HOFFMAN SABBAN & WATENMAKER

LAWYERS

2003 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.

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

In 2003, the lifetime exemption from gift and estate taxes is $1,000,000, the lifetime exemption from generation-skipping transfer taxes is $1,120,000, and the top rate for all of these taxes is 49%. In 2004, the lifetime exemption from gift taxes will remain at $1,000,000, but the lifetime exemption from estate taxes and from generation-skipping transfer taxes will increase to $1,500,000, while the top tax rate for gift taxes, estate taxes and generation-skipping transfer taxes will decline to 48%.

Any portion of the $1,000,000 lifetime gift tax exemption used reduces the maximum allowed estate tax exemption. Thus, for a person who dies in 2004, if he or she has used $400,000 of the lifetime gift exemption, then the remaining estate tax exemption is $1,100,000 ($1,500,000 minus $400,000). In addition, if the gift is a generation-skipping gift (e.g., to a grandchild), then that amount is also offset against the GST tax exemption.

The annual "per recipient per donor per year" gift tax exclusion is and will remain at $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 from 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.

Year	**Estate Tax Exemption**	**GST Tax Exemption**	**Maximum Estate and GST Tax Rate**	**Gift Tax Exemption**	**Maximum Gift Tax Rate**
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%)
2011	$1,000,000	$1,000,000 adjusted for inflation	50%	$1,000,000	50%

(If no intervening congressional action)

Even though the estate and generation-skipping transfer taxes are scheduled to be repealed in 2010, all tax reductions under the 2001 Tax Act are scheduled to be eliminated in 2011.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

There still seems to be strong support for a major increase in the estate and generation-skipping transfer tax exemption, regardless of which political party is in control, but it seems unlikely that the increase in the exemption will occur sooner than now scheduled. It also seems unlikely that the Congress would vote soon to make the tax cuts permanent. Since control of the House, Senate and Presidency may shift many times 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.

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. We discussed these issues in our 2002 letter to clients (see: Paragraph I.B. "Implications"). Please let us know if you would like us to send you a copy of that letter, or you can review it on our web site, www.hswlaw.com.

Several states (but not California) have instituted state estate or inheritance taxes which can increase the amount of estate tax payable beyond the amounts shown in the chart above. New York, in particular, has instituted a substantial estate tax. If you own real estate in another state, or have valuable tangible assets (such as paintings) in another state, then these state taxes may increase the amount of estate taxes payable on your death. Also, if you move to a state other than California, you may be subject to these state death taxes. Generally, for a married couple, estate plans we have prepared are designed to minimize the federal estate taxes payable on a couple's death. In some cases, maximizing the use of the federal estate tax exemption on the first spouse's death can result in another state's estate tax becoming payable on the first spouse's death. If you own assets in another state, and want to be certain that no estate taxes will become payable on the first spouse's death even if that means that additional federal estate taxes may become payable when the surviving spouse dies, please contact us so that we can review your particular situation.

2. <u>Split-Dollar Insurance Plans</u>.

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.

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

A very popular way to reduce the value of assets 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.

Until last year, the IRS enjoyed little success in fighting the use of FLPs and LLCs, although it 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 in certain fact situations. Here are the danger signs:

1. Where the operating rules of the FLP or LLC weren't followed. For example, distributions from the FLP or LLC must follow the distribution provisions prescribed in the Partnership or Operating Agreement.

2. Assets that were supposed to belong to the FLP or LLC weren't properly and promptly transferred into the name of the FLP or LLC.

3. Where the donors transferred substantially all of their assets into the FLP or LLC. The donors must retain enough assets outside the FLP or LLC to allow them to maintain their accustomed standard of living.

4. Where there is no business purpose for the establishment of the FLP or LLC. It is far better if there are non-tax reasons for establishing the entity, such as liability limitation or transferring management of the assets to the children.

5. Where the entity was established and operated without input or participation from the donees. It is best if the donees have independent lawyers involved and if they are also general partners or managers of the LLC.

6. Where all the assets derived from the donors. It is best if the donees also contribute assets to the entity; but where the entity consists primarily of stocks, bonds and cash, care must be taken to avoid having the entity treated as an "investment company," which could result in income taxes becoming payable on the appreciation upon formation 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.

In addition, if the powers of the general partner or managing member are too great, and the FLP or LLC doesn't make regular cash distributions to the partners, then the annual $11,000 per recipient gift tax exemption may not be available to apply against gifts of FLP or LLC interests.

Separate from the issue of whether the FLP or LLC will be respected in terms of achieving valuation discounts, care must be exercised when distributions are made from the FLP or LLC, or when the FLP or LLC is liquidated. In some cases, the distribution of an asset can create taxable income for the partners, including partners who did not receive the distribution! These problems are particularly acute where the distributions occur within ten years after an asset was contributed to the partnership. There are often tax problems that result from differences between the income tax basis of the partnership for contributed assets, and the basis of the partners in their partnership interests. It is essential that you obtain competent income tax advice before making any distribution from a partnership or before you liquidate a partnership.

4. <u>Registered Domestic Partners</u>. A gay or lesbian couple, or a heterosexual couple where one partner is at least 62 years old, can become Registered Domestic Partners. The rights of Registered Domestic Partners were expanded this year. For example, as of July 1, 2003, a Registered Domestic Partner became entitled to receive the same share of an intestate estate (one where the decedent died without leaving a Will) that a surviving spouse would have received in the deceased spouse's separate property.

Many of the benefits of being a Registered Domestic Partner can be attained by proper estate planning. For example, a Registered Domestic Partner is entitled access to a hospital room on the same basis as a family member; but even if you and your partner are not Registered Domestic Partners, if your partner holds your Advance Health Care Directive, then he or she will also have access to you in the hospital. However, there are some cases where Registered Domestic Partners have an advantage over other unmarried couples. Some of the most important are the following: First, if one partner has a child, a Registered Domestic Partner can adopt the child using the same simplified procedures as a step-parent. Second, if a Registered Domestic Partner owns California real property and dies, the other partner can inherit the property with the same property tax assessed valuation as the deceased partner, instead of having the property reappraised for property tax purposes. Third, in some cases, fringe benefit programs of one partner (such as medical insurance) can only be used by the other partner if the partners are Registered Domestic Partners. Fourth, beginning in 2005, the parties will be able to have community property. Fifth, since each partner owes a legal obligation of support to the other, the IRS should not be able to claim that this support provided by one partner for the other constitutes a gift for gift tax purposes to the supported partner.

While (at least after 2005) California law will generally regard Registered Domestic Partners in the same manner as spouses, for income tax purposes Registered Domestic Partners are not allowed to file as a couple but rather must file as single individuals, and the community property laws won't apply for income tax purposes. Also, you should note that, effective in 2005, the procedure for terminating a Registered Domestic Partnership will be the same as the procedure for obtaining a divorce, except in a very narrow set of circumstances where, among other things, the parties have been Registered Domestic Partners for less than five years, neither party owns any real property, there are no children, and there is less than $25,000 of joint assets. This will make it far more expensive and difficult to terminate a Registered Domestic Partnership than is the case today.

5. <u>Trustee Investments; Prudent Investor Rule; Accountings</u>.

If you are the Trustee of an irrevocable trust, remember that you have the obligation to invest the assets in accordance with the prudent investor rule. Generally (unless there is a contrary provision in the Trust), that means that you should diversify the investments among a broad range of stocks and bonds, and in appropriate circumstances, real estate and other types of investments. Generally, a Trustee should not invest <u>just</u> in bonds, certificates of deposit, Treasury Bills and bank accounts, since such holdings do not provide for capital appreciation because, in view of the likelihood of inflation, they tend to disadvantage the remainder beneficiaries. The current law encourages Trustees to hire a qualified investment professional to invest the Trust assets. If you take reasonable steps in choosing and periodically monitoring the advisor, and instruct the advisor to invest the assets in accordance with the standards discussed above, you as the Trustee won't be held responsible for investment losses. Also remember that beneficiaries are entitled to an annual accounting (unless they have waived it), and that the statute of limitations for suing you generally doesn't start to run until you have provided the beneficiary with an accounting.

6. **Private Foundations**.

The Boston Globe recently ran a series of articles describing abuses by officers and directors of several private foundations, including excessive salaries and perks such as use of private jets. This has led the Attorneys General of several states, including California, to investigate these foundations, and more investigations may be coming. If anyone is taking a salary from a private foundation, care needs to be taken to establish its reasonableness by consulting a resource guide, such as the compensation survey published by the Council on Foundations, or seeking the advice of an independent compensation specialist.

7. **Keep Your Trust Funded**.

Many of our clients have refinanced their mortgages recently. Some lenders will not lend money secured by a home held in a living trust, so clients who have a living trust are often required to remove their home from the living trust as a condition for getting the new mortgage. However, once the refinancing is complete, be sure to transfer your home back into the living trust. If you don't do this, then it might be necessary to probate the home upon your death. In addition, if you have a living trust, then whenever you purchase a valuable asset, or open a new bank or brokerage account, be sure to remember to take title in your name as Trustee of your living trust.

8. **Beneficiary Designations**.

Many clients do not realize that life insurance, pension and profit-sharing benefits, IRAs, and many other assets pass on death under the terms of beneficiary designations. **Your living trust or Will does not automatically control these assets.** Generally, we do not prepare change of beneficiary designations for our clients, but we can advise you on the proper designations. **It is essential that you contact your insurance agent, IRA or plan administrator, or benefits officer and check your designations to be certain that the designations reflect your estate planning wishes and correspond with your estate plan.**

9. **Gift Planning**.

IRS-mandated interest rates remain 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.

10. **Time to Review Your Estate Plan**.

We recommend that you review your estate plan every five years or so, to make sure that it still expresses your wishes. You may no longer be in contact with the persons you named as Executors, Trustees, Guardians or Health Care Agents, and thus may want to change these designations. Other changes, such as births, deaths, marriages or divorces, may make changes appropriate.