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2004 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.

In 2004, the lifetime exemption from **gift** taxes is $1,000,000, but the lifetime exemption from **estate** taxes and **generation-skipping** transfer ("GST") taxes is $1,500,000. The top rate for all of these taxes is 48%. In 2005, these exemptions will remain the same, while the top tax rate will decline to 47%.

Any portion of the $1,000,000 gift tax exemption used for lifetime gifts 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 the 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 unlimited gift tax exemption for amounts paid directly for school tuition or medical expenses).

As you may recall, the lifetime exemptions from estate and GST taxes are scheduled to increase, and the top tax rate for gift, estate and GST taxes is scheduled to be reduced, as follows:

Year	Estate TaxExemption	GST Tax Exemption	Maximum Estate andGST Tax Rate	Gift Tax Exemption	Maximum Gift Tax Rate
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)

Thus, the estate and GST taxes are scheduled to be repealed in 2010, but unless a new law is passed, in 2011 those taxes are scheduled to be brought back, the exemptions from those taxes are scheduled to fall to $1,000,000, and the top tax rate is scheduled to be increased to 50%.

There still seems to be strong support for a major increase in the estate and GST 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 that would make estate tax repeal permanent in 2011, a later Congress could, before 2011, eliminate the repeal.

Several states (but not California) have instituted state estate or inheritance taxes that 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 death taxes may increase the total 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 each spouse'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.

II. Planning for Repeal or Increased Exemption. We continue to urge most clients to take a "wait and see" approach to the possible repeal of estate and GST 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.

There are a couple of additional considerations that we would like to point out. First, you should note that if you have left a gift to your grandchildren equal to your unused GST exemption, that gift could now be larger than you anticipated at the expense of your children or other beneficiaries. Second, a typical estate plan for a married couple involves setting up a "Bypass Trust" at the first spouse's death, to hold assets equal to the estate tax exemption at the time of the first spouse's death. This planning assures that both spouses' estate tax exemptions are fully used, and will save on estate taxes if the surviving spouse's assets plus the assets in the Bypass Trust would exceed the estate tax exemption at the surviving spouse's death. However, this planning can have a negative effect if the total assets at the surviving spouse's death (taking into account both the surviving spouse's assets and the assets in the Bypass Trust) would not exceed the amount of the estate tax exemption. For example, appreciated assets in the Bypass Trust will not receive an increased income tax basis when the surviving spouse dies. If your and your spouse's assets total less than the new estate tax exemption, you should speak with us about possibly revising your estate plan in order to eliminate the Bypass Trust under your estate plan. If your spouse is deceased and your spouse established a Bypass Trust at his or her death, you may want to consider petitioning the Probate Court to allow that trust to be terminated.

III. <u>Computer Passwords & Confidential Information</u>.Many people keep important information on their computers protected by passwords. Many people only password protect financial information on programs such as Quicken or Money, but some people require password "logins" to access all information on their computer (including family digital photographs). On your death, will your Executor or Trustee be able to access this data? Does anyone know where your safe deposit box or home safe is located, and how to gain access to it? This important information should be held in a manner that is both safe and accessible. For example, you might consider placing a list of your login names and passwords in your safe deposit box, and then letting your named Executor or successor Trustee know the location and box number of your safe deposit box.

IV. <u>Registration by Professional Trustees</u>.

Beginning in 2005, a California individual who is the trustee of trusts for more than three families or individuals (or a combination of the two) must register with the California Attorney General. A "family" is defined as persons related by blood, marriage, adoption, registered domestic partnership or a relationship meeting the basic requirements of a domestic partnership. There is an exception where the trustee is related to a creator of the trust. There are many unanswerable questions about the scope of the new law, and we hope that additional guidance will be issued in the future. Failure to register may lead to removal of the trustee and the imposition of fines. Additional information on this new law, including information as to the registration procedure, is available on our firm's web site; or on request we will send you a copy of a memorandum we have prepared on this subject. You can register at http://www.ag.ca.gov/conservator/index.htm.

V. <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. Expanded rights for Registered Domestic Partners will become effective on January 1, 2005. The new law will treat the couple as having community property **<u>retroactive to the time they became Registered Domestic Partners</u>**. The law is not clear about the federal gift tax implications of such a retroactive transfer of assets between unmarried persons. It may be advisable for some currently registered Domestic Partners to terminate their partnership and then reregister the partnership in 2005 so as to avoid the retroactive effect of the law. Also, 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. Accordingly, some Registered Domestic Partners may want to enter into a written agreement, similar to a prenuptial agreement, to establish their rights upon a termination of the partnership, including upon the death of one partner.

VI. <u>Private Foundations</u>.

The Internal Revenue Service is auditing a number of private foundations regarding abuses by officers and directors, including excessive salaries and perks such as use of private jets. Note that a California non-profit charitable **<u>corporation</u>** can pay reasonable directors' fees, but cannot pay salaries to employees unless those salaries are approved by a board of directors where a majority of the board is "disinterested" (i.e., not themselves being paid a salary, and not related to the persons receiving the salaries). However, a non-profit charitable **<u>trust</u>** may pay reasonable salaries for work necessary to the foundation's activities; there is no requirement of approval by a disinterested majority, as long as "self-dealing" rules are observed. 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. Some members of Congress are also considering introducing legislation to prohibit payment of fees to any family members.

VII. Registration of Health Care Directives.

Beginning in 2005, the California Secretary of State is required to establish an Advance Health Care Directive Registry, issue an identification card to each person who registers, and respond to inquiries by health care providers by the end of the next business day. A copy of the form for registration can be obtained at http://www.ss.ca.gov/business/sf/forms/sf-461.pdf.

VIII. Posthumously Conceived Children.California will now recognize as a child of a decedent a baby conceived within two years after the decedent's death (other than as a result of cloning) if it can be proven by clear and convincing evidence that the decedent specified (in a document signed by the decedent and witnessed by one person) that his or her genetic material could be used for the posthumous conception of a child. It also requires that the person using the genetic material is the decedent's spouse or registered domestic partner or some other person named in the document. Within four months of the decedent's death, a written notice that such genetic materials are being held must be given by certified mail, return receipt requested, to a person who has the power to control the distribution of either the decedent's property or death benefits payable by reason of the decedent's death. If a person having control of the decedent's assets (such as an Executor or Trustee) has notice of such genetic materials, no distributions can be made until two years after the decedent's death.

IX. Trust Accountings.

A trust can now provide for a limited period of time for beneficiaries to contest matters shown in the accounting, as long as that period is not shorter than 180 days. Our firm has long provided for a 90 day period for objections, but under the new law this period will be deemed to be extended to 180 days.

X. FDIC Insurance for Living Trusts.New rules were issued in 2004 by the Federal Deposit Insurance Corporation (the agency that insures bank deposits up to $100,000 per account) with regard to accounts maintained through a living trust. Generally, accounts will be insured up to $100,000 per beneficiary of the trust as of the settlor's death, but only with respect to a beneficiary who is a spouse, parent, sibling, or descendant. So, for example, if an individual has a trust that will provide equally for her three children upon the individual's death, then the account will be insured up to $300,000. If a married couple have a joint living trust that will provide for the benefit of the surviving spouse for life, with provision for their three children on the surviving spouse's death, then (during the joint lives of the couple) up to $600,000 of coverage will be available. However, once part of the trust becomes irrevocable on the first spouse's death and is held for the sole current benefit of the surviving spouse, that irrevocable trust would be insured only for $100,000. Where a beneficiary of the living trust is someone other than a spouse, parent, sibling or descendant, that beneficiary will be ignored; the funds will be treated as if they were held for the sole benefit of the settlor of the trust.

XI. **2004 Tax Act**.

In October 2004, the American Jobs Creation Act of 2004 was enacted. This new law made major changes in the rules governing international income taxes. It also made changes in the taxation of S corporations, non-qualified deferred compensation, tax shelters, persons expatriating from the United States or who give up their green card, charitable donations of boats, aircraft or automobiles, contributions to partnerships of "built-in loss" assets, and many other areas. Of particular interest to individuals in the motion picture industry is a provision allowing writeoff of production costs of certain domestic productions up to $15 million per film. Of particular interest to individuals with foreign investments is an elimination of the Foreign Personal Holding Company rules, but those rules have been replaced by substitute provisions under the Controlled Foreign Corporation rules.

XII. **Do You Have a Full "General Assignment"?**

If, as is generally the case, probate avoidance is one of your estate planning objectives,substantially all of your assets should be held in your living trust, or in an investment vehicle that has a beneficiary designation (such as an IRA or insurance policy). Otherwise, your family may have to go through a probate administration after your death. (Note that up to $100,000 of assets can pass without probate, so small bank accounts or a car could be held outside the trust.) This has become more important than in past years because California now imposes probate filing fees based on the value of the probate estate. For example, on a $1,000,000 estate, the fee is $1,155; on an estate of $2,500,000, the fee is $3,905; and above $3,500,000, the fee is $3,905 plus 0.2% of the excess over $3,500,000.

About 10 years ago, a California court decision established the principle that if a person signs a General Assignment that indicates an intention to hold his or her assets in his or her living trust, then it is possible to avoid probate of assets that are not registered in the living trust. If a general assignment has been signed, following the person's death, a court petition must be filed, asking the court to declare the assets as part of the person's living trust. While this is clearly less desirable than simply holding your assets in the name of your living trust (since a court petition would still have to be filed), it is preferable to going through a full probate. Soon after that court decision was issued, Hoffman, Sabban & Watenmaker began preparing such General Assignments for all new trusts. However, if your trust was prepared more than 10 years ago, and you haven't had it restated since then, you may not have a full General Assignment; instead, your General Assignment may only assign your furniture and furnishings to your living trust. If you don't have a General Assignment that assigns substantially all of your assets to your living trust, contact us so that we can prepare a new General Assignment. In any event, if it has been more than five years since your plan was last reviewed, you should consider having a review to make sure that it still fits your needs and complies with current laws.

XIII. **Loans to Children or Grandchildren**.

Interest rates continue at historically low levels, but interest rates have begun to rise. You should consider making a long term loan to your children or adult grandchildren (or an irrevocable trust for their benefit) at a fixed interest rate. Over time, as interest rates increase, your children or grandchildren may be able to earn far more on the loaned money than they must pay you. The Internal Revenue Service issues a ruling each month establishing the minimum amount of interest that must be paid on such a loan; but if the loan is made at the established rate for the month it is made, and if the promissory note is for a fixed term (i.e., it is not a "demand note"), then the rate will remain effective for the entire term of the loan. Of course, you should be willing to run the risk that your children or grandchildren will not be in a position to repay you the money you have loaned them!

XIV. **Crummey" Notices**.

If you are making gifts to an irrevocable trust, including an insurance trust, you almost certainly should be sending notices to the trust beneficiaries in order to qualify for the annual $11,000 per recipient per year exclusion from gift taxes. Be sure to keep a record of the notices.

XV. **Family Limited Partnerships & Limited Liability Companies.**

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.

In our 2003 letter to clients, we wrote about some of the problems that can cause the IRS to disregard the existence of a FLP or LLC. (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.) We simply want to remind you about the importance of observing all of the formalities in these entities. For example, distributions should be made to all partners or members in proportion to their ownership interests.

XVI. **How is Your Life Insurance Performing?**

Some people bought cash value life insurance policies projected to be "paid up" with no further premiums due after seven to ten years. Due to continued low "crediting rates" on these policies, you may find that these projections are no longer true, and that after a number of years your policy may no longer be able to continue in force without your paying substantial additional premiums. Ask your insurance advisor for an updated policy projection; if you make a relatively small additional contribution now, it may prevent your policy from lapsing years from now.

XVII. **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, divorces, or changes in the size or nature of your estate, may make changes appropriate.

XVIII. **Firm Changes**.

Hoffman, Sabban & Watenmaker is pleased to announce that effective January 1, 2005, Jennifer L.Campbell will become a principal of the firm. Jennifer's practice continues to focus on estate planning, estate and trust administration, and charitable gift planning.