2005 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. <u>Unlimited Income Tax Charitable Deduction for pre-December 31, 2005 Contributions</u>.

Certain outright cash charitable contributions made during the period August 28, 2005 to December 31, 2005 are deductible up to 100% of your "adjusted gross income", rather than 50% as has been the case in the past and will be the case starting in 2006. These same outright gifts of cash also are exempt from the three-percent reduction in itemized deductions for individuals with an adjusted gross income over $145,950. This increased deduction limit does not apply to gifts made to private foundations, supporting organizations, donor advised funds, or donor directed funds. It does not apply to a gift to a public charity where the donor retains certain controls over the use of the donated funds.This ability to obtain an increased deduction for cash gifts may present an opportunity for a person who already makes very substantial charitable gifts each year, and who has a large IRA or other retirement plan that he or she intends to leave to a public charity. It might make sense to withdraw the funds from the IRA or retirement plan now and transfer them to charity before the end of the year. Note, however, that in some cases, a withdrawal from a retirement plan and contribution to charity can still increase your overall income tax bill, because some other deductions are limited to the extent by which they exceed a certain percentage of your adjusted gross income. Also, you may not be able to deduct the full charitable contribution for state income tax purposes, and so your state income tax bill may be increased if you take a distribution from your retirement plan and give the proceeds to charity.

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

In 2006, the lifetime exemption from **gift** taxes remains $1,000,000, but the exemption from **estate** taxes and **generation-skipping** transfer ("GST") taxes increases to $2,000,000. The top rate for all of these taxes is 46%.

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 2006, if he or she has used $400,000 of the lifetime gift exemption, then the remaining estate tax exemption is $1,600,000 ($2,000,000 minus $400,000). In addition, if the gift is a generation-skipping gift (e.g., to a grandchild), then the gift amount is also offset against the GST tax exemption (which is identical in amount to the estate tax exemption).

The annual "per recipient per donor per year" gift tax exclusion will increase in 2006 from $11,000 to $12,000 (in addition to the unlimited gift tax exemption for amounts paid directly for school tuition or medical expenses).

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. Also, there seems to be an acceptance in Congress that there are not enough votes in the Senate for outright repeal of the estate tax and GST tax. It seems likely that a compromise will be reached in the near future to increase the exemption and reduce tax rates beyond the levels discussed above.

III. State Transfer Taxes.

Twenty-four states and the District of Columbia (but not California) have instituted state estate or inheritance taxes which can increase the amount of estate tax payable where there are assets in those states at the time of death (for example, a vacation home in that state), as well as for decedents who are residents of those states. The states are: Connecticut, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont, Virginia, Wisconsin and Washington. These taxes can be quite onerous, and often apply to estates far below the federal estate tax exemption (often as low as $675,000). If you own real estate in another state, or have valuable tangible assets (such as paintings) in another state, then you should speak to us or a lawyer in the state in which the assets are located, to see if it may be possible to "shift the situs" of the assets (for example, by transferring the assets to a limited liability company formed outside of the state in question). In some cases, these states do not have gift taxes, and it may be less expensive to transfer the property during your lifetime (even if it means incurring a federal gift tax) rather than waiting until death.

Also, if you move to a state that imposes an estate or inheritance tax, you should have your estate plan reviewed to see if it makes sense to modify your estate plan to minimize the state estate 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.

IV. Planning for a Continued Estate Tax. We now consider it unlikely that the federal estate tax will be repealed in the near future. While estate tax exemptions are likely to increase to perhaps $3,500,000 to $4,000,000 per person (or $7,000,000 to $8,000,000 for a married couple with a properly planned estate), people with larger estates should consider taking steps to reduce the impact of estate taxes on the portion of their estate above that level. These include setting up a series of Grantor Retained Annuity Trusts, or forming a Family Limited Partnership. Basic estate planning opportunities, such as making annual gifts to family members (or trusts for their benefit), paying tuition for grandchildren, and paying medical expenses for family members, should also be utilized.

V. Registered Domestic Partners. A gay or lesbian couple, or a heterosexual couple where one partner is at least 62 years old, can become Registered Domestic Partners. We mentioned in last year's annual letter that effective on January 1, 2005, most California laws (other than income tax laws) that apply to a husband and wife began to apply to Registered Domestic Partners. In particular, that law treated the couple as having community property retroactive to the time they became Registered Domestic Partners. One of the areas of the law that had not changed as of last year had to do with property taxes when California real property was transferred between Registered Domestic Partners. However, beginning in 2006, all transfers of California real property between Registered Domestic Partners (either during life or on death) will allow the recipient Partner to retain the "Proposition 13" property tax basis of the transferring Partner.

VI. Conversion of "All Income Trusts" Into Unitrusts.

Beginning in 2006, California law will allow most trusts that provide for a distribution of all of the net income to a beneficiary, to convert to a "unitrust". A unitrust is a trust that annually distributes to the beneficiary a fixed percentage of the value of the assets. The trust assets are appraised annually, and the beneficiary receives a percentage (fixed at between 3% and 5%) of that appraised value during the year.With a regular "all income" trust, the current income beneficiary (for example, the surviving spouse) usually wants a high income distribution (typically obtained by a large allocation of the investments to bonds or other fixed income investments), while the remainder beneficiaries (for example, the children) want the assets invested in growth securities (which typically pay little or no dividends). The conversion to a unitrust payout can meet the objectives of both the current and remainder beneficiaries simultaneously. The trust assets can be invested mostly for growth (which pleases the remainder beneficiary), and the current beneficiary will still receive a reasonable annual distribution even if the income earned by the trust is low. In addition, the total income tax liabilities of a unitrust and the beneficiaries can be lower than with an "all income" trust if the assets are invested for long term capital gains instead of for dividend and interest income.

No expenses (such as Trustee fees or investment advisor fees) are charged against the unitrust amount.

The mechanics of converting depend on a number of factors, but in some cases it is possible to make the conversion without going to court, as long as notice is given to both the current and remainder beneficiaries and they don't object. In other cases, court permission is needed. It is possible to make a conversion to a unitrust, and then after a couple of years, to revert to an "all income" trust, or to alter the unitrust percentage, if circumstances make such a conversion appropriate for the beneficiaries.

VII. Extension of Time to File Tax Returns.

Beginning in 2006, it will be possible to get automatic extensions of time to file returns for longer periods than previously possible. For example, an individual can obtain an extension of time to file income tax and gift tax returns for up to six months by filing Form 4868. There is no need to sign the request or explain why an extension is sought. As under the current rules, taxpayers must make a proper estimate of any tax due; failure to pay any tax as of the original due date of the return may subject the taxpayer to penalties and interest. If you don't want to obtain an extension of time to file your **income** tax return but do want a six month extension of time to file your **gift** tax return, then a new Form 8892 will be issued for that purpose, and the new form will no longer require an explanation of the need for the extension of time to file or a signature.Partnerships, estates and trusts will also be able to get a six month extension of time to file their returns, by filing new Form 7004. However, you should note that this may cause a hardship to partners (including members of LLCs treated as a partnership for income tax purposes) and beneficiaries of estates and trusts, since they may receive the information necessary to prepare their own tax returns months later than under the current rules.

VIII. IRS Guidance on Charities.

The Internal Revenue Service has posted two web pages that describe the tax issues that charities face, from formation, to ongoing operation, and finally upon termination. The web page dealing with private foundation is called “Life Cycle of a Private Foundation” and is located at http://www.irs.gov/charities/charitable/article/0,,id=127912,00.html. The web page dealing with public charities is called “Life Cycle of a Public Charity” and is located at http://www.irs.gov/charities/charitable/article/0,,id=122670,00.html.

IX. Loans to Children or Grandchildren.

Interest rates continue to be 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 to 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 borrowed money than they must pay you in interest. 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. For example, in December 2005, you can make a loan to children or grandchildren with annual repayments of interest for a period of over nine years at an interest rate of 4.79%. 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!

X. Family Limited Partnerships & Limited Liability Companies.

A very popular way to reduce the value of assets for gift and 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 gifted interest (typically) will not allow the recipient to control the entity. On your death, any retained interest you have may be discounted for estate tax purposes for similar reasons.

The IRS has continued to attack these entities, seeking to deny a discount for gift and estate tax purposes. To increase the likelihood that a discount will be permitted, we suggest the following: First, form and fund the entity while you are in good health. Second, retain enough assets outside the entity to allow you to pay for all of your personal expenses. Third, to avoid estate tax problems, it would be best if you are not a General Partner or Manager. Fourth, be sure to observe all formalities in these entities, and in particular, only make distributions to partners or members in proportion to their rights to receive distributions.

XI. 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 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 also make changes appropriate.

XII. Hoffman, Sabban & Watenmaker Lawyers Honored.

We are proud to note that seven of our firm's lawyers were named as "Southern California Super Lawyers" in the field of Estate Planning and Trusts by Los Angeles Magazine. This designation is applied to the top 5% of lawyers in the field, based on surveys of other lawyers. Four of the firm's lawyers were named as "Best Lawyers in America" by that publication. Lawyers in the firm continue to serve the legal profession in a variety of capacities. For example, firm lawyers serve as members of the planning committees for the University of Southern California Probate and Trust Conference and the UCLA-CEB Estate Planning Institute, and serve on the Executive Committees of the Los Angeles County Bar Tax Section, the California State Bar Trusts & Estates Section and on the Estate Planning, Trust and Probate Law Advisory Commission of the Board of Legal Specialization for the State Bar of California.