HOFFMAN SABBAN & WATENMAKER

LAWYERS

2011 Update

Hoffman, Sabban & Watenmaker strives to keep its clients and friends informed of important developments affecting their estate and tax planning. This letter summarizes some of those developments.

The future of the gift tax, estate tax and generation-skipping transfer tax ("GST") (collectively, "transfer taxes") remains in limbo as we enter 2012.

I. Current Status of the Gift, Estate & Generation-Skipping Transfer Taxes.

A. Gift & Estate Taxes; Income Tax Basis.

For gifts made in 2011 and 2012, the annual exclusion from gift tax is $13,000 per recipient. For 2011, the lifetime exemption from both estate and gift tax is $5,000,000, but in 2012 that exemption will increase to $5,120,000 due to an inflation adjustment. (Generally, if you make a gift, it simultaneously reduces both your gift and estate tax exemptions.) The tax rate on gifts and estates in excess of the lifetime exemption is and will remain 35% through the end of 2012. 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 (known as "portability").

In general, if you make a gift, the recipient will have the same income tax basis as the donor of the property. However, on a death, 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").

B. Generation-Skipping Transfer Tax.

For generation-skipping transfers occurring in 2011, the exemption is $5,000,000, and in 2012, the exemption will increase to $5,120,000 (due to an inflation adjustment). The tax rate for generation-skipping transfers above the exemption is 35%.

C. Current Law Expires After 2012.

The current transfer 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. Most Democrats in Congress, as well as President Obama, support an exemption of $3,500,000 and a tax rate of 45%, and some Democrats in Congress support repeal of the transfer taxes. Most congressional Republicans support repeal of the transfer taxes. It would not be surprising if Congress takes no action on the future of the transfer taxes until after the 2012 election.

As a result of the increase in the estate tax exemption, many people are no longer concerned about estate taxes. For 2009 (when the estate tax exemption was $3,500,000), there were 47,000 federal estate tax returns filed in the United States, and for 2010 there were 29,000 filed. For 2010, 5,119 federal estate tax returns originated from California, 17% of all returns filed. The Estate Tax produced about $21.5 billion in receipts for 2009 and $16.9 billion for 2010. The Gift Tax produced about $3 billion for 2009 and $2.8 billion for 2010. This amounts to about 0.8% of total federal tax revenue. With a $5,000,000 exemption for 2011 and a $5,120,000 exemption for 2012, these numbers should decrease.

Should you make gifts now, out of a concern that the gift and estate tax exemptions may drop in the future? We believe that tax planning should not drive the decision to make gifts. Rather, the primary factors in deciding whether to make gifts should be (a) whether you can afford to make the gifts, particularly given the current low rates of return and lengthening life expectancies, (b) the impact of the gifts on the recipient (such as whether it will adversely affect the desire of a young person to work hard on developing his or her marketable skills), and (c) whether your relationship with the recipient may change in a way that may cause you to regret having made the gift (e.g., your relationship with the recipient deteriorates as a result of a later dispute).

If you can afford to make gifts, and you're not concerned about the impact of the gift on the recipient or the fact that a gift is irrevocable, then you should make gifts regardless of your view of the future of transfer taxes. First, any income earned on, and any appreciation in value of, the transferred assets, will be out of your estate for estate tax purposes. Second, if you create an "intentionally defective irrevocable trust," you will continue to pay the income tax on the transferred assets, which is essentially the same as an annual gift of the income tax, but your payment of the income tax is not treated as a gift for gift tax purposes. Third, by making gifts of fractional interests in assets, valuation discounts are available not only for the gifted interests, but also for the retained partial interests. Finally, you'll have the pleasure of seeing the recipient enjoy the transferred property, and ideally the person will gain experience in handling funds under your tutelage.

D. Portability of Predeceased Spouse's Exemptions.

Generally, current law provides for "portability" of a deceased spouse's unused estate tax exemption to a surviving spouse, provided that an estate tax return is filed for the deceased spouse's estate. 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 in our 2010 letter to clients, this may allow some people to adopt a simpler estate plan, while still taking advantage of both spouses' transfer tax exemptions.

The requirement of filing an estate tax return on the first spouse's death can create a "trap for the unwary." Suppose, for example, that a married couple has $10 million of community property, and that the assets all pass to the surviving spouse on the death of the first spouse to die. No estate tax would be due, since (in general) all assets passing to a surviving spouse are free from estate tax. If an estate tax return is filed for the deceased spouse's estate, the surviving spouse would "inherit" the predeceased spouse's estate tax exemption, so that the surviving spouse could give away during life, or leave on death, a total of $10 million free of gift and estate tax. (The amount of the exemption may be somewhat higher due to inflation adjustments.) But, if no estate tax return is filed for the deceased spouse, then only $5 million would escape estate tax on the surviving spouse's death, giving rise to a tax of about $1,750,000. Thus, even if the estate of the first spouse to die is well below the estate tax exemption amount, it may be advisable to file a federal estate tax return so that the deceased spouse's exemption is made available to the surviving spouse.

II. Inflation Adjustments for 2011.

A gift to a Section 529 college savings plan in 2011 and 2012 can be as much as five times the current $13,000 annual gift tax exclusion amount, or $65,000, 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 $136,000 for 2011 and will be $139,000 for 2012.

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 $14,723 in 2012.

If you pay estate taxes in installments (generally, over a 15-year period), the portion of the tax on which the interest rate is 2% will be $1,390,000 in 2012.

The foreign earned income exemption amount increases to $95,100 in 2012.

III. Low Interest Rates Make Tax Planning Techniques Attractive.

For December 2011, the IRS "hurdle rate" for Grantor Retained Annuity Trusts ("GRATs") is 1.6% and for Charitable Lead Trusts is 1.4%. For January 2012, the GRAT rate will be 1.4%. If you can earn more than this rate, these techniques enable you to move assets to your children at little or no gift tax cost.

In December 2011, you can loan money to a child for more than nine years at 2.8% (or higher), if interest payments are made annually, without triggering the "imputed interest" rules. Thus, if your child can earn more than 2.8% annually over the term of the loan, 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 0.2%, and loans over 3 years up to 9 years can be made at a rate of 1.27%). 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 and a Qualified Personal Residence 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. The IRS announces a different interest rate each month, governing transactions in that month.

IV. 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 remains effective through 2011, but is set to expire at the end of this year. 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 a projection of your 2011 tax situation.

V. Mexican Property Trusts.

In many cases, Mexican real property owned by U.S. persons must be held through a *fideicomiso*, which is a type of trust with a Mexican bank as the Trustee. The IRS has informally taken the position that there are mandatory U.S. filing requirements for such *fideicomisos*. Failure to file Forms 3520 and 3520-A can result in significant tax penalties.

VI. Basis Reporting By Securities Brokers.

Starting in 2011, in general, your securities broker must retain records and report to the IRS the income 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.

VII. 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 and thus your accounts. You should maintain in a secure location a list of your accounts with login names and passwords and provide it to your named successor Trustee or a trusted advisor.

VIII. Nina Sabban Retires.

It is with mixed feelings that we announce the retirement of Nina Madden Sabban, one of our founding partners. Nina has had a distinguished legal career, including being elected to membership in the American College of Trust & Estate Counsel, and having been recognized as one of the top 50 women lawyers in Southern California. We will make every effort to make sure that Nina's clients receive the same level of care and attention that she provided to them. While we will miss Nina's wisdom, and practical approach to solving problems for our clients, we are happy for the new found free time she will now have to pursue her interests outside the law.

IX. HSW and Its Lawyers Honored in 2011.

Paul Gordon Hoffman 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 listed as among the Best Lawyers in America. Six lawyers in the firm were named as "Super Lawyers." Five of our attorneys are also Fellows in the prestigious American College of Trust and Estate Counsel ("ACTEC"), membership in which is limited to a very small number of Trust and Estate attorneys across the nation.

X. 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.