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To: Clients and Friends
From: The Attorneys at Bove & Langa
Re: Firm Newsletter: March 2008

DEVELOPMENTS AND PLANNING IN ESTATE ADMINISTRATION

An important service we provide our clients is assistance in settling a loved one's estate. It is not an easy time for a family since emotional loss often becomes intertwined with concerns over financial security – a potent mixture. Even with a comprehensive estate plan in place, guidance is often needed to achieve the deceased's goals, which typically include providing for surviving family members, minimizing estate taxes, keeping a business going, and maintaining privacy. Thus, we thought we would dedicate this newsletter to the process of estate administration by pointing out some recent developments in this area and explaining important steps in the process. Many of these steps are undertaken by the person with responsibility for administering the estate, which may be the "executor" under the deceased's will, an "administrator" of an intestate decedent (someone without a will or trust, typically), or a "trustee" under the deceased's trust. With a modern estate plan in place, often it is the trustee who performs the task of administration, but in this newsletter we will refer to the person administering the estate as the "executor" since this is the term most often used in the popular press.

RECENT DEVELOPMENTS IN ESTATE ADMINISTRATION

The Internal Revenue Service Proposes To Enter The Afterlife: At present, when someone dies, the Internal Revenue Service ("IRS") permits the estate of a decedent to deduct from the gross value of the estate: (1) funeral expenses; (2) administration expenses; (3) claims against the estate; and (4) certain unpaid debts. The amount an estate may deduct for a "claim against the estate", however, has been a highly litigious issue since the tax code does not contain any specific direction on how to value a claim on the estate tax return.

To address this issue, the IRS has proposed regulations to permit an estate to take a deduction only for amounts actually paid in the settlement of a claim. If the claim is contested or contingent when the estate tax return is due, an estate will be allowed to file a protective request for a refund to preserve its right to benefit from a deduction. If the claim is fixed, but payments will be made over a period of time, a deduction will be allowed only as each payment is made. Both procedures may force estates to remain open while claims against it are pending or payments in satisfaction of claims are being made. Stay tuned, as the IRS is gathering comments from practitioners prior to issuing final regulations.

Let The Unbundling Begin…: Most estate plans involve a client signing and funding a revocable trust, which for tax purposes has no independent existence from the client. This changes at death, when the trust becomes irrevocable and elevates to the status of an independent taxpayer, with the attendant requirement to report income and the ability to take deductions against this income. Deductions might include management fees charged by the trustee, accounting fees, legal fees, and investment fees (which could be charged by the trustee where the trustee managed the investments, or might be charged by an outside investment advisor employed by the trust). Traditionally, all such fees were 100% deductible. No longer. In a recent U.S. Supreme Court ruling (*Knight v. CIR*) it was held that investment fees incurred by a trust that could be incurred by an ordinary taxpayer will be treated as miscellaneous itemized deductions, and subject to the 2% floor. Where the trustee performs multiple functions, the trustee will now have to "unbundle" the fees and isolate those unique to the investment of trust assets. Interim guidance has been issued by the IRS in Notice 2008-32 (February 2008).

Preparer Penalties Now Apply To Estate Tax Returns: Recent amendments to the tax code (i) subject preparers of estate and gift tax returns to preparer penalties for understatement of tax, where such penalties previously were reserved for preparers of income tax returns; (ii) raise the standards to which return preparers are held; (iii) increase the penalties imposed on return preparers for failure to comply with the standards; and (iv) broadens the definition of "return preparer" to include in some instances an advisor who does not sign the return.[*]

A penalty will not be imposed where the preparer or advisor reasonably believes that the position taken on the return is *more likely than not* correct, meaning a good faith belief that the position taken on the return has a greater than 50% chance of being correct. However, if the signing preparer discloses the position taken on the return by filing Form 8275 with the return, or if the non-signing advisor advises the taxpayer about proper disclosure, the penalty will be avoided if there is a *reasonable basis* for the position, meaning the position was reasonably based on authority recognized by the IRS, such as the Code, regulations, case law, and the like.

[*] Sections 6694(a) and 7701(a)(36)

The preparer penalty has been increased from $250 to the greater of (i) one-half of the preparer's fee, or (ii) $1,000. Additionally, in the case of willful or reckless understatement the penalty is increased from $1,000 to the greater of (i) one-half of the preparer's fee, or (ii) $5,000.

What does all of this mean to the taxpayer? Expect the advisor to be a bit more cautious when the taxpayer advocates an aggressive return position.

Gain Exclusion On Sale Of Home Survives Death Of Spouse: Generally, when married clients plan on selling their principal residence, we advise them that up to $500,000 of the profit will escape income tax (after meeting certain holding and use requirements). However, until now, if a spouse died during the sales process then the full $500,000 gain exclusion was only available if the house was sold in the *same* calendar year as the death. This rule applied even in the unfortunate situation where the spouse died on December 31st and the surviving spouse sold the principal residence on January 2nd of the next year. In that case, only the single person exclusion of $250,000 would apply. Congress recently recognized the absurdity of this rule and changed the law for *sales* that take place *after* December 31, 2007. Therefore, for any sale by a surviving spouse that takes place after 2007, the surviving spouse will be able to exclude the first $500,000 of gain provided that the sale occurs not later than two years from the *date of death* of the deceased spouse. This is a sensible change in the law since it allows for an appropriate time to grieve and give consideration to the future. Keep in mind that even though in many cases a step-up in tax basis, equal to one-half of the value of the principal residence, is achieved upon the death of the first spouse, the potential for income tax savings can still be substantial where the value of the home has increased dramatically from its original cost basis.

SELECTED TOPICS IN ESTATE ADMINISTRATION

So You're In Charge – What Are You Going To Do? After the death of a loved one, it is human nature for there to be a period of emotional upheaval while coming to terms with the loss. However, for the executor in charge of administering the estate the period after death is a very important, and often requires fairly quick action. For example, there may be an empty house to secure, or investment assets that need immediate attention. Also, action may need to be taken to continue a business operation if relevant to the decedent or to minimize a possible claim against the estate. It is very important to comply with time periods for probate of the estate, filing of income tax returns, and filing of the federal and Massachusetts estate tax returns. In order to assist the executor, we have prepared a checklist of issues to serve as a guideline. While the list is very comprehensive, other issues may need to be addressed based on the particular situation of a decedent. The checklist may be accessed at our website's homepage at www.bovelanga.com.

Retirement Benefits Chaos (RBC): And, in case you don't go to our website to read the checklist, here are some specific dates to keep in mind with regard to retirement assets. Within the first month, the executor should determine the type of retirement benefits owned at death, whether the decedent had been receiving "required minimum distributions" (RMDs), if the decedent was receiving RMDs, whether the decedent had received the RMD for the year of death, and the identity of the primary and contingent beneficiaries.

If the decedent had employer related retirement benefits such as a 401(k), Keogh, or 403(b) plan, the executor will also need to request from the employer an explanation of the retirement plan's beneficiary distributions rules. These rules will determine when and how a named beneficiary will receive access to the retirement benefits, and such rules can vary from plan to plan.

If the decedent had an IRA, or if the decedent's retirement plan uses the default rules established by the tax code the following dates are important:

> *December 31st of the year of death*: If the decedent was receiving RMDs each year, and did not receive one in the year of death, such RMD will need to be distributed to the beneficiary or beneficiaries by December 31st of the year of death to avoid penalties.
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> *September 30th of the year following the year of death*: If all named beneficiaries qualify as "Designated Beneficiaries" under the IRC, there are wonderful tax deferral opportunities. However, if any named beneficiary does not qualify as a Designated Beneficiary, it will ruin the tax deferral for everyone. Where the tainted beneficiary is removed by the September 30th deadline (for example by early payment of its share), the way is cleared for the Designated Beneficiaries to reap the benefits of tax deferral.
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> *December 31st of the year following the year of death*: Hopefully, by this date the executor is only dealing with Designated Beneficiaries. If the executor wants a beneficiary to be able to elect to receive RMDs over such beneficiary's respective lifetime, for example (instead of with reference to the decedent's previous withdrawal schedule or a payout over the five years following death), each Designated Beneficiary's interest in the retirement plan must qualify under the "separate account rules". Such accounts must be established by December 31st of the year following the year of death, and, all Designated Beneficiaries must begin receiving RMDs by that date.

"Mom Always Liked You Best!": Managing The Expectations Of Beneficiaries: "Mom said I was to get the stock and I want it now!" An often worrisome problem for the executor is the unreasonable expectation that distributions from the estate will commence shortly after the deceased is laid to rest. Not so. Prior to making distributions, the executor has to collect all the deceased's assets, determine debts owed, and settle the decedent's affairs, including the payment of outstanding income taxes and estate taxes. Because the executor has personal responsibility and liability for these obligations, it is not advisable to distribute estate assets until the debts and taxes are paid, and a

"closing letter" is obtained from the taxing authorities. While the initial filing deadline for an estate tax return is nine months after the date of death, an automatic six month extension is often utilized, and when the extension is obtained the first distributions should not be anticipated until at least fifteen months after the loved one's passing.

Creation Of An Estate Plan + Not Administering The Estate Of The First Spouse = Higher Estate Tax Liability (Among Other Things): You and your spouse spent the time and money to create an estate plan that will greatly reduce, if not eliminate, estate taxes. However, if the first decedent spouse's estate is not properly administered, all such planning and expense could be for naught. Why? The reasons, both tax and non-tax, are many. If the estate exceeds the estate tax filing threshold, the executor has the legal duty to file the estate tax return, even if no tax will be paid. If having a legal duty to do so is not enough to convince the executor, by not filing, some important elections on the tax return that will affect the tax treatment of the second spouse's estate may be missed. As well, filing the estate tax return(s) leads to the next logical step: properly funding the decedent's trust to ensure the couple receives the maximum estate tax savings, and failure to do so could cause significantly greater tax in the second spouse's estate.

By failing to administer the first estate, creditor protection that may have been available to the surviving spouse would be lost. Additionally, if the first estate holds any interest in real estate, there will be title issues if and when the real estate is sold, because title will not have been cleared of the immediate estate tax lien placed on the property by the Massachusetts Department of Revenue at the first spouse's death. Finally, failing to properly administer the first estate could cause the surviving spouse to file incorrect income tax returns in the years following the first death. To correct such filings, amended income tax returns will need to be filed, usually at a significant cost, including accounting and possibly legal fees, delinquent taxes, interest, and in some cases tax penalties.

Don't Touch The Family Trust – Invest For Growth: It is common knowledge that trusts are important in almost every estate plan, but less known, perhaps, is that a trust's importance can be magnified by careful administration. As any married couple that has done an estate plan with our firm knows, planning to minimize overall estate taxes for a family often involves the use of a trust. During the creator's life, the trust generally provides that the trust assets are to be used to benefit the creator and possibly the creator's family. Upon the death of the creator, the trust typically divides into separate shares commonly known as the "marital trust" (where there is a surviving spouse) and the "family trust" (or credit shelter trust.) The family trust is designed to escape estate taxes in both spouses' estates, and thus should be the last pot of assets the surviving spouse dips into (she should first use assets which will be taxed in her estate). If the family trust is not needed to sustain the surviving spouse, let it grow, and the family trust's investment strategy should reflect this preference for growth. Simply stated, the family trust should be nurtured for growth, just like the family.

The Paper Reduction Act? Not In Florida! Adding to the often tedious nature of estate administration, Florida now requires a Florida estate tax return to be filed with the state Department of Revenue whenever a federal estate tax return is filed with the IRS for a decedent whose estate includes property located in Florida, even when the decedent's estate does not owe any Florida estate tax. As a matter of fact, under current law, Florida does not even have an estate tax until 2011. Prior to this change, Florida merely required that a copy of the federal estate tax return be filed with its Department of Revenue.

When You Die, Will Your Secrets Go With You? You are likely aware that when you die, many personal secrets will die with you. And if you weren't already dead, your executor might kill you for taking those secrets with you! In order to assist your executor with the smooth administration of your estate, it is advisable to leave behind a folder of information that includes the location of title certificates to automobiles and boats, names and account numbers of insurance and annuity policies, and a list of all online accounts together with the account password (including email accounts). Knowledge of your accounts is only the first step, quick and easy access is equally important.

ANY QUESTIONS?

: *I can't wait fifteen months to receive a distribution from the estate, what can I do?*

A: Where there is a surviving spouse and a good estate plan in place, there should be no estate tax due at the death of the first spouse. In that case, the liability exposure is low and the surviving spouse can continue to use the decedent's assets. In other cases, it is sometimes possible to estimate the debts owed and taxes due, and if there is a comfortable margin of "extra assets", the executor can make some preliminary distributions, with the beneficiary signing an agreement to give back the distribution in the event it is needed to pay debts, expenses, or taxes.

: *How will I know what type of retirement plan the decedent had?*

A: Hopefully the decedent left a list of his or her assets. If not, many executors get information regarding the decedent's assets by looking through the decedent's mail for statements regarding their investment accounts, including retirement accounts. The statement should state the type of retirement account. However, if you are still unsure, we recommend contacting the retirement account administrator.

: *How do I know if a named beneficiary of a retirement account meets the definition of a "Designated Beneficiary"?*

A: To qualify as a "Designated Beneficiary" the named beneficiary must be an individual or a "look through" trust. All other named beneficiaries, such as charities, do not qualify as "Designated Beneficiaries". To determine whether a named beneficiary qualifies, we recommend contacting the administrator of the retirement account or the attorney assisting with the administration of the estate.

 **:** *I am the surviving spouse and beneficiary of both the marital trust and family trust established by my husband, but I am not sure why it matters which trust pays me. Isn't all the money mine since both trusts are from my husband's estate?*

A: There is a major difference as to which trust makes the distribution because whatever is left in the marital trust will be taxed in the surviving spouse's estate, but what is left in the family trust will escape taxation in the surviving spouse's estate. Assume George dies and leaves $1 million in a marital trust and $2 million in a family trust, both for the benefit of his wife, Gracie. If Gracie uses $500,000 from the marital trust, then upon her death, only the remaining $500,000 from the marital trust will be included in Gracie's estate (nothing from the family trust is in her estate). However, if Gracie instead took the $500,000 from the family trust, then the full $1 million of the marital trust will be included in her estate.

FINANCIAL TIP

April 15th IRA Deadline: Although this letter has focused on the time period after one has died, while you are still alive, don't pass up a tremendous opportunity to reduce income taxes and save for the future. If you have not already made your 2007 contribution to an IRA, you may still be able to do so by April 15, 2008. Please consult with your financial advisor. You may be able to contribute and deduct up to $4,000, or if you've reached 50, you may be able to contribute and deduct up to $5,000.

SUMMARY

We hope you have found this estate administration newsletter informative. If you wish to discuss any of the ideas mentioned above or have suggestions for topics for future newsletters, please do not hesitate to contact any of us.