2002 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.

A. Increased Exemptions, Lower Brackets and Repeal.

This year, the lifetime exemption from gift and estate taxes rose to $1,000,000. The lifetime exemption from generation-skipping transfer taxes was increased to $1,100,000. The top rate for all of these taxes was reduced from 55% to 50%. The annual "per recipient per donor per year" gift tax exclusion was increased to $11,000 (in addition to the gift tax exemption for amounts paid directly for school tuition or medical expenses).

As you may recall, the lifetime exemptions for estate and generation-skipping transfer taxes are scheduled to increase, and the top tax rate for gift, estate and generation-skipping transfer taxes is scheduled to be reduced, as follows. In spite of the increased estate and generation-skipping transfer tax exemptions, the lifetime gift tax exemption is scheduled to remain at $1,000,000.

Year	Estate Tax Exemption	GST Tax Exemption	Maximum Estate and GST Tax Rate	Gift Tax Exemption	Maximum Gift Tax Rate
2002	$1,000,000	$1,100,000	50%	$1,000,000	50%
2003	$1,000,000	$1,120,000	49%	$1,000,000	49%
2004	$1,500,000	$1,500,000	48%	$1,000,000	48%
2005	$1,500,000	$1,500,000	47%	$1,000,000	47%
2006	$2,000,000	$2,000,000	46%	$1,000,000	46%
2007	$2,000,000	$2,000,000	45%	$1,000,000	45%
2008	$2,000,000	$2,000,000	45%	$1,000,000	45%
2009	$3,500,000	$3,500,000	45%	$1,000,000	45%
2010	Unlimited	Unlimited	None	$1,000,000	Highest individual income tax rate (35%)

Even though the estate and generation-skipping transfer taxes are scheduled to be repealed in 2010, all tax reductions under the 2001 Tax Act are scheduled to be eliminated in 2011. Thus, the provisions of the gift, estate and generation-skipping transfer taxes effective in 2001 would again become effective in 2011 unless Congress acts to extend the provisions of the 2001 Tax Act.

An attempt was made earlier this year to permanently repeal the estate and generation-skipping transfer tax in 2010. The bill overwhelmingly passed the House of Representatives; it required 60 votes to pass in the Senate (due to the Budget Act) but only garnered 54 votes. A competing bill, sponsored primarily by Democrats, would have increased the lifetime exemption to between $3,500,000 and $4,000,000, and would have exempted all closely-held businesses from estate tax, but that bill only garnered 45 votes. Still, this shows that there is strong support for a major increase in the estate and generation-skipping transfer tax exemptions, regardless of which political party is in control.

It seems likely that with Republican control of the Congress and the Presidency, there will be an attempt early in 2003 to make the tax cuts permanent. Indeed, there may be a move to accelerate some of the rate reductions or exemption increases. However, since control of the House, Senate and Presidency may shift again between now and 2011, it may be many years before we can predict what will happen to these taxes. For example, even if a bill passes which would make estate tax repeal permanent in 2011, a later Congress could, before 2011, eliminate the repeal.

For a more complete discussion of the new tax law, please see last year's letter to clients, a copy of which is posted on our web site, http://www.hswlaw.com in the section entitled "Memos of Interest."

B. Implications.

We continue to urge most clients to take a "wait and see" approach to the possible repeal of estate and generation-skipping transfer taxes. Most estate plans should not be revised simply because of the possibility of repeal. There are, however, a few situations where a review and possible change may be advisable.

First, we are now asking clients how they might change their estate plans if there were no estate tax. Our clients have frequently provided that following their deaths, some type of irrevocable trust will be established, typically for the benefit of a spouse or partner, children and grandchildren. Most couples provide that when the first spouse or partner dies, an irrevocable "bypass trust" is established in order to utilize the estate tax exemption of each spouse or partner. Some people also set up irrevocable "generation-skipping trusts" for their children for life, in order to take advantage of the generation-skipping transfer tax exemption and allow assets to pass to grandchildren (after their child's death) without estate taxes.

These types of trusts provide two benefits beyond simply saving taxes. First, they allow the beneficiaries to enjoy their inheritances but keep the assets exempt from most creditor claims, and keep separate property from being commingled with community property. Second, they allow the creator of the trust to control who will inherit the assets when the main beneficiary dies. Still, some clients tell us that if there were no tax savings to be gained from the use of such trusts, they would simply leave their assets outright to their spouses, partners or children. This would eliminate the administrative burden of maintaining an irrevocable trust (including the cost of annual income tax returns and record keeping for the trust).

Where a client would (but for estate and generation-skipping transfer tax savings) want to leave assets outright to the main beneficiary, we are now including a provision authorizing an *independent* trustee to end the trust, and distribute the trust assets to the main beneficiary, if estate taxes are permanently repealed after the death of the client. Also, if your and your spouse's combined assets are less than the current estate tax exemption (or if, in the future, the exemption rises above your and your spouse's combined assets), you may want to consider eliminating any bypass trust under your estate plan. If either situation applies to you, then you may want to contact us regarding a revision to your plan.

Second, some clients (especially those with children from a prior marriage, and whose spouse has substantial assets of his or her own) have estate plans which leave their assets to their children, rather than to a trust for their spouses. This type of planning will subject the assets to estate taxes, if the value of the assets exceeds the estate tax exemption. In view of the possibility of repeal, these clients may want to consider revising their estate plans to leave their assets in excess of the exemption to a trust for their spouses for life, with the assets passing to the children after the spouse's death. This would allow the trust for the spouse's benefit to qualify for the estate tax marital deduction, thus eliminating estate taxes at the client's death. If the client dies before the estate tax is repealed, and the spouse lives until the estate tax is repealed, estate taxes may be entirely avoided and the client's children may eventually receive far more than they would have received if the assets had been left directly to the children at the first spouse's death.

There are other situations where you may want to consider making changes if and when the estate tax exemption increases or the estate tax is eliminated.

First, if and when the increased exemptions go into effect, you may want to consider undoing some estate planning now in effect. For example, if you have assets worth less than the estate tax exemption, you may want to dissolve any family limited partnerships so that the value of your share of the assets currently held in the partnership is increased, and you can "step up" the income tax basis to the higher value. This may also allow you to avoid some of the annual costs of maintaining such complex tax planning arrangements, such as annual income tax return filings.

Second, if you are married and your estate plan leaves an amount equal to the estate tax exemption to your children, grandchildren or friends, with the balance to your spouse, you may want to consider limiting the gift to children, grandchildren and friends to an amount less than the exemption. Otherwise, as the estate tax exemption increases, your spouse may receive too little and your children, grandchildren or friends, too much. Similarly, if your plan leaves the amount of your GST exemption to grandchildren, you may want to consider limiting this, since it may leave your children too little and your grandchildren too much.

Third, if repeal becomes effective or if the estate tax exemption increases dramatically, provisions for charity should be reviewed or perhaps added. If you no longer have to pay about half of your assets in estate taxes, you may conclude that your children will receive from you more than you would want them to inherit, and thus you might want to consider leaving more to charity. On the other hand, since you will not get a tax benefit from leaving assets to charity, you might want to leave more to your children (who will then get an income tax deduction for amounts they give to charity during their lives).

If you would like to read a somewhat more detailed summary of the new law and its implications, a memorandum is available in the "Memos of Interests" page of our web site, www.hswlaw.com.

II. Section 529 Plans.

Qualified State Tuition Plans (also called Section 529 Plans) have been useful for making gifts to children, grandchildren and others, because they may be established by people with high incomes (unlike some other arrangements which are limited to persons with income below certain levels), and because you can contribute up to $55,000 in one year free of gift tax. (This gift uses up your current year's $11,000 annual gift tax exemption plus the next four years of exemption. The contribution limits were increased from $50,000 and $10,000 which were effective last year.) Earnings inside the plan are not subject to current income taxes. The donor can retain the right to approve distributions to the beneficiary, and can even take back the assets in the plan (although the accumulated earnings portion of the reversion would be subject to penalty taxes). There is no income tax deduction for amounts contributed to a Section 529 Plan.

The law now provides that amounts withdrawn from Section 529 Plans to pay qualified higher education costs will not be subject to federal income tax. This makes such plans even better devices for gifts on behalf of young people than under prior law. The law makes other technical changes to such plans making them more attractive. However, unless a "sunset" provision is repealed, the income tax free withdrawal provision will not apply after 2010.Many state plans allow a trustee of an irrevocable trust for a child to form a Section 529 plan. Thus, if you are the trustee of such a trust, you might want to consider transferring some or all of the trust's assets to a Section 529 plan, and name yourself (as Trustee) as the owner, with the trust's primary beneficiary as the Section 529 plan's beneficiary.

III. IRA & Qualified Plan Distributions.

Recently released final regulations have changed the amount that must be withdrawn from IRAs and qualified retirement plans after the participant reaches age 70-1/2, or dies. The new rules are effective for 2001 and after, and the final regulations contain a new required minimum distribution table that is even more favorable than the rules under the proposed regulations that we wrote to you about last year. There are numerous changes which affect the distribution of benefits following a death where a trust is named as a beneficiary of plan benefits. You should check with us or a retirement plan advisor to see how these new rules affect your retirement plan designations. A detailed technical outline regarding the new regulations appears on the "Memos of Interest" page of our web site, www.hswlaw.com.

Some people want to take withdrawals from IRAs before age 59-1/2 without paying penalties. This can be done if the funds are withdrawn in substantially equal installments over the participant's life expectancy. Recently released rules have dramatically reduced the maximum annual amount that can be withdrawn.

IV. Split Dollar Insurance Plans.

Split dollar insurance plans generally divide the cost and benefits of an insurance policy between a corporation and an employee. Recently issued rules may adversely affect these types of plans. If you participate in a split dollar plan, you should have it reviewed by us or by an insurance professional.

V. <u>Family Limited Partnerships & Limited Liability Companies</u>.

A very popular way to reduce the value of assets for gift or estate tax purposes is to transfer those assets to a Family Limited Partnership ("FLP") or Limited Liability Company ("LLC"), and then make a gift of interests in that entity. The value of the interests given away may be discounted for gift tax purposes to reflect the fact that you are only giving away a fractional interest in the entity, that the recipient would have a hard time selling the interest, and that the recipient doesn't control the entity. On your death, any retained interest you have may be discounted for estate tax purposes for similar reasons.

The IRS has, in general, enjoyed little success in fighting the use of FLPs and LLCs, although it has had some success in contesting large discounts. However, recent cases have indicated that the IRS may be successful in eliminating discounts for estate tax purposes where the operating rules of the FLP or LLC have not been closely followed. For example, distributions from the FLP or LLC must follow the distribution provisions prescribed in the Partnership or Operating Agreement. Assets that are supposed to belong to the FLP or LLC must be properly and promptly transferred into the name of the FLP or LLC. Failure to abide by these rules may allow the IRS to avoid recognizing the FLP or LLC for purposes of discounts, and may even allow the IRS to argue that prior gifts should be ignored and the transferred percentages should be included in the donor's estate for estate tax purposes.

Another recent FLP case indicates that if the powers of the general partner or managing member are too great, and the FLP or LLC doesn't make regular cash distributions proportionately to <u>all</u> of the partners or members, then the annual $11,000 per recipient gift tax exemption may not be available to apply against gifts of FLP or LLC interests.

VI. <u>GST Allocations</u>.

New rules applicable to certain kinds of generation-skipping trusts affect how your generation-skipping transfer tax exemption will be applied. Generally, under the new rules, your GST exemption will automatically be applied to gifts to a trust unless at least 25% of the trust must be distributed to a child before age 46, whether or not a gift tax return is filed. However, the new rules are hard to interpret in many cases. Generally, we advise our clients to file a gift tax return whenever they make a gift to a trust from which grandchildren may benefit, and expressly indicate on the return <u>whether or not</u> they intend to allocate their GST exemption to that gift.

VII. <u>Funding Your Living Trust</u>.

A few years ago, a California case established the principle that if a person is both the creator of a revocable living trust and the trustee of that trust, and that person signs a document indicating his or her intent that certain assets (which could be all of his or her assets) are actually assets of the trust, then the court would issue an order after the person's death directing that the record title to the assets be changed so that the assets would be part of the trust. Such an order avoids the need to go through a formal probate in order to get the assets transferred into the trust. While it is still far preferable to actually register all of your assets in the name of your living trust (to avoid a court proceeding of any kind), this procedure can be very useful in some cases.

Prior to the decision in that case, we did not, as a matter of course, have our clients sign a General Assignment to transfer their assets into their living trusts. Instead, we formerly had our clients sign a document assigning only their tangible personal property to their living trusts, and we instructed them to individually transfer all other assets into their trusts. If we did not have you sign a full General Assignment when we prepared your living trust, and you would like us to do so now, please contact us. This generally can be done for a nominal cost.

VIII. <u>Life Insurance</u>.

Recent reductions in interest rates have led some insurance companies to reduce the "crediting rate," or amount they pay on the cash or accumulation values of policies with cash values (such as universal life insurance). Recent stock market losses have dramatically reduced the cash values of most variable life insurance policies. These changes may mean that you will have to increase the premiums you are paying on your universal or variable life policies (or extend the period over which the premiums must be paid), if you hope to keep your policy in force for many years into the future. You should contact your insurance agent and ask him or her for an "in force ledger," showing how long your policy will remain in effect if you continue to pay premiums at the current level, based on **current** interest rates or investment performance.

IX. <u>Estate and Gift Tax Audits</u>.

Every estate tax return is examined by an IRS agent, but most returns are not subjected to a full audit. In many cases, this is because the estate qualifies for a marital deduction, so an audit would not produce revenue for the government. Most smaller returns are not audited (in 2001, under about $1,000,000), and most returns that lack valuation issues aren't audited (e.g., returns which report only marketable securities and cash). Overall the audit rate in 2001 for **estate** tax returns was only about 6%. However, the IRS audits a large percentage of taxable returns which have "hard to value assets," such as closely-held businesses or commercial real estate, or where significant valuation discounts are claimed. The audit rate on **gift** tax returns in 2001 was under 1%, so we continue to urge clients to file gift tax returns where valuation issues could arise, since the three-year statute of limitations only starts to run when a gift tax return is filed and a full disclosure is made.

X. <u>Gift Planning</u>.

IRS-mandated interest rates are at or near historic lows. This may be a good time to consider loaning money to children at the IRS-mandated minimum rate, since they may be able to earn more than they must pay you (thus increasing their assets). These low rates also make it advisable to consider using such sophisticated tax planning approaches as a Grantor Retained Annuity Trust, Charitable Lead Annuity Trust, or Charitable Lead Unitrust.