HOFFMAN SABBAN & WATENMAKER
LAWYERS

1997 UPDATE – Tax Act of 1997

Hoffman, Sabban & Watenmaker tries to keep our clients and friends informed about important developments. On August 5, 1997, the Taxpayer Relief Act of 1997 was enacted. This memo summarizes some of the Tax Act provisions which we feel would be of most interest to you. Please note that California has not passed any legislation to conform to the changes in the federal tax law. Please call us if you have any questions or want more information about the matters discussed below.

1. **<u>Increase in estate and gift tax unified credit</u>**

For decedents dying and gifts made after 1997, the "unified credit" (basically, your lifetime exemption from gift and estate taxes) will gradually increase. The current effective exemption of $600,000 will rise to an effective exemption of $1,000,000 in 2006, as follows:

YEAR	EXEMPT AMOUNT	CREDIT AMOUNT
1998	$625,000	$202,050
1999	$650,000	$211,300
2000	$675,000	$220,550
2001	$675,000	$220,550
2002	$700,000	$229,800
2003	$700,000	$229,800
2004	$850,000	$287,300
2005	$950,000	$326,300
2006	$1,000,000	$345,800

In most cases, Wills and Living Trusts drafted by Hoffman, Sabban & Watenmaker will not need to be revised due to <u>this</u> change. If you have any questions regarding your documents, please call us. **People who can afford to do so should make added gifts each year to use up their exemption**.

2. **<u>Indexing of other estate and gift tax provisions</u>**

Beginning in 1999, the following items will be increased for inflation; but inflation must increase to certain minimum levels before these items will increase. For example, the gift tax exemption can only increase in $1,000 increments, so it may take several years for changes to occur.

(1) $10,000 annual exclusion for gifts.

(2) $1,000,000 generation-skipping transfer tax exemption.

(3) $750,000 ceiling on special use valuation.

(4) $1,000,000 ceiling on the value of a closely-held business eligible for the special low interest rate.

In most cases, our forms will automatically adjust to keep pace with increases in the Generation-Skipping exemption.

3. **<u>Family-Owned Businesses</u>**

A complex new section provides that, under certain circumstances, an interest in a family-owned business which is includible in a decedent's estate and valued at up to $1,300,000 will not be subject to estate tax. This is in lieu of, not in addition to, the $600,000 to $1,000,000 general exemption discussed above. There are many conditions which must be satisfied before this section applies, including a requirement that the business must make up more than 50% of the decedent's estate, and (in general) the business must stay in family hands for 5 years before and 10 years after the death. Thus, if the business interests are sold to partners at death, the exemption probably won't be available.

Due to the many conditions applicable to this provision, it will be available in far fewer cases then one may think. Furthermore, after the exemption increases to $1,000,000 the extra estate tax savings will be less than $150,000. It may be possible to take steps to allow a business to qualify. If you would like more information on this new provision, please call us.

As before, estate taxes on many closely-held businesses can be paid off over 15 years. But for decedents dying after 1997, the interest on the deferred taxes will not be deductible against the estate tax (and as before won't be deductible for income tax purposes.) However, the interest rate will drop to 2% on the first $1,000,000 of business assets in excess of the lifetime gift and estate tax exemption, and will be 45% of the normal IRS interest rate on the balance.

There is a special election available where a decedent died in 1997 or earlier, and anyone currently making installment payments of estate taxes should contact us to discuss this election.

4. **Repeal of Excess Distribution and Excess Retirement Accumulation Tax**

The Tax Act repeals (retroactive to the beginning of 1997) two excise taxes on retirement plan assets: the 15% tax on excess distributions (generally over $150,000) and the 15% tax on excess accumulations at death. However, the combined effect of federal and state income and estate taxes can still result in taxes close to 90% on retirement assets.

There is no longer a need to pull money out of retirement plans over the next three years to avoid paying the 15% excise tax. (A prior law had suspended the excess distributions tax and many people were planning to take distributions to avoid the excess accumulations tax.) Retirement plan or IRA benefits are still the best assets to give to charity.

5. **Capital Gains**

The Tax Act made major revisions to the capital gains tax rate. For your convenience, we have summarized the changes below:

TAX RATES ON CAPITAL GAINS

EFFECTIVE SALE DATE	HOLDING PERIOD	ASSET OR INCOME RESTRICTIONS	TAX RATE
Before 5-7-97	12 Months		28%
5-7-97 - 7/28/97	12 Months		20%
7/29/97 and Subsequent	Less than 12 Months		Ordinary Income Rate
	12 - 18 Months		28%
	18 Months		20%
		Gain from depreciation recapture on sale/exchange of depreciable real property.	25%
		Sale/exchange of "collectibles."	28%
1998 and Subsequent (in addition to the rules post 7/29/97)	18 Months	Rate limited to taxpayers in the 15% tax bracket: Married taxpayers earning up to $41,200; Single taxpayers earning up to $24,650.	10%
2001 and Subsequent (in addition to the rules above)	Held for more than 5 years	Purchased in 2001or later.	18%
		Rate limited to taxpayers in the 15% tax bracket: Married taxpayers earning up to $41,200; Single taxpayers earning up to $24,650.	8%

Continuing prior law, certain "small business stock" bought after 1993 and held at least 5 years will qualify for a 15% rate.

While the reduced rates make it less costly to sell appreciated assets, if there is no need to sell an asset it is better to hold onto the asset until death when a step-up in basis occurs. The old method of using a charitable remainder trust to avoid the capital gains tax will still make some sense, but the method has been restricted (see Item 10 below).

6. **Adjustments for Gifts Within 3 Years of Decedent's Death**

Effective for gifts made after August 5, 1997, you can make gifts equal to the annual exclusion of $10,000 directly from your revocable trust and those gifts will not be included in your estate. Thus, you no longer need to withdraw funds from your living trust and place them in your personal account before making gifts. You should also note that recent California non-tax cases indicate that gifts of community property should be signed by both spouses.

7. **Gift Tax Returns**

Effective August 5, 1997, gifts may not be revalued for estate tax purposes if a gift tax return is filed, **the gift is "adequately disclosed" on the return**, and more than three years have passed since the filing of the gift tax return. The filing of a gift tax return will not start the gift tax statute of limitations running with respect to a gift unless that gift is "adequately disclosed."

Where there are possible valuation questions, this makes it worthwhile to file a gift tax return.

8. **Income taxation of Decedents, Estates & Trusts**

The income taxation of estates and trusts has been greatly changed. For example, distributions from an estate within 65 days after the end of the estate's tax year can be treated as if made during the prior year. There is no longer a "throwback rule" forcing complex tax calculations where income is accumulated in a trust. The income of a deceased partner will now be taxed to the partner, rather than to his or her estate. There are many other changes as well.

9. **Exclusion of Gain from Sale of Personal Residence**

Effective May 7, 1997, a single taxpayer will not be taxed on the first $250,000 of gain ($500,000 if married) generated by the sale of a personal residence in which he or she has lived for two of the last five years. This exemption applies without regard to the taxpayer's age, but it can only be used once every 2 years.

However, a taxpayer can no longer defer tax on capital gains upon sale of a personal residence by purchasing a replacement home equal to or greater in value than the one sold. The law granting individuals over 55 a $125,000 exemption has also been repealed.

A taxpayer should consider selling his or her principal residence whenever $250,000 (single) or $500,000 (married) of gain has accrued, further gains are expected, and the taxpayer expects to eventually sell the residence. However, the tax advantage of a sale may be outweighed by the transaction costs; and the capital gain problem will in any event go away at the time of death when the assets get a step-up in basis.

10. **Charitable Remainder Trusts**

The Tax Act restricted the use of charitable remainder trusts. Under the new law, a charitable remainder trust will be tax qualified only if the present value of the remainder passing to charity is at least 10% of the value of the assets passing into the trust. In addition, recently proposed regulations cut back on the use of certain planning techniques in these trusts. **These new rules do not affect assets already in such trusts, but new contributions to existing charitable remainder unitrusts should not be made without checking with us.**

These new restrictions make it costly, if not impossible, to set up a charitable remainder trust for the benefit of children or grandchildren. A charitable remainder trust generally won't be useful to a single person under his or her late 30s or early 40s, or for couples under their early 50s. Please contact us if you want further information on this subject.

11. **Contributions of Stock to Private Foundations**

The deductibility at fair market value of publicly traded stock contributed to private charitable foundations has been extended from May 31, 1997 through June 30, 1998.

12. **Hope Scholarship and Lifetime Learning Credits; Education Loan Interest Deduction**

Various tax credits and interest deductions are available for educational expenses incurred by taxpayers, their spouses, or their dependents. These credits and deductions are phased out for single taxpayers with modified adjusted gross income of $40,000 - $50,000 and married taxpayers with modified adjusted gross income of $80,000 - $100,000.

13. **Penalty-Free Withdrawals from Individual Retirement Plans**

Effective in 1998, a taxpayer may withdraw funds from his or her IRA without a 10% early withdrawal penalty to pay for higher education expenses (tuition, fees, books and other related expenses) for the taxpayer, his or her spouse or his or her child or grandchild, at an eligible educational institution. Penalty-free withdrawals may be made to allow qualified first-time home buyers (the taxpayer, his or her spouse, child, grandchild, or the ancestor of the taxpayer or his or her spouse) to buy a home. Of course, regular income taxes will still be due on the withdrawal.

14. **Increase in Phase-Out Range for IRA Deduction**

Effective for taxable years after December 31, 1997, if an individual is an active participant in an employer-sponsored retirement plan, the $2,000 IRA deduction limit is phased out over the following levels of adjusted gross income: $30,000 to $60,000 in the case of a single taxpayer, and $50,000 to $100,000 in the case of married taxpayers.

15. **A Few Miscellaneous Points**

The IRS has recently attacked Family Limited Partnerships and other vehicles for discounting gifts when created shortly before the donor's death. In addition, the new 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.**

16. **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. Older forms of Health Care Powers of Attorney were only effective for seven years, and may now be void. 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?