

ESTATE PLANNING NEWS



Property Tax Alert: SBOE Changes Position on Non-Prorata Distributions of Encumbered Real Estate

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On September 5, 2007, the State Board of Equalization (“SBOE”) issued an internal memorandum that significantly restricts some beneficiaries’ ability to qualify for the real property reassessment exclusion. (For a general overview of California’s real property tax, and how to avoid triggering a reassessment, please refer to my April 2007 newsletter, available at www.nicoledavidsonlaw.com.)

Non-Prorata Distributions Defined

In a prorata distribution, each beneficiary receives an equal portion of each asset in the trust or estate. In a non-prorata distribution, each beneficiary receives an equal proportion of the entire trust or estate, but not necessarily of each asset.

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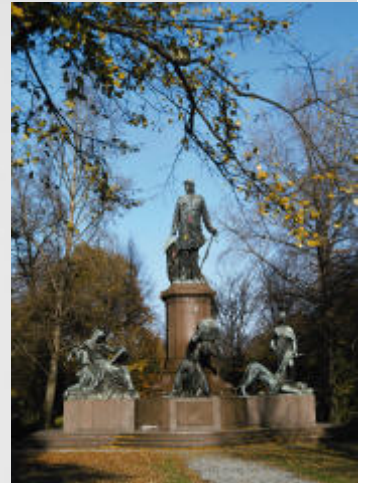
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Announcements

Tax professionals' fears of infringing upon patented tax strategies (*i.e.*, tax shelter patents that are designed to minimize, avoid, defer, or otherwise affect liability for federal state, local, or foreign tax) may soon be a thing of the past. On July 18, 2007, the House Judiciary Committee adopted an amendment to the Patent Reform Act, H.R. 1908, that would eliminate these tax strategy patents. On September 7, 2007, the House passed the measure on a 220-175 vote. A similar measure remains under consideration in the Senate.



Tip of the Month

Witness Cannot Sign Will After Testator Dies

When a testator (*i.e.*, will maker) signs her will, California law requires that she affix her signature in the presence of two disinterested adult witnesses, who then sign their names on the will. But sometimes testators are not so careful.

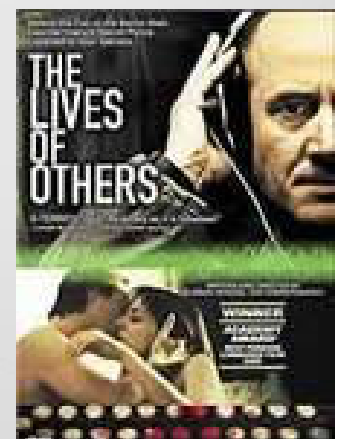
In *In re Estate of Saueressig*, testator had his will notarized but not witnessed. After testator's death, the notary's husband made a sworn statement that he had been present and was ready to sign the will as a witness. The Court declined this late offer, determining that testator died intestate (*i.e.*, with no will).



Entertainment

The Lives of Others (2007)

Set in 1980s East Berlin, director Florian Henckel von Donnersmarck's debut feature (which earned him an Oscar for Best Foreign Language Film) provides an exquisitely nuanced portrait of life under the watchful eye of the state police as a high-profile couple is bugged. When a successful playwright and his actress companion become subjects of the Stasi's secret surveillance program, their friends, family and even those doing the watching find their lives changed too.



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I always turn to the sports section first.
The sports section records man's accomplishments;
the front page has nothing but man's failures.

- - EARL WARREN

Quoted in Sports Illustrated

22 July 1968

Property Tax Alert

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California law automatically grants trustees authority to make non-prorata distributions of trust assets. However, the executor of a will must be given specific authority in the will to make non-prorata distributions. The use of non-prorata distributions can have a major impact on the property taxes to be paid by a beneficiary who inherits real estate.

Hypothetical

Tina dies, leaving her home, which she owned free and clear, with a Proposition 13 base year value of \$100,000, to her two children, Uma and Val. Tina had a trust permitting non-prorata distributions. However, since the home was Tina's only asset, Uma and Val must each receive 50% of the home. They avoid reassessment under the parent-child transfer tax exclusion.

Now Uma wants to buy Val out of the house. However, transfers between siblings do not qualify for a reassessment exclusion. If Uma buys Val's half of the house, then that half of the property will be reassessed, and Uma's tax base will increase dramatically.

Could proper planning have avoided this result?

Prior Law

Previously, it was possible to distribute real property non-prorata to beneficiaries without triggering a reassessment, even though the real property's value exceeded the value of other trust assets. More specifically, reassessment was avoided by encumbering the real property in order to equalize the value of the trust's assets.

The preferred method of encumbering the property involved the trustee obtaining a loan from a third party lender. However, it is difficult for trusts to secure loans from commercial lenders.

In a June 4, 2004 memorandum, the SBOE explained an alternative method for encumbering the property. "[T]he beneficiary receiving the property [could] execute a note and deed of trust in favor of the trustee in exchange for the property." The trustee would then assign that note and deed of trust to the other beneficiary(ies).

Thus, in the hypothetical scenario, Uma could have executed a promissory note and deed of trust in favor of the trustee. The trustee would then assign the note and deed of trust to Val.

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The SBOE Changes Its Position

The SBOE has taken away this option. In a September 5, 2007 memorandum, the SBOE states that this alternative method (*i.e.*, the beneficiary executing a note and deed of trust in favor of the trustee) is not a viable option for encumbering the property and avoiding reassessment.

Planning to Avoid Reassessment

The September 5, 2007 memorandum makes it clear that the trustee may encumber real property only with a loan made by a third party, or, alternatively, with a loan made by a beneficiary who is not receiving the real estate in question.

Rather than wait until the trust is administered to find a suitable lender, what other plans might Tina have made to ensure that Uma could assume ownership of the family home without being subject to increased property taxes?

1) Make a Specific Gift

If equality were not paramount, Tina may have considered making a specific gift of the family home to Uma. In this example, though, Tina had no other assets and would have effectively disinherited Val.

2) Consider Other Assets

Let's change the hypothetical so that, in addition to the home, Tina had a sizeable IRA, which she inherited from her husband. Tina might consider leaving the house to Uma (through the trust) and the retirement account to Val (by naming Val as sole beneficiary of the IRA).

3) Leverage with Life Insurance

Let's return to the original example, where Tina owns only the home. If Tina is insurable, and wants to treat her children equally, she could purchase a life insurance policy that would pay a death benefit equal to or greater than Tina's equity in the home. Although Tina has effectively tied all her assets up in her home, she could take out a home equity loan, writing a check off the equity line to pay for the annual insurance premiums.

If addition of the life insurance's death benefit to Tina's estate would create an estate tax liability, then Tina could consider (a) creating an Irrevocable Life Insurance Trust, or (b) asking Val to own the policy.

Conclusion

The SBOE's change in position is significant for beneficiaries who plan to keep the family home without increasing the property's tax base. The SBOE now specifically disapproves of having a trustee encumber property by distributing that property to a beneficiary in exchange for a promissory note and deed of trust. Although the SBOE has taken away this method for avoiding reassessment, other strategies exist. Other opportunities are best explored -- and factored into the estate plan -- before the original homeowner dies.

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