HOFFMAN SABBAN & WATENMAKER

LAWYERS

2010 Update

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.

As widely reported recently, the newly-enacted 2010 tax act extends the so-called Bush tax cuts in income taxes for 2011 and 2012. More significantly, the 2010 tax act makes major changes in the law regarding gift tax, estate tax and generation-skipping transfer tax ("GST") (collectively, "transfer taxes"). As a result, there are significant differences in the transfer tax laws for 2009, 2010 and 2011/2012. The first part of this letter explains the new tax regimes for 2010, and for 2011/2012 (those two years are treated nearly identically). The rest of this letter consists of advice for clients who are planning their estates and clients who are responsible for administering the estate or trust of a person who dies in 2010 or 2011.

I. <u>Changes in the Gift, Estate & Generation-Skipping Transfer Taxes</u>.

A. <u>Gift Tax</u>.

For gifts made in 2010, the annual exclusion for gifts remains at $13,000 per recipient, the cumulative lifetime exemption is $1,000,000, and the gift tax rate on gifts in excess of $1,000,000 is 35%.

For gifts made in 2011, the annual exclusion will remain at $13,000 per recipient. For 2011 and 2012, the lifetime exemption will increase to $5,000,000, and the gift tax rate on gifts in excess of $5,000,000 will remain 35%. The $5,000,000 exemption will be adjusted for inflation starting in 2012. Note that the rate for 2010, 2011 and 2012 is lower than the rate was in 2009, when it was 45%. Also, in certain cases where the donor has a predeceased spouse who died in 2011 or later, the donor may be able to use part of the predeceased spouse's unused gift and estate tax exemption.

B. <u>Estate Tax</u>.

For people who die in 2010, the general rule is that the estate tax exemption is $5,000,000 (reduced by certain lifetime gifts) and the tax rate on the portion of the estate above the exemption is 35%. In general, as was the case prior to 2010, all of the decedent's assets (other than "income in respect of a decedent," such as IRAs and retirement plan benefits), as well as the surviving spouse's half of any community property, will have an income tax basis equal to the fair market value of those assets at the date of death (generally referred to as a "stepped up basis").

However, the executor of the decedent's estate can elect to use the "estate tax repeal" regime and pay no estate tax, regardless of the size of the estate, but have only a limited "stepped up basis". If the executor makes this election, then the estate and its beneficiaries can increase the basis of the decedent's assets (including the surviving spouse's half of any community property), but not above the fair market value of those assets at death, by (a) $1,300,000, plus (b) another $3,000,000 for assets passing to (or in trust for) the surviving spouse, plus (c) the amount of certain "built in losses" as of the date of death.

For 2011 and 2012, the estate tax exemption will remain $5,000,000 (reduced by certain lifetime gifts, but adjusted for inflation in 2012), and the tax rate on the portion of the estate above the exemption will remain 35%. The unlimited "stepped up basis" rules discussed above will apply.

C. Generation-Skipping Transfer Tax.

For generation-skipping transfers occurring in 2010, the GST tax technically is in force; the GST exemption is $5,000,000 but the tax rate is **zero percent** on transfers in excess of the exemption. The effect of this rule is that "direct skip" transfers (e.g., gifts to a grandchild or a trust for the benefit of grandchildren and younger generations) will use up the GST exemption unless the transferor files a gift tax return or estate tax return and elects not to use the exemption on that transfer. However, even if the transfer exceeds the exemption, there will be no tax imposed on the direct skip.

On the other hand, if the2010 transfer is to an "indirect skip trust" (e.g., a trust for the benefit of a child for life and then passing to grandchildren, or a trust for the combined benefit of children and grandchildren) it will reduce the transferor's GST exemption (unless the transferor "opts out" of the allocation). In that case, if a taxable event occurs in 2011 or later, the GST tax will be imposed in that year on the portion of the trust not protected by the exemption at the tax rate then in effect (probably 35%). The taxable events that would trigger a GST tax in a future year include a distribution to a grandchild from an "indirect skip trust," and the death of the child who benefits from an "indirect skip trust" if the only remaining beneficiaries of that trust are grandchildren (or in a younger generation). If either of those events occurs in 2010, the GST tax will be zero.

For generation skipping transfers occurring in 2011 or 2012, the exemption will be $5,000,000 (adjusted for inflation in 2012) and the tax rate will be 35%.

D. Filing Deadline.

All 2010 gift tax returns are due on April 15, 2011. All estate tax and GST tax returns for 2010 deaths and transfers are due nine months after the later of the date of enactment of the new law or the date of death. Disclaimers as a result of a death (but not as a result of a gift) in 2010 can be made up to nine months after the date of enactment of the new law.

E. New Law Expires After 2012.

The new tax law will be in effect only for 2011 and 2012, after which it will "sunset" (expire). Thus, unless Congress and the President agree on a different result, beginning in 2013, the transfer tax will be imposed with rates that can reach as high as 55%, and the exemption, in general, will be $1,000,000.

F. Portability of Predeceased Spouse's Exemptions.

The new law provides for "portability" of a deceased spouse's unused estate tax exemption to a surviving spouse (limited, in general, to $5,000,000). This means that, for example, if the first spouse to die does not use all of his or her exemption (because the estate is not as large as the exemption), the "unused" portion of that spouse's exemption can be used by the surviving spouse with respect to both gift taxes and estate taxes. As discussed below, this may allow some people to adopt a simpler estate plan, while still taking advantage of both spouses' transfer tax exemptions.

II. Should You Revise Your Estate Plan?

A typical estate plan for a married couple generally provides for the establishment of a "Survivor's Trust," a "Bypass Trust" and possibly a "Marital Trust." One of the purposes of creating the Bypass Trust is to capture assets equal to the deceased spouse's estate tax exemption so that both spouses' exemptions are fully utilized. Under the new "portability" law, if one spouse dies and leaves assets to persons other than the surviving spouse and charity totaling less than the estate tax exemption, the surviving spouse's estate will be able to use the unused portion of the deceased spouse's exemption (generally limited to $5 million) plus the surviving spouse's own estate tax exemption.

This "portability" provision of the new law may avoid the need for creating a Bypass Trust at the first spouse's death. For example, if the first spouse to die leaves all of his or her assets to the surviving spouse, no part of the exemption is used because of the marital deduction available for assets passing to a surviving spouse. When the surviving spouse dies, he or she will have a $10 million exemption available (his or her own $5 million exemption, plus his or her spouse's unused $5 million exemption). Similarly, if the first spouse to die leaves $1 million to his or her children, the surviving spouse's estate can utilize the remaining $4 million of the deceased spouse's exemption when the surviving spouse dies, in addition to his or her own exemption, for a total of $9 million.

However, in many cases, for both tax and non-tax reasons, it will be advisable to continue to utilize a Bypass Trust as part of your estate plan. We have posted a memorandum on our website, www.hswlaw.com, under the Memos of Interest section, that discusses the pros and cons of establishing a Bypass Trust upon the death of the first spouse to die. You may review the memorandum on the website, or call Hoffman, Sabban & Watenmaker and we will send you a copy. You may also want to schedule a meeting with your lawyer at Hoffman, Sabban & Watenmaker to discuss how the new law affects your particular situation.

III. What Should the Executor of a 2010 Decedent's Estate Do?

Under the new tax law, the Executor of an estate of a person who died in 2010 can choose between the "repeal" regime that has been in place for 2010 so far, or the new "taxable" regime applicable in 2011/2012. As noted above, this means the Executor can either (i) avoid all estate taxes but get only a limited stepped up basis, or (ii) get an unlimited stepped up basis by subjecting the decedent's estate to estate tax to the extent its value exceeds $5,000,000 (reduced by certain lifetime gifts), excluding amounts passing to a surviving spouse or to charity. This will require a careful analysis of the estate and income tax implications of each option.

If the value of the estate is less than (or not much more than) the exemption (generally, $5,000,000), an Executor will likely choose the new "taxable" regime applicable for 2011/2012 in order to take advantage of the unlimited stepped up basis in the estate's assets. This might also be true if the estate is considerably in excess of $5,000,000, if the excess amount passes to or in trust for a surviving spouse, because the marital deduction avoids tax, at least until the surviving spouse's death. However, if the value of the **surviving spouse's** estate is likely to be considerably higher than the new estate tax exemption ($5,000,000), including the amount the surviving spouse receives from the deceased spouse's estate (outright or in trust), the benefit of the complete avoidance of estate tax in the first spouse's estate is likely to outweigh the benefit of an unlimited stepped up basis. This result will be achieved by choosing the "repeal" regime. Thus, very large estates (for both married and single individuals) will most likely benefit more by electing the "repeal" regime to avoid the 35% estate tax, whether or not that tax can be delayed until a surviving spouse's death. In that case, the heirs will receive the assets with a carryover basis in the assets (the same basis the decedent had), except for a limited amount of "step up" that can be allocated to the assets. As a result, when the assets are sold, capital gains tax will be payable, but the capital gains tax rate (including both federal and state taxes) probably will still be less than the estate tax rate.

Where there is a surviving spouse, another factor to consider in deciding which tax regime to apply is how the estate plan divides assets between the surviving spouse and the children. Some estate plans provide that the maximum amount that can pass free of estate tax is to pass to children, and the excess is to be held in trust for (or pass outright to) the surviving spouse. This was sometimes used to provide distributions to children of a decedent's prior marriage, in an amount equal to the then current estate tax exemption (up to $3,500,000 in 2009).

Suppose, for example, that a married couple has an estate plan that contains such a formula, and that the couple's assets consist of $11 million of community property.

a. Under the default rule (the "taxable" regime), at the first spouse's death, $5 million would pass to the children free of tax, and the remaining $500,000 of the deceased spouse's community property share would pass to the surviving spouse. All of the assets would receive a full, stepped up basis. On the surviving spouse's later death, his or her $5.5 million plus the $500,000 inherited from the predeceased spouse would be included in his or her taxable estate, for a total of $6 million (assuming the values do not change). Of this amount, only $5 million can pass free of estate tax to the children, with the remaining $1 million being taxed at 35%. This results in an estate tax of $350,000.

b. If, instead, the "repeal" regime is elected, all of the deceased spouse's $5.5 million would pass to the children free of estate tax, and nothing would pass to the surviving spouse. The basis step up would be limited to $4,300,000 (which may or may not be enough to bring all of the assets up to a full, fair market value basis). The surviving spouse would then have an estate of $5.5 million (assuming the values do not change), of which $5 million would later pass to the children free of tax and $500,000 would be taxed at 35%. This results in a tax of $175,000 (half of the amount of tax payable under the taxable regime).

IV. Inflation Adjustments for 2011.

A gift to a Section 529 plan in 2011 can be as much as five times the current $13,000 annual gift tax exclusion amount, or $65,000 (the same as in 2010), but doing so uses up the gift tax annual exclusion ratably over the current year and the four following years.

The annual exemption for gifts to non-citizen spouses is $134,000 for 2010 and will be $136,000 for 2011.

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 $14,375 in 2011.

If you pay estate taxes in installments (generally, over 15 years), the portion of the tax on which the interest rate is 2% will be $1,360,000 in 2011.

The foreign earned income exemption amount increases to $92,900 in 2011.

V. FDIC Insurance.

The FDIC bank deposit insurance limit is generally $250,000 per account. Usually, 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 up to five beneficiaries. (In certain cases, the insurance for a revocable trust with more beneficiaries can be higher, depending on the number of beneficiaries and the share that each beneficiary has in the trust.) For example, suppose that a couple creates a living trust that 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, 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.) This rule will apply regardless of the relationship between the trust settlors and the beneficiaries. You can learn more about this subject at http://www.fdic.gov/deposit/deposits/insured/ownership4.html.

For 2011 and 2012, amounts held in non-interest bearing accounts are FDIC insured without limit.

VI. No Contest Clauses.

Effective in 2010, the law regarding "no contest" provisions changed to make it harder to penalize a beneficiary who challenges an estate planning document. The new rules are effective for documents that became irrevocable in 2001 or later, so it will be retroactive for approximately nine years! While the new law made 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. Under prior law, it was possible to file a petition with the Probate Court prior to filing an action, to see if the proposed action would violate the no contest clause; but that is no longer permitted under the new law.

VII. Low Interest Rates Make Tax Planning Techniques Attractive.

For December 2010, the IRS "hurdle rate" for Grantor Retained Annuity Trusts ("GRATs") and Charitable Lead Trusts is 1.8%. If you can earn more than this rate, these techniques can move assets to your children at little or no gift tax cost. In December 2010, you can loan money to a child for more than nine years at 3.53% (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 3.53% annually, the excess will belong to the child and be out of your estate. (Loans with a term up to 3 years can be made at a rate of 0.32%, and loans over 3 years up to 9 years can be made at a rate of 1.53%). These interest rates are reset monthly (but only with respect to loans made during that month), so you should check with us or your accountant prior to making a loan to a related person. Other techniques (such as a Charitable Remainder Trust) become less favorable during low interest rate periods. The interest rate generally is set when the trust is funded or the loan is made, but the IRS announces a different interest rate each month, governing transactions in that month.

VII. Transfers from IRAs to Charities.

In the 2010 tax law, 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 2012. 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 and have him or her prepare an projection of your 2010 tax situation.

VIII. Same Sex Marriage and Registered Domestic Partners.

Between June 16, 2008 and November 5, 2008, California recognized marriages between same sex persons. While Proposition 8 put a halt to same sex marriages in California, a pending federal case has challenged the constitutionality of Proposition 8. Gay and lesbian couples in California can register as Registered Domestic Partners, which generally extends marriage treatment to the couple for California law purposes. Whether a gay or lesbian couple is married or Registered Domestic Partners, for California income tax purposes, the couple must either file a joint income tax return or each person must file as married filing separately (rather than as a single person, as they must do for federal income tax purposes). Any money earned by either of them during the relationship is community property.

The federal government still does not recognize same sex marriage and for most purposes does not treat Registered Domestic Partners as if they are married. For example, the gift tax and estate tax marital deduction, and the ability of a married couple to treat gifts made by either as having been made half by each, does not apply to a gay or lesbian married couple nor to a couple who are Registered Domestic Partners. Similarly, they may not file as a married couple for federal income tax purposes.

The IRS recently made an important announcement. The IRS will recognize the California community property laws as they apply to same sex married couples and Registered Domestic Partners. Thus, for example, if one member of a gay or lesbian married couple or Registered Domestic Partnership earns money from employment, half of the income must be reported on each spouse's or partner's federal income tax return.

Despite this concession by the IRS, we continue to recommend different planning techniques for same sex married couples and Registered Domestic Partners than we do for straight married couples. The failure of the federal law to recognize gay and lesbian marriages also has important, adverse consequences when a gay or lesbian married couple divorces, or when Registered Domestic Partners terminate their domestic partnership. Same sex couples who separate need to obtain specialized tax advice, which our firm can provide.

IX. Basis Reporting by Securities Brokers

Starting in 2011, in general, your securities broker must retain records and report to the IRS the tax basis of your securities. If you receive securities as a gift on which gift tax is paid, or if you inherit securities that have received a stepped up basis, you should be sure to notify your broker of the proper income tax basis of these securities.

X. Provide Login and Password Information to Your Successor Trustee.

Planning Tip: Many people use the Internet to check their account statements with their brokers, mutual fund companies, retirement funds and banks. If you were to die or become seriously disabled, how would your successor Trustee know where you maintain your accounts, and how to access the information? In the past, the successor Trustee would simply check your mail and see the account statements as they come in. Now, if a notice is sent to your email address, your successor Trustee may not be able to access your email (nor your accounts). You should maintain a list of your accounts with login names and passwords and provide it to your named successor Trustee or a trusted advisor.

XI. HSW and Its Lawyers Honored in 2010.

Two of our lawyers, Erin L. Prouty and Geraldine A. Wyle, were recently elected to the prestigious American College of Trust & Estate Counsel, bringing our firm's total membership in that organization to six. Paul Gordon Hoffman was chosen by Best Lawyers in America as the "Top Tax Lawyer" in the metropolitan Los Angeles area, and was recognized as among the Top 100 Southern California Super Lawyers. U.S. News & World Report recognized Hoffman, Sabban & Watenmaker as one of six firms in the "top tier" of Trust & Estate firms in the Los Angeles Metro Area. Six of the firm's lawyers were recognized as among the Best Lawyers in America. Six lawyers in the firm were named as "Super Lawyers".

XII. Time to Review Your Estate Plan?

We recommend that you review your estate plan at least every five years or so, to make sure that it still expresses your wishes. You may no longer be in contact with the people you named as Executors, Trustees, Guardians, or Health Care Agents, and thus you may want to change these designations. Other life changes, such as births, deaths, marriages, divorces, or changes in the size or nature of your estate, may also make changes appropriate. Finally, the new tax law may affect your estate plan, and you may want to revise your plan to take account of the new law.