1998 UPDATE

We at Hoffman, Sabban & Watenmaker try to keep our clients and friends informed about important developments from time to time. This memo summarizes some recent and pending changes in the law that may affect your estate plan. It also discusses some problems clients of ours have had over the last year, and ways of dealing with those problems. Keep in mind that the information in this memo may not necessarily apply to your situation. We will be pleased to discuss any questions you may have about your estate or tax planning situation, or how the issues discussed below may affect you.

1. Additional $25,000 Available in 1998 for Tax-Free Gifts

Remember that the gift and estate tax exemption (previously $600,000) was increased to $625,000 for 1998. So, if you have previously made gifts of $600,000, you can make additional gifts of $25,000 this year without paying tax. In 1999, the gift and estate tax exemption is scheduled to increase again, to $650,000, so that another $25,000 of gifts can be made without tax. We would be happy to discuss with you estate tax saving opportunities through gift giving.

2. Revaluation of Gifts After Expiration of Statute of Limitations

Last year, a change in the law provided that a prior gift may not be revalued by the IRS after the death of the donor, in connection with determining the estate tax due on the donor's death, if a gift tax return was filed which fully disclosed the value of the prior gift, and the statute of limitations relating to that gift tax return has expired. It is therefore important to adequately describe gifts on gift tax returns. It may also be advisable to file gift tax returns for non-taxable gifts (such as gifts under $10,000 per year) in order to start the statute of limitations.

3. Contribution of Publicly-Traded Stock to Private Foundations

Temporary tax laws allowed a donor to deduct the full fair market value of most publicly-traded stock contributed to private charitable foundations. That law expired on June 30, 1998. However, last-minute legislation was enacted which makes this rule permanent, retroactive to June 30, 1998. (The "Tax and Trade Extension Relief Act of 1998" was included as part of the Omnibus Appropriations package signed by the President on October 21, 1998.) If you have been considering contributing publicly-traded stock to a private foundation, you probably can now do so and claim the full fair market value as a charitable deduction. Charitable deductions are subject to numerous limitations, so you should check with us or your accountant to determine if these limits apply to you.

4. Deduction for Health Insurance Expenses for Self-Employed Individuals

In 1998, self-employed individuals who are not eligible to participate in a group health plan maintained by an employer (or a spouse's employer) can deduct 45% of the expenses for maintaining health insurance for both spouses and dependents. The percentage which is deductible was scheduled to increase to 50% in 1999, with further increases until 100% was to be deductible beginning in the year 2007. The Tax and Trade Relief Extension Act of 1998, just passed into law, accelerates this phase-in so that 60% of such expenses will be deductible in years 1999-2001, 70% in 2002, and 100% from 2003 on.

5. Inflation Increases

The $1,000,000 exemption from the generation-skipping transfer tax will increase for 1999 to $1,010,000. This increase reflects the indexing to keep pace with inflation, adopted as part of the 1997 Taxpayer Relief Act.

For estate tax purposes, real property devoted to farming or to a closely held business may be valued lower than the "fair market value" standard normally applicable to a decedent's assets. Such property may be valued as used in the business or as a farm (which may be less than the highest price a willing buyer would pay). However, the total reduction in value cannot exceed $750,000 (for decedents dying in 1998). This limitation will be increased by $10,000 for 1999, to $760,000, to keep pace with inflation.

6. Acceleration of Phase-In of Increased Unified Credit

The Taxpayer Relief Act of 1997 increased the estate and gift tax exemption from $600,000 to $1,000,000, phased in over nine (9) years, so that the full $1,000,000 exemption would be effective in the year 2006 and thereafter. A tax bill was passed in

the House of Representatives in September 1998, which would have accelerated the phase-in so that the $1,000,000 unified credit would apply in 1999. That tax bill died in the Senate, thus delaying any chance for acceleration of the increased unified credit until the next Congress. Also, President Clinton had stated he would veto the bill. Nevertheless, the Republicans are making the repeal or reduction of estate taxes a high priority. You might therefore consider holding off making any taxable gifts until Congress decides what changes, if any, will be made to the estate and gift tax laws.

7. Form for Medical Authorization for Minors

We can prepare a form for you to authorize someone else, such as a babysitter or nanny, to give medical consent for your minor children. This may be important when you travel out of town. You can also find this form on our web site.

8. Be Sure Title to Property Is in Trust After Refinancing

Refinancing a home or other property is common in these times of low interest rates. Many lenders require that title to your property be taken out of your living trust before the new deed of trust is recorded (so you can sign the note and deed of trust in your individual capacity, rather than as Trustee). Be sure to transfer title back into your trust after the refinance is completed. If your home is held in a Qualified Personal Residence Trust ("QPRT"), you should not take title out of the trust for refinancing purposes. Some lenders are not familiar with QPRTs, but assume they are the same as living trusts and ask you to transfer title out of the trust into your individual name. This could create tax problems. If you are financing or refinancing property held in a QPRT, we would be happy to work with your lender to protect the estate planning advantage you have created through your QPRT.

9. Trust Named as Additional Insured

You should add your living trust as an additional insured on your homeowner's insurance and title insurance. Many insurance companies will add your trust with little or no cost to you.

10. Administering Charitable Remainder Trusts

If you transfer assets to a newly-created charitable remainder trust, such as a Charitable Remainder Unitrust or a Charitable Remainder Annuity Trust, certain rules must be followed so that the tax favored status of the trust is not jeopardized. For example, the trust cannot pay out more than 50% of the value of its assets annually to non-charitable beneficiaries, and the charity's remainder interest in the trust assets must be at least 10% (in almost all cases). Also, if a Charitable Remainder Unitrust

holds "hard-to-value" assets (anything other than cash, cash equivalents or marketable securities), the trustee must obtain a "qualified appraisal" of the "hard-to-value" assets from a "qualified appraiser," unless the trustee is an unrelated party or a charity.

For most types of charitable remainder trusts, the annual payment which must be made to non-charitable beneficiaries must be paid by the end of the taxable year. The previous reprieve which allowed payments to be made within a reasonable time after the close of the year no longer applies.

If you have created a charitable remainder trust and are not sure if your trust continues to comply with all of these rules, please call our office.

11. Durable Powers of Attorney for Health Care Decisions

If you have an older Durable Power of Attorney for Health Care Decisions, it might have expired! Prior to January 1, 1992, these documents were only valid for seven (7) years. Be sure to check yours and make sure it is still effective. If you are not sure, please call us and we would be happy to look over your form for you. Also, if you have children over age 18, you should encourage each of them to fill out a Durable Power of Attorney for Health Care Decisions in case they are in an accident and are unable to make decisions for themselves. As a parent of an adult child, you do not have the same authority to make medical decisions that you did when the child was a minor.

12. Gifts to Children

Making gifts to children (and grandchildren) is a good way to reduce the size of your taxable estate. Each person can give up to $10,000 per year per donee (child or grandchild) without any gift tax consequence. You can also pay tuition and medical bills without gift tax consequences. So, the sooner you start making annual gifts to your descendants, the more wealth you can transfer out of your estate free of tax. All the appreciation in value of the gifts also stays out of your taxable estate.

Although gifts to a minor child can be made in a simple manner by opening an account in the child's name under the Uniform Transfers to Minors Act ("UTMA"), you should consider establishing a trust for the child instead. A trust allows continuing control over the funds, allowing you to restrict use of the money for the purposes you deem important (such as education, health, and support). Also, a trust can continue until the child reaches an age you choose, or for the child's entire lifetime. On the other hand, funds held under the UTMA are available to the child at age 18 or 21 (depending on how the account was set up), without any continuing restrictions.

A child's trust can be flexible, allowing trustee discretion to make distributions to the child if the child has demonstrated the ability to handle money responsibly. On the

other hand, if an independent trustee does not believe the child would use funds wisely, or if the child has a creditor problem or is going through a divorce, the trustee can withhold distributions, thus protecting the funds from the child and the child's creditors. The trust can also provide for alternate recipients in the event of the child's untimely death.

13. Prepare Your Loved Ones for Their Inheritance

Are your family members prepared to manage the assets they will inherit from you? Parents often do not want their children to know just how much money is in the family. But this attitude, if taken to the extreme, can result in disastrous mismanagement after the death of the parents. We recommend that, as children grow and mature, parents think about educating them on financial matters: managing money and planning their own estates. A good time to start this process might be when the child becomes entitled to funds held under the UTMA (or the Uniform **Gifts** to Minors Act). Often those funds have grown substantially over the years. We sometimes suggest that the parents talk to the child about establishing a trust for himself/herself, so that the money can be properly managed and used in the manner the parents always intended. Many of our clients like the idea of having the child serve as a co-trustee, along with a more seasoned manager, so the child can learn to manage money responsibly.

Sometimes one spouse handles all the family finances or runs a family business. Should something happen to that spouse, the other spouse might not know how to manage the business or other assets. We also recommend preparing for this situation by educating the spouse or other family members.

14. Maintaining Life Insurance Trusts

If you have established a life insurance trust, be sure to follow proper procedures when making cash gifts to the trust. Is your Trustee sending the required notices to the beneficiaries when cash is contributed to the trust? Are you making cash contributions far enough in advance of premium due dates to allow the "Crummey" lapse period to expire? These and other procedures are vitally important to maintaining the non-taxable status of insurance proceeds upon your death. Please call us if you have any questions about this, or if you would like a "check-up" for your insurance trust.

15. Asset Protection: "Delaware Trusts" and "Alaska Trusts"

Alaska and Delaware have recently enacted laws that purport to offer creditor protection for assets held in trusts created under those states' laws. The Trustee will have discretion to pay assets back to you if you need them. These trusts are irrevocable, and require a resident of that state (such as a Delaware bank) to be the

trustee. If you have assets other than California real estate and retirement funds and are interested in this kind of protection from creditors, please call our office for more information. We note, however, that these are relatively new laws and have not yet been fully "tested" for durability in the face of an attack by a creditor.

16. Trustee Duties

If you are a trustee of any irrevocable trust, remember that you have certain fiduciary duties such as maintaining records, preparing annual accountings, and filing income tax returns. If you would like us to review your situation to make sure you are in compliance with these obligations, please make an appointment to see us.

17. Trust Income Distributions

Many trusts are what the law calls "simple trusts," which means all income (generally, interest and dividends but not capital gains) generated by the trust is required to be distributed to one or more beneficiaries every year. If all the income of a simple trust is not distributed as required, there could be adverse tax consequences. A Marital Trust, for example, is typically established after the death of the first spouse, and qualifies for the federal estate tax marital deduction so that no estate tax is due until the second spouse's death. In order to qualify for this tax deferral, all income must be distributed to the surviving spouse each year. Failure to do so could trigger estate taxes on the assets in that trust. If a trust holds stock in an "S" Corporation, failure to distribute all trust income each year could cause the corporation to lose its "S" status.

18. Gifts to Charity

If you make a gift to charity of $250 or more, remember to ask for written confirmation of the donation from the charity, which should include the charity's tax identification number and a statement from the charity stating either (i) that no goods or services were provided to you in exchange for the donation, or (ii) the value of the goods or services provided to you.

19. General Assignment of Property to your Trust

If you did not sign a General Assignment when you signed your living trust, you should ask us to prepare one for you. A general assignment, while not a permanent method of transferring property into your trust, is a good back-up measure, and can be extremely useful where, for example, an untimely death occurs before accounts have been transferred into trust. This will not be effective, however, for real estate.

20. Web Site

Please visit our web site, at ***www.hswlaw.com***