HOFFMAN SABBAN & WATENMAKER

LAWYERS

1999 UPDATE

Hoffman, Sabban & Watenmaker tries to keep our clients and friends informed about important developments. Please call us if you have any questions or want more information about the matters discussed below.

1. Proposed repeal of estate and gift taxes.

Congress passed a bill providing for a repeal of the federal estate, gift and generation-skipping taxes by 2009, but President Clinton vetoed it and it appears that no compromise legislation will be adopted this year. Since California's estate tax is based on a percentage of the federal estate tax, this bill would have also repealed California's estate tax. However, a little noticed provision of the law would have, in general, eliminated the "step-up" in income tax basis when a person dies. Thus, after 2008, the bill would have provided that your heirs would take over your income tax basis for the assets they inherit. This would have had important ramifications for people who have old real estate investments (where the basis is often less than the amount of debt on the property) as well as for others who have very large gains. We believe that conservatives in Congress will continue to press for repeal of the estate tax, and estate planning should be undertaken with the possibility of repeal in mind.

2. Increase in Estate Tax Exemption; Indexing of Other Estate and Gift Tax Provisions.

Effective for 2000, the exemption from gift and estate taxes will be $675,000, which is a $25,000 increase over the 1999 exemption of $650,000. If you want to maximize your use of your exemptions and can afford to do so, think about giving away your full exemption now. In that way, any future income earned on the assets, and any growth in the value of those assets, will be out of your estate and thus escape estate tax on your death.

Since 1999, certain gift, estate and generation-skipping transfer tax exemptions have been subject to increases for inflation; but inflation must rise to certain minimum levels before increases occur. Here are the 1999 amounts, and the expected 2000 amounts (although the IRS has not yet officially announced the adjustments):

Exemption	1999	2000
Annual Gift Tax Exclusion	$10,000	$10,000
Generation-Skipping Transfer Tax Exemption	$1,010,000	$1,030,000
Special Use Valuation Ceiling	$750,000	$770,000
Closely-Held Business, amount qualifying for 2% interest rate	$1,010,000	$1,030,000

In most cases, estate planning documents which Hoffman, Sabban & Watenmaker prepared will automatically adjust to keep pace with increases in the exemptions.

3. Small Business Stock.

Many people are unaware of two provisions of law affecting certain "small business stock" bought after August 10, 1993. First, if the stock is held at least 5 years, up to $10,000,000 (and in some cases, even more) of gain will qualify for a 10% (federal) capital gains rate. (Section 1202.) Second, if the stock is held for at least 1 year, any gain can be "rolled over" within 60 days, without payment of tax, into other "qualified small business stock." (Section 1045.) Most startup businesses formed after 1993 will be "qualified small businesses." Another special tax break which has received little publicity is the ability to roll over (on a tax deferred basis) up to $50,000 of gain per year from the sale of publicly traded securities, into stock of a "specialized small business investment company." (Section 1044.)

While the reduced capital gains rates make it less costly to sell appreciated assets, if there is no need to sell an asset it may be better to hold on to the asset until death when a step-up in basis occurs. The use of a charitable remainder trust to avoid capital gains tax will still make sense in some cases.

4. Contributions of Stock to Private Foundations.

The right to deduct, on your federal income tax return, the fair market value of publicly traded stock contributed to private charitable foundations has been made permanent. Note, however, that an individual and his or her family cannot contribute and deduct more than 10% of the stock of a company. California has not conformed to this rule, so your deduction would be limited on your California return to the lower of your basis or the fair market value of the stock. Also, if you contribute appreciated stock to a public charity, the untaxed gain is an item of tax preference for California income tax purposes.

5. **Section 529 Plans for Education Savings.**

Most of the education savings incentives are "phased out" and thus unavailable to taxpayers with incomes over $100,000. However, Section 529 Plans provide an important option for high income taxpayers. These plans are sponsored by state governments. Benefits include:

- Income earned on the account is tax deferred, and when funds are paid to the beneficiary for college or graduate school expenses (including tuition, room and board), the income is taxed at the beneficiary's tax bracket. However, note that California will currently tax earnings on Section 529 plans other than the California Golden State ScholarShare Plan.
- Assets in the account can be used to pay education costs at any public or private college, and need not be in the state which sponsors the program.
- You can contribute up to $50,000 per beneficiary (typically your child or grandchild) in the first year, and treat it as a prefunding of your $10,000 annual gift tax exclusions for the next 5 years. This is better than giving $10,000 per year for 5 years, since income earned on the full $50,000 accumulates for the beneficiary from the beginning.
- The maximum amount you can contribute is based on the estimated future cost of attending the most expensive college in the state, the age of the beneficiary, and projections about the future earnings. The maximum amount will probably exceed $100,000.
- You can change beneficiaries or withdraw the money at any time. If you change to another member of the beneficiary's family, there is no tax consequence. Funds can be held for the beneficiary until the beneficiary is age 45. Funds not used for college or graduate school will be taxed (to the extent of the accumulated income) at your tax bracket with a 10% penalty, unless due to the beneficiary's death, disability or the beneficiary receiving a scholarship, in which case the penalty won't apply.

The funds in a Section 529 Plan are managed by a well known investment manager selected by the state. For example, Fidelity Investments handles the New Hampshire and Delaware plans; Vanguard Group handles the Iowa plan; TIAA-CREF handles the California and New York plans; Merrill Lynch handles the Maine plan; and Collegiate Capital Group handles the Connecticut and Rhode Island plans. The annual administrative fee varies from plan to plan. The percentage of the plan assets allocated to stock vs. bonds depends on the state plan and the age of the beneficiary. For more information on the plans offered by the various states, check the following web site: http://www.savingforcollege.com. Full details on the California plan are available at the following web site: http://www.scholarshare.com or by calling 1-877-728-4338.

6. Prepaid Private School Tuition.

You can make gifts of $10,000 per recipient per year, and pay school tuition and medical expenses of any amount, without filing a gift tax return or using any part of your lifetime exemption from gift and estate taxes. Generally, these gifts are also exempt from Generation Skipping Transfer Tax. The IRS recently held in a private letter ruling that a grandparent could prepay 10 years of tuition for a grandchild, and the payment would be an exempt gift. The ruling was based on the fact that the money was non-refundable, and if the grandchild left the school for any reason, the school would keep the money.

7. New Principal and Income Act.

California has adopted a new Principal and Income Act, effective January 1, 2000. This makes major changes in the definition of "income" for trusts which provide that "income" can or must be distributed. For example, in most cases, for distributions from trusts, only 10% of money derived from exploitation of copyrights or literary properties, and only 10% of most distributions from a qualified retirement plan or IRA, will be considered "income," and the remaining 90% of the payment will be considered "principal." (This does not change the income tax result. All of the payment will still be taxed as income for income tax purposes. If any portion of the payment is retained by the trust as "principal," then, if the trust is not a "grantor trust" for income tax purposes, the trust must pay income tax on that receipt. If the income is distributed to the beneficiary, the beneficiary will pay income tax on the receipt. But, trusts are almost always taxed at the highest possible tax rates.) In some cases, independent trustees are allowed to recharacterize principal and income if that would produce a fairer result. Major changes have been made in the treatment of income derived from rental real property. We have prepared a special report on highlights of the new law, which is available on our web site (www.hswlaw.com), or which we will mail to you upon request.

8. New Domestic Partner Law.

California has adopted a new law allowing some domestic partners to register with the state, and then assume certain obligations to each other and receive certain legal benefits. Only adults of the same sex, or persons over age 62 of opposite sexes, may register as domestic partners. They must live together and agree to be jointly responsible for each other's basic living expenses (and in some cases, medical expenses) while they remain domestic partners. They must not be married to anyone else, nor be a member of another domestic partnership. (Generally, if a domestic partnership terminates, neither partner can become a member of another domestic partnership for six months after the termination.) They must not be related to each other in a way that would preclude them from marrying. A domestic partner is treated as a member of the family of the other partner for most insurance purposes (specifically, employer provided medical insurance) and for purposes of having access to the other partner when he or she is hospitalized.

9. New Health Care Power of Attorney Law.

California has made major changes in its Health Care Power of Attorney law. Health Care Powers which are in effect remain valid, and there is no need to sign a new form simply because of the new law. (However, if you signed a power of attorney before 1992, or you signed a power after 1991 on an old form, that document was only valid for 7 years, and thus it would be ineffective today.) The new law contains a procedure for a court determination as to whether a principal lacks capacity, if there is a question regarding the matter. The law now allows a person who is being treated by a health care professional, or in a health care facility, to orally inform his or her supervising health care provider that he or she wants someone to act as his or her "surrogate" for making health care decisions while he or she is being cared for, or while he or she is in that facility.

10. Rights of Publicity.

California has broadened its protections of the exploitation of a deceased celebrity's name and likeness, by limiting the exceptions under prior law. Also, the rights will now last for 70 years following the celebrity's death, rather than 50 years as under prior law.

11. Earnings of Child Actors & Athletes.

California has changed the law regarding the earnings of child actors and athletes. Previously, this income belonged entirely to the parents. However, if a court order was obtained under the "Coogan Law" to make a contract involving the child legally enforceable, the court could order up to half of the net earnings to be set aside for the child. Such orders were rarely obtained for television commercials or for athletes, so the child was not entitled to any part of his or her earnings.

Under the new law, a minor will have the right to keep his or her earnings from creative services (including as a singer, musician, composer, writer or similar activities) or as an athlete. If a court order is obtained to make a contract enforceable against the minor, then the court must order that 15% of the child's gross earnings be set aside in a trust for the child; but even if no court order is sought, an employer is required to see that 15% of the child's gross earnings are set aside in trust for the minor. While the law is not entirely clear, it appears that out of the remaining 85%, the parent is to pay the child's income taxes, any amounts for "personal or professional services rendered to the minor or the business related to the contract," and any other liabilities incurred by the minor under the contract. The parent must act as a fiduciary with respect to those funds, which may prevent the parent from paying himself or herself a fee for services the parent renders for the child. Clearly, the parent cannot use the child's earnings for the support of the child, the parent, or the other members of the child's family.

12. Estimated Taxes.

For individuals with an adjusted gross income over $150,000 in 1999, wage withholding and estimated taxes must equal at least 105% of your prior year's tax in order to come within the automatic "safe harbor" and avoid underwithholding penalties. For 2000 and 2001, the percentage will increase to 106%.

13. A Few Miscellaneous Points.

The IRS has continued attacking Family Limited Partnerships and other vehicles for discounting gifts when created shortly before the donor's death. In addition, the gift tax return form asks if a discount has been taken in valuing the gift being reported. **However, this type of estate planning is still very effective if done in an organized and timely manner.**

14. Time for a Checkup?

Estate plans should be reviewed when your financial or family circumstances have changed, or in any case roughly every five years. Health Care Powers of Attorney signed before 1992, and some Powers signed after that, were only effective for seven years, and may now be void. Have you checked your retirement plan beneficiary designation to make sure you and your family will obtain the best income tax and estate tax results? Do you own insurance on your life? If so, it will be subject to estate tax on your death. Have you considered succession planning for your business (who will take over on your death)? Do you have grandchildren now, so that generation-skipping planning may make sense? We have developed many new approaches in our planning which may not be reflected in your current plan. For example, if your spouse dies and you become elderly, does your trust give you the right to appoint a Co-Trustee to serve with you, or the right to change successor Trustees? Are you aware of other techniques for reducing estate taxes, such as Qualified Personal Residence Trusts, Grantor Retained Annuity Trusts, Family Limited Partnerships, and Family Limited Liability Companies? Have you considered setting up a family charitable foundation, or a trust to benefit both your family and charity? If you'd like to review your plan, please call to make an appointment.