HOFFMAN
SABBAN &
WATENMAKER

LAWYERS

# 2008 Updates

**Hoffman, Sabban & Watenmaker strives to keep our clients and friends informed of important developments affecting their estate and tax planning. This letter summarizes some of those developments.**

## I. Changes in the Gift, Estate & Generation-Skipping Transfer Taxes.

In 2009, the lifetime exemption from **gift** taxes **remains $1,000,000**, but the exemptions from **estate** taxes and **generation-skipping** transfer ("GST") taxes **each will increase to $3,500,000** (up from $2,000,000 in 2008). The top rate for all of these taxes is 45%.

Any portion of the $1,000,000 gift tax exemption used for lifetime gifts reduces the maximum allowed estate tax exemption. Thus, if a person who dies in 2009 had previously used $400,000 of the lifetime gift tax exemption, then the remaining estate tax exemption is $3,100,000 ($3,500,000 minus $400,000). In addition, if the lifetime gift is a generation-skipping gift (e.g., to a grandchild), then the gift amount is also offset against the $3,500,000 GST tax exemption.

**In 2009, the annual "per recipient per donor per year" gift tax exclusion will increase to $13,000 (in addition to the unlimited gift tax exemption for amounts paid directly for school tuition or medical expenses),** up from $12,000 in 2008**.**

**A gift to a Section 529 plan in 2009 can be as much as five times the $13,000 annual gift tax exclusion amount, or $65,000** (up from $60,000 in 2008)**, but doing so uses up the gift tax annual exclusion ratably over the current year and the four following years.**

The estate and GST taxes are scheduled to be eliminated in 2010, and return with a $1,000,000 exemption in 2011, but we continue to believe that neither of these changes will occur. President-elect Obama supports continuing the estate and GST taxes, retaining a $3,500,000 exemption and keeping the estate tax rate at 45%. Generally, Republicans want the exemption raised and the tax rate lowered. Since it takes at least 60 votes in the Senate to stop a filibuster and get a bill passed, achieving a compromise in the Senate may be difficult. Thus, while we feel it is likely that the estate tax exemption will reach $3,500,00, and stay at least at that level, we cannot predict the future of the estate tax beyond that.

The annual exemption for gifts to noncitizen spouses will be $133,000 for 2009 (up from $128,000 in 2008).

If the value of the aggregate "foreign gifts" received by a U.S. person (other than a charity) exceeds a threshold amount, the U.S. person must report each "foreign gift" to the IRS. Different reporting thresholds apply for gifts received from (a) nonresident alien individuals or foreign estates, and (b) foreign partnerships or foreign corporations. For gifts from a nonresident alien individual or foreign estate, reporting is required only if the aggregate amount of gifts from that person exceeds $100,000 during the tax year. For gifts from foreign corporations and foreign partnerships, the reporting threshold amount will be $14,139 in 2009 (up from $13,561 in 2008).

The foreign earned income exemption amount increases to $91,400 in 2009 (up from $87,600 in 2008).

## II. <u>FDIC Insurance</u>.

The FDIC bank deposit insurance limit has been increased to $250,000 per account (up from $100,000) from October 3, 2008 through the end of 2009. The recent failure of a number of banks has given rise to questions by clients about the way FDIC insures funds held by revocable trusts and retirement accounts. Generally, all retirement accounts of a single "participant" at a particular bank are insured up to $250,000. All accounts held by a revocable trust are insured on a "per settlor/per beneficiary" basis, but with special rules for a situation where the settlor has more than $1,250,000 at a single institution, or where the trust has more than five beneficiaries. For example, suppose that a couple creates a single living trust, and provides that on the death of the first spouse, the assets will all be held for the surviving spouse for life, and that on the death of the surviving spouse, the assets will be divided into equal shares for their three children. In this case, through the end of 2009, while both spouses are living, $1,500,000 of funds would be insured at each bank where the trust maintains accounts (husband is treated as having three $250,000 beneficiaries, and wife is treated as having three $250,000 beneficiaries.) The rules where there are more than five beneficiaries, or where a settlor has more than $1,250,000 at an institution, are not yet entirely clear. The new rules also provide that if a revocable trust becomes irrevocable, the rules applicable to revocable trusts will continue to apply. The FDIC announced that effective September 26, 2008, this rule will apply regardless of the relationship between the trust settlors and the beneficiaries; previous law only provided this protection to certain close family members.

## III. <u>No Contest Clauses</u>.

Effective in 2010, the law regarding "no contest" provisions will be changed to make it harder to penalize a beneficiary who challenges an estate planning document. The new rules will be effective for documents that became irrevocable in 2001 or later, so it will be retroactive for approximately nine years! While the new law will make many changes, probably the most important is that a person who files a contest based on "probable cause" will <u>not</u> forfeit his or her inheritance, even if the contest fails.

## IV. **Low Interest Rates Make Tax Planning Techniques Attractive.**

For November 2008, the IRS "hurdle rate" for Grantor Retained Annuity Trusts and Charitable Lead Trusts is 3.6%, so if you can earn more than this rate, these techniques can move assets to your children at little or no gift tax cost. Similarly, for November 2008, you could loan money to a child for more than nine years at 4.24% (or higher), if interest payments are made annually, without triggering the "imputed interest" rules. Thus, if your child can earn more over the term of the loan than 4.24% annually, the excess will belong to the child and be out of your estate. Other techniques (such as a Charitable Remainder Trust) become less favorable during low interest rate periods. Please note that the interest rate changes monthly.

## V. **Sale of Former Vacation or Rental Home.**

The Housing and Economic Recovery Act of 2008 substantially reduces the tax benefit of converting a vacation or rental home to a primary residence prior to sale. In general, the law allows a person to exclude $250,000 (if single) or $500,000 (if married) of gain on a sale of a primary residence that has been used as a primary residence for at least two of the prior five years. Some people who had a vacation or rental home that had appreciated in value would change their primary residence to the vacation or rental home, live there as their primary residence for two years, and then sell the home and claim the full exclusion from gain. Under the new rules, you lose a percentage of the exclusion for periods after 2008 where you own a home but you (or your spouse or former spouse) don't use it as your primary residence. Let's say that you own a home that you bought for $600,000 that you rent out to others. On January 1, 2012 (three years after January 1, 2009) you move into the home and begin using it as your principal residence. You live there two years and sell it on January 1, 2014 for $1,100,000, for a profit of $500,000. Under prior law, you would have been able to exclude the entire $500,000 gain from taxable income. Under the new law, you could exclude only two-fifths of the gain, or $200,000, since the other three-fifths would be considered attributable to the three years the home wasn't your principal residence. Thus, if you're considering selling a second home in the next few years, it may be advisable to begin treating that home as your primary residence before January 1, 2009.

## VI. **Transfers from IRAs to Charities.**

As part of the financial industry bailout (the Emergency Economic Stabilization Act of 2008, H.R.1424), signed into law on October 3, 2008, Congress restored and extended the law allowing a person over age 70-1/2 to transfer up to $100,000 directly from an IRA (other than a SEP-IRA or a "Simple Retirement Account") to a public charity (generally, not a private foundation) without taking the income into account. This provision is now effective through 2009. Note that you can't receive a benefit from the charity that results from making the transfer. (For example, you can't transfer an amount to charity to fund a life income gift such as a Charitable Remainder Trust.) Generally, the funds can't be transferred to a supporting organization or donor advised fund, even though those organizations are treated as public charities. Making a charitable transfer will save taxes for many people over age 70-1/2 who are receiving distributions from an IRA and who want to benefit a public charity. To find out if this new law will help you, we suggest that you contact your tax preparer.

## VII. Gay Marriage.

Starting in mid-May 2008, California recognized marriages between gay persons, but Proposition 8 on the November 2008 ballot sought to eliminate recognition of gay marriages in California. It appears that Proposition 8 passed, but court cases have already been filed seeking to void the election result. It is unclear what status will apply to gay couples who married earlier this year. The federal government is barred from recognizing gay marriages by the "Defense of Marriage Act" and does not treat Registered Domestic Partners as if they are married, so from a federal tax standpoint we continue to recommend different planning techniques for gay married couples and Registered Domestic Partners than we do for straight married couples. The failure of the federal law to recognize gay marriages also has important, adverse consequences when a gay married couple divorces, or when Registered Domestic Partners terminate their domestic partnership. Gay couples who separate need to obtain specialized tax advice, which our firm can provide. President-elect Obama has supported repeal of the federal "Defense of Marriage Act." However, with the apparent passage of Proposition 8, it will be necessary to not only repeal the Defense of Marriage Act, but also to change federal law generally to treat Registered Domestic Partners in the same manner as married couples.

## VIII. California Right to Die Legislation.

California still does not allow assisted suicide, but it did enact two laws effective in 2009 that can facilitate the wishes of a patient who wishes to terminate all life support. The Terminal Patients' Right to Know End-of-Life Options Act, A.B. 2747, is the first in the nation to provide terminally ill patients with a full disclosure of, and counseling about, all available end-of-life care options accepted in law and medicine. When requested, information about hospice care, refusal or withdrawing of life-prolonging treatments, voluntary stopping eating and drinking ("VSED"), palliative care and palliative sedation will be discussed with the patient. The Act also requires that health care providers who do not wish to comply with a

particular patient's choice must refer or transfer the patient to another provider. The second act, A.B. 3000, provides for recognition of a Physician Orders for Life Sustaining Treatment ("POLST"). This form complements an advance health care directive by taking the individual's wishes regarding life-sustaining treatment, such as those set forth in the advance directive, and converting those wishes into a medical order. The POLST must be signed by a physician, and includes instructions regarding whether attempts should be made for resuscitation, whether antibiotics should be given, and whether a feeding tube should be used. The preamble to the bill anticipates that the POLST will be used for individuals who are frail and elderly or who have a compromised medical condition, as well as for people with a prognosis of one year of life, or a terminal illness. Since 2004, California has had a statewide registry for Advance Health Care Directives. You can find information at www.sos.ca.gov/ahcdr/index.htm. The cost for registering an Advance Health Care Directive is $10. You cannot register online, but you can obtain the registration forms on the web site.

## IX. Trusts for Pets.