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A Report of Legal Trends

David R. Frazer, Editor

A Bright New Year

As we reflect on the events in 2002, it has clearly been a year of growth at our firm. With the credentials Chick Arnold, Amy Gittler and Chuck Whetsstine bring to our firm, we have expanded our ability to offer exceptional expertise to serve your diverse legal needs. In addition, we are pleased to announce that Liana Cocanower, Jim McDougall and Kim Zack

also joined our firm in 2002.

Throughout the year, we will highlight our new attorneys in this newsletter to provide more information on their areas of specialization, and we will continue to bring you up-to-date legal and tax information and ideas geared to keep you as current as possible in our ever-changing legal scene. ■

Plan For That Story Book Ending

Happily ever after turned out to be a fairy tale for Snow White and the Prince so they sat down to amicably settle their affairs prior to divorce. Snow White was concerned that the King might not be as generous to her as the Prince if the Prince died, especially as she hadn't produced an heir, and the Prince planned to marry the duke's daughter and begin a family. As a result, Snow White asked the Prince to purchase a life insurance policy that would give Snow White the financial security she needed in the event of his death, which he did.

by

Liana C. Cocanower
Attorney At Law

Following the Prince's anticipated untimely death, Snow White collected the proceeds of the life insurance policy and had plenty of money to support her for the rest of her life. However, kingdoms, like many people, are notorious for investing in illiquid assets, like land and jewels. The Prince's widow and newborn son, although living in style in the palace with the King, were cash poor. The Prince's widow was dismayed to learn that the life insurance proceeds collected by Snow White were included in the Prince's estate for federal and state estate tax purposes. Consequently, the estate would have to pay estate taxes on the policy proceeds collected by Snow White. Furthermore, Snow White refused to pay voluntarily the portion of the estate taxes attributable to the life insurance policy, so a lawsuit would have to be filed to try to collect the taxes from her, further depleting the estate's cash resources available to the Prince's new family.

This is not an unusual situation; however, it can be avoided with proper planning. If the requirement to provide the life insurance policy is contained in the marital settlement agreement or divorce decree, the personal representative of the estate could argue that the estate was entitled to a deduction equal to the amount of the proceeds as a result of the obligation owed to the former spouse. The Internal Revenue Service could, however, contest or deny the deduction.

A better alternative would be for the insured spouse to set up an irrevocable life insurance trust ("ILIT") with the former spouse or, if the policy was intended to benefit children of the former marriage, the children, as the beneficiary or beneficiaries. Properly drafted, an ILIT will keep the insurance policy proceeds out of the estate altogether. As a result, the beneficiaries will receive the full amount of the proceeds free of any tax, and the new family will not be burdened with estate taxes on amounts received by the former spouse or other children.

If you are planning to purchase life insurance to fund a perceived need, consult your estate planning attorneys first to be sure that the manner in which the insurance will be held is the most advantageous under the circumstances. Ideally, this should be done before the application for the insurance policy is signed or the medical exam is undertaken, so that the ILIT can be the owner of the policy from the beginning. ■

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Congress Gives— Congress Takes Away

by
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Planning for Incapacity

by
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IRA Distributions

by
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As most of you know by now, in 2001 Congress passed and the President signed legislation that significantly revised Estate and Gift Tax law.

Most notable of the revisions is an increase in the estate tax exemption from \$675,000 per person to \$1,000,000 per person. In 2004, the exemption is increased to \$1,500,000 and by 2009 the exemption will have increased to \$3,500,000. In 2010, pursuant to the new estate tax law, the estate tax will be fully repealed.

Before you get too excited, you will not be thrilled to learn that in 2011, the estate tax will revert in all aspects to the law as it reads today with an estate tax exemption of \$1,000,000 per person, unless Congress makes the estate tax repeal permanent between now and 2010.

Several months ago, in 2002, a new estate bill was passed easily by the House but the Senate vote fell

We've all come to understand how important it is to plan for the potential of our future incapacity. Indeed, national attention was focused on Nancy Cruzan because she failed to plan for her future needs through the use of Powers of Attorney and other planning documents. Had Nancy Cruzan taken the time to effect these documents, none of us would have heard of her unfortunate plight.

The importance in engaging in such planning is magnified when one has a disabled family member. Specifically, while it is important that each of us takes the time to plan for our own incapacity, when we have a family member with disabilities, such planning is even more important.

Who will do what we do for our disabled family member? Who will know what we know about the special and unique needs of our loved one?

Unfortunately, in our community, the answer is often no one.

The unique demographics of our community which result in people moving here and leaving family members and social networks elsewhere often create a

six votes short. In order to pass repeal legislation in the Senate, it requires 60 votes rather than a simple majority of 51.

Now, after November 4th, the Republicans have a stronger position in the House and a bare majority (51) in the Senate, but enough to control all of the leadership positions in that chamber. While the election was helpful for estate tax repeal, at least nine Democrats need to join 51 Republicans to accomplish the desired goal.

Even with a favorable vote in 2003, the repeal may be phased in until 2010 pursuant to the terms of the present law. As a result, we suggest that present estate plans be reviewed to take advantage of what Congress has temporarily bestowed. We cannot predict future legislative action but we can help revise your wills and trusts and other subsidiary documents to protect your family and to save estate tax dollars. ■

significant void as a result of the lack of family support systems that exist in many of our nation's older communities. When coupled with the conservative philosophy of government that has emerged in our community, such that the governmental authority may not be available to assist in our disabled family member's care, the need to plan becomes more important than ever.

Our firm now offers an opportunity to effect complete life care plans for all clients, and specifically, opportunities to plan for the unique needs of our clients' disabled beneficiaries. Through the use of carefully drawn trust documents, Powers of Attorney, and other life planning documents, one's wishes, thoughts and concerns can be manifested in such a way as to assure successful management of the needs of a beneficiary with disabilities.

Take comfort in knowing that a small investment of time and energy can result in the avoidance of future difficulties relating to your disabled beneficiary's needs. The tools we have available are important pieces of a family's overall care plan. ■

Recognizing the substantial investment losses many taxpayers have suffered in the past several years, the IRS has granted some relief to taxpayers who began withdrawing assets from their IRAs before they reached the age of 59 1/2. This relief is set forth in Revenue Ruling 2002-62 issued in October 2002.

Under current law, a taxpayer must pay an additional 10% tax on pre-59 1/2 distributions from an IRA. Among the many exceptions to this rule is the provision that a taxpayer does not have to pay the extra 10% tax on the distribution if the distribution is part of a "series of substantially equal periodic payments". The 10% tax is not imposed on distributions which are:

- ✓ based on the taxpayer's life expectancy or the life expectancy of the taxpayer and the beneficiary,
- ✓ substantially equal, and
- ✓ made for the longer of 5 years or until the taxpayer reaches age 59 1/2.

The 10% additional tax does not, however, simply evaporate once the taxpayer starts the series of distributions. Instead, it lies in wait so that if the taxpayer changes the distribution schedule, the 10% tax reappears and applies to all past distributions and to all future distributions made before the taxpayer turned

- ✓ made at least annually,

Deadline For Amending Qualified Retirement Plans

by

Charles W. Whetstone
Certified Tax Law Specialist

A deadline for amending qualified retirement plans is approaching and some deadlines have already passed. In general, if your company maintains a prototype or volume submitter plan, your company must amend and restate its qualified retirement plan by adopting a new prototype or volume submitter plan by September 30, 2003. (This deadline was just extended by the IRS from December 31, 2002 to September 30, 2003.) The amendments are required to comply with numerous laws that have been enacted by Congress since 1994. These laws are collectively referred to in the pension industry as amendments required by "GUST." The GUST amendments require that all qualified retirement plans be updated for such things as the increase in the threshold for mandatory distribution to terminated participants from \$3,500 to \$5,000, technical changes to the "top-heavy" rules and changes in the definition of a "highly compensated employee."

If amendments are not made by the deadline, the qualification of your company's retirement plan will be jeopardized. If a retirement plan loses its qualification, then employer deductions to the plan would be disallowed, earnings in the trust maintained under the plan would be subject to taxation and highly compensated employees would be required to include the value of their benefits in their income for tax purposes.

It should be noted that if your company's qualified retirement plan is not sponsored under a current prototype or volume submitter plan, but is "individually designed" (such as an ESOP), then the deadline for amending or restating the plan has already passed. Even if your company missed this deadline, the plan

can still be amended and restated and filed with the IRS under a correction procedure which will require the payment of a compliance fee based on the size of the plan and the nature of the delinquent amendments.

In addition to the amendments for GUST, when Congress passed the \$1.6 trillion tax cut in 2001, part of the tax legislation dealt with pension plans. The 2001 tax law is referred to as "EGTRRA." This tax law changed such items as increasing compensation limits considered under a qualified retirement plan, increasing contribution and deduction limits and changing the vesting schedule for matching contributions. The IRS has not yet issued regulations interpreting the EGTRRA amendments. However, the IRS has issued a sample "good faith" amendment which, in many cases, should have already been adopted.

By now, you should have heard from the sponsor of your prototype or volume submitter plan concerning the amendments for GUST and the process of amending and restating the plan may have already commenced. Under recent procedures issued by the IRS, it is no longer mandatory to file a prototype or volume submitter plan with the IRS to be eligible for

the delayed time period in which amendments could be adopted for GUST, although all individually designed plans must be filed with the IRS. If you have not heard from the sponsor of your prototype or volume submitter plan regarding the amendment and restatement for GUST, you should contact the sponsor at this time.

If you have any questions concerning the amendment or restatement process, feel free to contact me at 602-200-7365. ■



59 1/2. This requirement that distributions, once begun, must remain constant has created significant problems for taxpayers.

During the exuberant 1990s when the value of many taxpayers' IRAs skyrocketed, many taxpayers elected to start withdrawing from their IRAs before they were 59 1/2. Those taxpayers calculated the amount of the "substantially equal distributions" using either an annuity or amortization method based on an assumed rate of return. Those methods basically took the value of the IRA on a set date and computed the distribution amount necessary to make equal payment to the taxpayer over the taxpayer's lifetime. The sharply declining stock market of the past three years and swooning IRA values significantly impacted the taxpayer's tax planning. The decline in the value of the IRAs could have forced a taxpayer to skip a distribution or reduce the amount of a required annual distribution. Once the taxpayer skipped or reduced the amount of a required distribution, the 10% additional tax would be imposed on all distributions because a "modification" of the distribution schedule had occurred. Even if the taxpayer avoided the 10% tax by continuing to pay the full amount of

each required distribution, the IRA would be exhausted long before the taxpayer had originally planned.

Recognizing these problems, the new ruling issued by the IRS provides two avenues of relief. First, the 10% tax will not be imposed on a taxpayer who maintains the same distribution schedule until the IRA runs out of money even though distributions stop before the required period has passed. Second, and more importantly, the IRS now allows the taxpayer to make a one-time election to change the method of calculating the amount of the distributions to a "required minimum distribution method." Under that method, the amount of the distribution is based on an annual revaluation of the account balance. Using this method, bad news in the stock market will result in a reduction in the subsequent year's payment and should prevent the exhaustion of the IRA. This election also provides a tax planning opportunity when an IRA substantially increases in value. In that case, the taxpayer could make the one-time election and increase the amount of the distributions. ■

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