

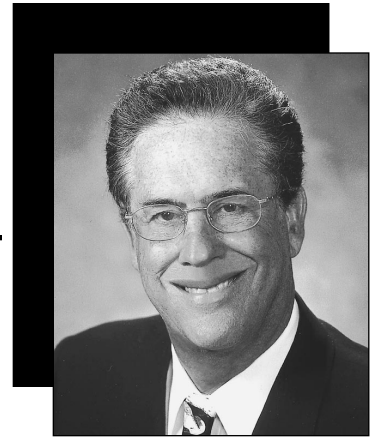
# THE BERNSTEIN TAX LETTER

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**JUNE 2007**

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Dear Reader,

Some tax legislation should be completed over the summer. One item that probably should have been resolved already is the combined minimum wage and small business tax relief provision. One version (The Small Business and Work Opportunity Tax Act of 2007, HR 1591) has already been vetoed because it contained the funding provisions for Iraq and Afghanistan. The minimum wage is expected to increase by \$2.10 per hour, and a small business tax incentive package of \$2 billion to \$4.8 billion will be included in the final legislation, once the politics can be worked out. One key component with bipartisan support is an increase in the current expensing (rather than depreciating) of business property under Sec. 179 to \$125,000 with, perhaps, a delay in the sunset of this provision beyond 2011.

The 2008 budget discussions have begun with conferees named from both parties. An interesting topic has ensued concerning the tax cuts that are scheduled to expire after 2010 in most instances. The House and Senate Republicans called for making the capital gains and dividend tax cuts permanent, noting the positive impact on the economy and the lowering deficits. However, there is debate about a tax-cut trigger that would make tax relief contingent on a budget surplus expected in 2012. There is a difference of opinion on the tax relief provisions that would be extended and the measure of the expected surplus. Some items, such as extending the child tax credit and relief from the marriage penalty, received overwhelming support in the Senate.

Bipartisan legislation was introduced last month to provide an incentive for private sector solutions to the problem of maintaining living standards during retirement. The "Retirement Security for Life Act" (H.R. 2205) would provide a tax break for retirees who elect guaranteed life annuities. The bill would permit retirees to exclude one-half of the income from an annuity up to \$20,000 annually. The legislation would encourage the use of life annuities versus maintaining account balances in retirement plans. This strategy would reduce the risks of living longer than expected and mismanagement of the investment and distribution of account balances.

Cordially,

*Richard S. Bernstein*

**A Second Opinion Costs You NOTHING,  
But Could Save You MILLIONS!**

**WHEN IT COMES TO YOUR HEALTH, YOU GET A SECOND OPINION,  
SHOULD YOUR FINANCIAL WEALTH BE ANY DIFFERENT?**

## **THE DURABLE POWER OF ATTORNEY: AN ESSENTIAL FINANCIAL AND ESTATE PLANNING TOOL**

Estate planners warn their clients about the risks of dying without a will. Failing to plan for future incapacity could also result in irreparable harm to an individual and his or her family. Furthermore, the likelihood of a long-term disability is much greater than that of death during much of a person's lifetime. The risk of serious incapacity increases with age, and the demographic trends indicate that the segment of the population over age 65 is growing much faster than the rest of the population. This problem and the uncertainty about the future of the federal estate tax, state estate or inheritance taxes, and other estate-settlement costs indicate that estate and financial plans should be flexible to adapt to changing needs. The durable power of attorney is an inexpensive device that permits a person to designate a family member or professional advisor to make critical financial and personal decisions and to take action to preserve the estate when incapacity occurs.

### **WHAT IS A POWER OF ATTORNEY?**

A power of attorney is a document in which the client (the principal) authorizes an agent (otherwise known as an attorney-in-fact) to act in his or her behalf. The power may be quite limited: for example, permitting the agent only to make deposits to the principal's bank account. Or the power can be broad, authorizing the agent to engage in nearly any transaction that the principal could.

A power of attorney is also limited in its duration. It can be expressly limited in time. For example, the agent may be given a power of attorney that terminates when a specific act is completed. Even if no duration is specified, a conventional or common-law power of attorney becomes inoperative upon the incapacity of the principal. To extend the power beyond the incapacity of the principal, the power must be made expressly durable.

A durable power of attorney takes effect immediately when the document is executed even though it may not be needed until much later, if ever. Some individuals, however, are reluctant to grant an agent broad powers to act at a time when the principal is capable of acting. These people would prefer to use a "springing" durable power of attorney. Recognized in many states, a springing power lies dormant and ineffective until a designated time, such as the principal's incapacity.

### **WHEN SHOULD A DURABLE POWER BE USED?**

A durable power of attorney should be used whenever an individual feels he or she will need someone to make important financial and/or personal decisions after the individual loses capacity. Most individuals will have assets or personal affairs that must be managed should they lose capacity. If the individual has a complex estate plan, the durable power is essential. A wealthy individual who has begun his or her estate plan by making lifetime gifts or charitable donations will need someone to have the power to continue making such gifts or donations after the donor loses capacity. It would often be devastating to the individual's estate plan if the gifts could no longer be made. The uncertainty over the future composition of the federal estate tax indicates an increased need for flexibility to alter the plan. In addition, the Deficit Reduction Act of 2005 has made early Medicaid planning more important, and we certainly expect more changes in this area as health care costs continue to rise and place greater burdens on the federal and state governments. The

durable power of attorney provides a mechanism for making the necessary changes to an estate plan without court approval for a legally disabled principal.

For example, suppose the individual makes regular contributions to an irrevocable life insurance trust. A durable power must be in effect for the premiums to be paid from the principal's funds after the principal loses capacity. Otherwise, the principal's family might have to pay the premiums from their own funds for the rest of the principal's life. This, of course, would be counterproductive to the principal's estate plan. Or suppose the principal has a living trust with terms that have become inappropriate due to tax law changes. The attorney-in-fact can be empowered to revoke or amend the trust as necessary.

All states authorize the health care power of attorney. This durable power permits the agent to make health care decisions for the principal if the principal loses capacity. Many individuals prefer the health care power of attorney to a living will; some use the health care power in conjunction with a living will..

### **WHAT CAN A DURABLE POWER ACCOMPLISH?**

One of the primary uses of a durable power is the delegation to an agent of the management and control of the principal's financial affairs during his or her incapacity. The following is a sample of the types of property management powers that might be considered for a power of attorney:

- to make deposits and withdrawals from bank accounts
- to sign tax returns and appoint an agent to represent the principal with the IRS
- to make investment decisions
- to deal with retirement plans, including IRAs
- to have access to the principal's safe-deposit box
- to create a living trust or fund a previously created living trust
- to revoke or amend a living trust or to direct the trustee to make distributions
- to revoke or change beneficiary designations
- to forgive or collect the principal's debts
- to enter into contracts on behalf of the principal
- to make gifts on behalf of the principal
- to disclaim gifts or bequests made to the principal
- to deal with life insurance on the life of the principal

### **WHY MUST THE DURABLE POWER BE DRAFTED CAREFULLY?**

An individual might be tempted to avoid attorney's fees by purchasing a durable power document form from a business supply store or using consumer-oriented computer software to draft the power. However, a power of attorney is useful only if it works as intended. The likelihood of success is far greater if the individual seeks the appropriate professional advice.

Because the possibility of abuse exists when the agent is managing the principal's financial assets, financial intermediaries such as banks, stock brokers, and insurers are often hesitant about complying with broad powers granted to an agent. State law often construes the power very narrowly to prevent the abuse of the power. If court intervention is required, it will be costly and will perhaps further limit the agent's flexibility to use the durable power since the courts are likely

to construe the power narrowly. Drafting the document so that the powers granted the agent are very specific is helpful in persuading third parties to enter into transactions with the agent. The more specific the language, the more likely it is that third parties will honor the power because the intent of the principal is expressly stated in the document.

Another important point is the effectiveness of the exercise of a power of attorney for tax purposes. The IRS has successfully challenged and denied the annual gift tax exclusion for gifts made under broad-form powers of attorney in which the agent was not expressly empowered to make the gifts. A similar result should occur if the agent attempts to disclaim property inherited by the principal. The IRS may treat the disclaimer as invalid for tax purposes. A power of attorney granted without these express powers would render these estate planning techniques ineffective and increase the amount of estate taxes the principal's family will have to pay.

## RECENT CASES AND RULINGS

### CASE DEMONSTRATES INCOME TAX TREATMENT OF JOINT ACCOUNT

The decedent created a joint brokerage account with her son and funded the account with stock she received when her interest in an Internet casino company was acquired by eConnect, Inc. Evidence was clearly presented with respect to the nature of the account, which was joint with rights of survivorship and clearly indicated that either accountholder could make transactions with the account. The stock was sold in the account, generating substantial gains, which were ultimately determined to be short-term. The decedent's return reported only one-half of the gain and was selected for audit. The IRS determined that the decedent should have reported all of the gain and found the deficiency to be \$567,964 with an additional \$113,572 penalty. The decedent passed away during this period, and the case was continued by her estate.

The tax court (*Estate of Freedman v. Commissioner*, TC Memo 2007-61) determined that the relevant state for the account in question was Texas and examined its probate law. The existence of the joint account is not in dispute, but the case depends on whether a gift was intended at the time the account was created. The probate law would continue to treat the account as belonging to the decedent, since her contribution was 100 percent of its assets unless clear and convincing evidence indicates that an irrevocable gift was intended. The estate presented evidence of an intended gift, but the court determined that the standard of proof was not met. The decedent continued to exercise dominion over the account and never filed a gift tax return when the account was opened. Thus, the decedent was found to be taxable on 100 percent of the gain.

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This Tax Letter is intended to assist you to conserve your estate and to protect the interests of your family and business associates. Estate planning involves the joint services of a competent Trust Officer, Attorney, Accountant, and Life Underwriter. The experience and advice of each is generally essential.

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