafter "exemption"), if needed, thereby reducing or eliminating federal estate tax. Recent changes in California law have enhanced the effectiveness of the AB Trust with regard to maximizing the use of both spouse's exemptions.

The effectiveness of the AB Trust to reduce or eliminate federal estate taxes decreases as the ratio of retirement assets to trust assets increases. Pursuant to the Internal Revenue Code, retirements accounts (e.g., IRA, 401K, 403B, pension plan, etc.) must remain in the employee's name during the employee's lifetime. Therefore, title to these assets are typically NOT changed to an AB Trust. Instead, the AB Trust is usually named as the contingent beneficiary of the account, after the spouse as primary beneficiary

Since in the year 2003, each person, including each spouse, has a $1,000,000 exemption, you would think that an AB Trust would be able to shelter $2,000,000 from federal estate tax. This *is* possible if *all* of the $2,000,000 is in the name of the trust (no retirement assets). But what happens when the estate has significant retirement assets?

Take an estate worth $1,800,000, consisting of $900,000 in retirement assets (primary beneficiary spouse, secondary beneficiary Trust) and $900,000 in trust assets (mostly a home and some investments). As seen in Figure 1, the $900,000 in trust is divided at the death of the first spouse, thereby using the deceased spouse's exemption for the $450,000 in the B Trust. It is important to realize that the rest of the deceased spouse's exemption is *wasted.*

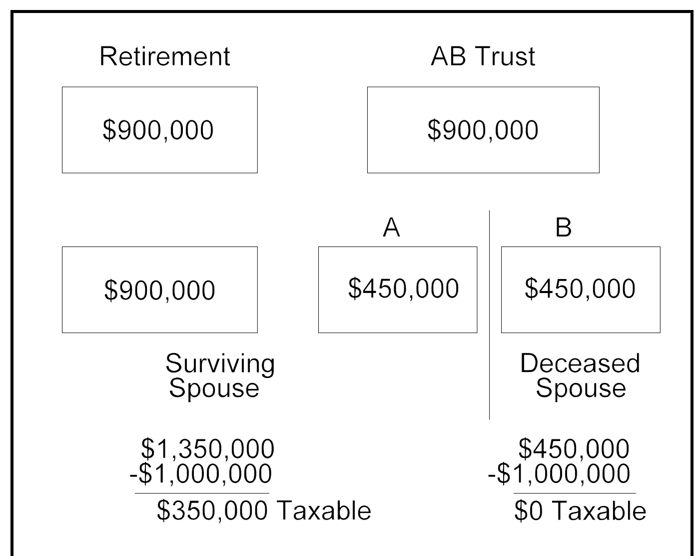

Figure 1

This leaves the retirement accounts and A Trust assets, totaling $1,350,000 to be sheltered by the surviving spouse's exemption of $1,000,000, leaving $350,000 exposed to estate tax, starting at around 41% equals $143,500.

So, if two people can shelter $2,000,000 with an AB Trust, why is there $143,500 in estate tax in a $1,800,000 estate? It is because the $900,000 in retirement assets were not in the AB Trust, and therefore could not be funded in part into the B Trust at the first spouse's death, at least not without adverse income tax consequences.

What adverse income tax consequences? If you fund the B Trust with a retirement account, the account automatically goes into payout mode, just as if the

surviving spouse has reached his or her required beginning date and must commence taking minimum distributions. This means that income tax that had otherwise been deferred now has to be paid.

So what can the change in California law do to help this problem of under utilizing the deceased spouse's exemption? California law now clarifies that married couples can state *in writing* that they intend to use the "aggregate theory" of community property for their estate, as opposed to the "item theory". The aggregate theory states that each spouse owns an undivided one-half interest in the total marital estate, not one-half of each and every marital asset, as the "item theory" suggests.

This aggregate theory approach allows planners to make *compensating adjustments* between retirements assets and trust assets at the time of the first death. Take the same $1,800,000 estate as illustrated above, but see the difference in the outcome in Figure 2. Since all the estate assets are community property, each spouse owns one-half of the aggregate. Now we can swap $450,000 of the surviving spouse's interest in the trust assets, for $450,000 of the deceased spouse's interest in the retirement assets.

As a result, all $900,000 of the trust assets can be funded into the B Trust, better using or fully using the deceased spouse's exemption, and the retirement accounts can be distributed to the surviving spouse, as usual, but this time without estate tax.

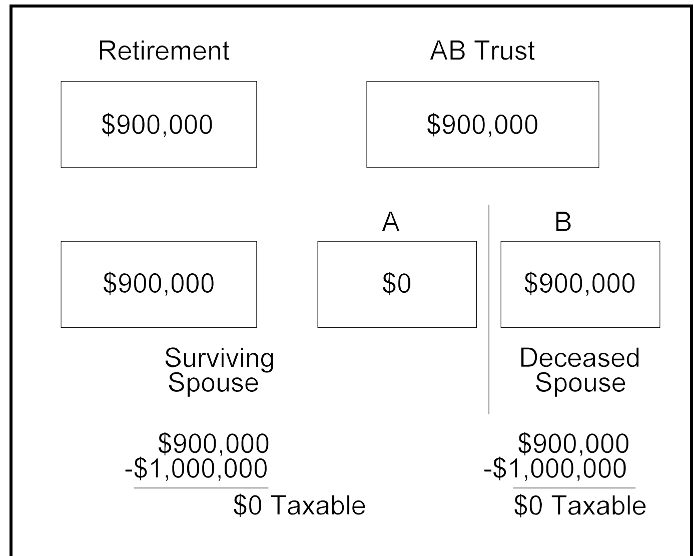

Figure 2

Having this planning tool can result in significant estate tax savings. Over time, other benefits will probably surface which are unknown at this time. Therefore, it is our recommendation that all of our married clients obtain this update to their Community Property Agreement, even if their estates are significantly less than the $2,000,000 maximum.

------------------------------------ please detach and return in enclosed envelope---------------------------------------

The Law Firm of Richard O. Barndt recommends that all Community Property Agreements drafted by this firm before 7/1/2000 be updated. Updates are offered for a fee of **$100.00** and can be obtained during your usual three-year review, however, we recommend that this update be done as soon as reasonably possible.

____ Please call us to schedule an appointment to obtain our Community Property Agreement update.

____ Please mail us our updated Community Property Agreement. We will have it notarized and mail you a completed copy. Please find enclosed a check in the amount of **$100.00** payable to **Richard O. Barndt.**

____ We elect to decline the update to our Community Property Agreement. We hereby release the Law Firm of Richard O. Barndt for any consequences resulting in substantial part from not obtaining this update.

A non-response will be deemed a declination and release without further notice.

Dated: ___________

_________________________________ Signature

_________________________________ Signature