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To Our Clients and Friends:

We have been waiting for some time for our legislators in Washington, D.C., to provide clarification concerning the future of our estate and gift tax system. However, it now seems probable that we will see no major changes to the system in the near term. In all likelihood, our legislators will address the repeal of the estate tax scheduled for 2010 simply by retaining the current system, with a possible increase in the exemption amount and a reduction in the estate tax rate.

Currently, the estate tax exemption is $2,000,000, increasing to $3,500,000 in 2009, while the amount of the exemption that may be used against gift transfers remains limited to $1,000,000. The annual gifting exclusion is $12,000 per year per donee. A number of other exclusions and limitations have changed in 2007. We have summarized these in a chart on page 3 of this newsletter.

We hope that you will find the information included in this newsletter helpful. As always, if you have any questions or would like to arrange for an appointment to review or update your existing estate plan, please do not hesitate to contact me or any of the attorneys in the firm's wealth management practice.

Wishing you much success, health, and happiness,

Peter LaBoskey

Peter LaBoskey
Partner, Estate Planning & Wealth Management

Lifetime Gifting Vehicles: Custodial Arrangements, Irrevocable Trusts, and Section 529 Plans

We receive many inquiries about how to make gifts utilizing the annual gifting exclusion while still maintaining control over the gifted assets. This can be accomplished through the use of a custodial arrangement, an irrevocable trust, or, in the case of saving for college or graduate school, a 529 plan, each of which is discussed below.

Custodial Arrangements: Under the California Uniform Transfers to Minors Act, gifts to a minor may be made to a custodian, who is charged with holding and managing any assets so gifted for the benefit of the minor until the minor attains age 18 (such age can be affirmatively extended to age 21). A custodial arrangement is in effect a trust whose terms and provisions are set forth by statute. It is a simple and effective management vehicle for gifts to a minor. We continue to advise that someone other than the donor act as the custodian. Effective as of January 1, 2006, assets held in custodial arrangements for a beneficiary under age 18 are subject to the so-called "kiddie tax" and are taxable at the beneficiary's parents' income tax rates.

Irrevocable Trusts: In many situations, a custodial arrangement may not be appropriate. For example, the donor may have specific wishes regarding how the assets are to be used for the donee's benefit, and the custodial assets are required to be distributed to the donee by no later than age 21. In such cases, the donor may desire a more flexible gifting vehicle: an irrevocable trust. By creating an irrevocable trust, the donor can determine how the assets may be used for the benefit of the trust beneficiary, and when the assets may be distributed to the beneficiary.

Although the trust assets are out of the donor's estate for estate tax purposes, in certain situations the gifts to the trust can be further leveraged by providing in the trust instrument that the assets remain income taxable to the donor.

One requirement for using the annual gifting exclusion is that the donee obtain a present interest in the gifted asset. Generally, transferring a beneficiary's gift to a trust does not qualify as a present interest. The most common method of conveying a present interest gift to a trust involves the use of a *Crummey* provision, pursuant to which the beneficiary is granted a temporary right to withdraw the asset gifted to the trust. The disadvantage of the *Crummey* provision is that notice of the gift must be given to the beneficiary, and the beneficiary does have the right to withdraw the gift during the withdrawal period.

Section 529 Plan: 529 plans are state-sponsored college savings plans that have advantages over custodial arrangements and irrevocable trusts. They offer more control than custodial arrangements because the assets are not required to be distributed to the beneficiary as early as 18 or 21 (although the exact age depends on the state plan). They are more flexible than irrevocable trusts because the beneficiary of the 529 plan can be changed to certain other family members if the beneficiary does not use the assets for higher education.

Gifts to a 529 plan qualify for the annual gifting exclusion, and donors are allowed to aggregate five years of allowable annual gifting exclusions to contribute to the plan (in 2007, $60,000 for an individual, and $120,000 for a couple).

Unlike custodial arrangements and irrevocable trusts, the donor may be the 529 plan owner and maintain control over the distribution of plan assets without being subject to an estate tax for such assets. In contrast, under the Deficit Reduction Act of 2005, a 529 plan *is* considered an asset of the plan owner for college financial aid purposes. This rule is significant because the federal formula for aid takes into account a student's assets to a greater extent than the student's parents' assets. Under the Pension Protection Act of 2006, 529 plans have preferable tax treatment as well. Funds in a 529 plan grow income-tax free (unlike funds in custodial accounts, which are subject to the "kiddie tax"), and withdrawals from the plan for qualified education expenses also are income-tax free.

There are several restrictions tied to the use of 529 plans. Unlike custodial arrangements and irrevocable trusts, only cash can be gifted. In addition, the assets must be used for qualified higher education expenses only; a distribution for any other purpose is subject to a 10 percent federal tax penalty in addition to any income tax due. Every state plan is also different, with different contribution amounts, beneficiary ages, resident and non-resident restrictions, investment options, and fees and expenses.

Each of these gifting alternatives has its own advantages and disadvantages. Please let us know if you are interested in discussing in further detail which vehicle would work best in your specific situation.

Pension Protection Act of 2006: Implications for Charitable Giving and IRAs

On August 17, 2006, the Pension Protection Act of 2006 (PPA) was signed into law, ushering in a number of favorable changes for clients. Retirement assets always have been—and still are—attractive candidates for a number of forms of charitable planning through your estate plan. Charitable planning with such assets helps to avoid both estate and income taxes that could otherwise be imposed on your noncharitable beneficiaries.

However, until recently, such assets were a much less attractive option for lifetime charitable giving; for many clients, the charitable deduction obtained by donating such assets wouldn't offset all the income recognized upon withdrawal. This disparity actually made it more expensive to give away these tax-advantaged assets during one's lifetime, when compared with after-tax assets.

With the passage of PPA, some taxpayers enjoy favorable new rules that allow charitable donations of assets held in an IRA on a much more tax-advantaged basis. If over age 70-1/2 during 2007, a taxpayer may make a direct transfer of IRA assets of up to $100,000 per year to a qualified charity without causing income recognition. Even better, such a transfer can be used to satisfy the taxpayer's required minimum distribution from the plan for that tax year.

However, certain restrictions apply that make this opportunity somewhat less desirable than originally anticipated. First, no charitable deduction actually is allowed for such transfers—the tax savings come from exclusion of the distribution from the taxpayer's income, not from a deduction. In the proper case, however, exclusion from income may be more favorable than income recognition coupled with a charitable deduction. Second, the donee of such funds must be a public charity or a conduit private foundation. Unfortunately, ordinary private foundations, donor-advised funds, supporting organizations, and the like are not permissible donees for this purpose.

Despite these drawbacks, this change in law could prove useful in your philanthropic planning. Accordingly, interested clients should start thinking about whether they have IRA assets that might be attractive for a charitable gift in 2007.

At the same time PPA altered the rules governing IRAs with respect to charitable transfers, it also loosened restrictive rules on inherited IRAs. Beginning in January 2007, nonspousal beneficiaries can "roll over" employer-sponsored retirement plans in a manner similar to that previously enjoyed only by spouses. Such a rollover allows beneficiaries to stretch IRA payments over a longer period and thereby obtain greater benefits from tax deferral. While a number of complexities exist, clients whose estates are significantly weighted in IRAs or employer-sponsored retirement plans should consider reviewing their estate and retirement plans to take into account the effects of this change in the IRA rules. Similarly, if you have been withdrawing more than the required minimum distribution out of concern for the ultimate income and estate tax consequences of your IRA investments, you may wish to reconsider such a strategy.

Key Figures for the 2007 Tax Year	
Estate Tax Applicable Exclusion Amount	$2,000,000
Gift Tax Applicable Exclusion Amount	$1,000,000
Marital Gift Tax Exclusion Amount (to non-U.S. citizen spouse)	$125,000
Annual Gift Tax Exclusion Amount (per donee)	$12,000
Maximum Estate/Gift Tax Rate	45%
401(k) Contribution Limit	$15,500
401(k) Catch-Up Contribution (if age 50 or older by end of 2007)	$5,000
Roth IRA/Traditional IRA Contribution Limit	$4,000
Roth IRA/Traditional IRA Catch-Up Contribution (if age 50 or older by end of 2007)	$1,000

HIPAA Privacy Regulations and Your Estate Plan

You may have noticed that your doctors' offices have been providing you with their privacy policy notice and asking you to acknowledge that you have received it. This is because of privacy regulations under the Health Insurance Portability and Accountability Act (HIPAA). HIPAA privacy regulations were enacted to protect your private medical information from unauthorized disclosure. Unfortunately, the regulations are very broad and have created unforeseen problems for estate planning.

One major problem that HIPAA has created for your estate plan is its impact on incapacity planning. Your estate plan, among other things, provides for the management of your affairs should you become incapacitated during your lifetime. In your estate plan documents, you probably have named people in various capacities to handle your financial affairs and make healthcare decisions for you, should you become unable to undertake these tasks yourself. These include your successor trustee, agent under a durable power of attorney for asset management, and agent under a durable power of attorney for healthcare decisions. The incapacity planning provisions in most estate plan documents "spring" into effect upon your incapacity, as determined by a physician's certification.

Under the HIPAA privacy rules, however, physicians now are prohibited from disclosing protected health information, including a finding of incapacity, to anyone other than the patient. Even those people named in your estate plan documents to manage your affairs will be unable to obtain the information needed to begin acting on your behalf unless they can provide your physician with a written authorization that meets the requirements of HIPAA that you executed *before* you became incapacitated.

A solution to this problem is a well-drafted authorization pre-authorizing your health-care providers to disclose the necessary information to the people named in the authorization. In most cases, you will need at least two separate authorizations—one giving your health-care agent access to your medical information in order to make healthcare decisions for you, and another giving your financial agent (such as successor trustee or agent for financial decisions) access to your health information in order to determine your capacity to manage your affairs. The HIPAA authorizations should be coordinated with any estate plan that you already have in place. Such authorizations also must be drafted to meet any applicable state privacy laws. For example, in California, the authorizations must comply with the state's Confidentiality of Medical Information Act. The authorizations should name at least your executors, trustees, and agents under a power of attorney. In addition, the authorizations should limit the authority granted to minimize concerns regarding invasion of privacy.

Issues to Consider when Reviewing Your Estate Plan

We generally recommend that clients review the provisions of their estate plans with their attorney every three to five years. Doing so ensures that you take advantage of, and plan for, any changes in the tax code since your last update. Regular reviews of your plan also will allow you to make any alterations that may be necessary or desirable due to intervening life events. In addition, we recommend that you review your assets as a part of this process to ensure that they are properly funded into any revocable living trust that you may have created. Many clients find it most convenient to review these issues as they prepare annual income tax returns, since the same financial information needs to be gathered as a part of that process.

Beyond the changes that inevitably occur in the tax code, certain life events may trigger a need to update your documents. For instance, you may want to take into account whether you, your spouse, your children, or any other person you have named as a beneficiary or trustee has gotten married or divorced, had children, or passed away since your last update. Your financially savvy former son-in-law, for example, no longer may be the best choice as a successor fiduciary. Likewise, if you have grandchildren, you may wish to make a special provision for them in your estate, leveraging your personal exemption from generation-skipping transfer tax by doing so.

Similarly, if your financial picture has changed, you may find certain planning techniques more attractive, or you may need a tighter correlation between the disposition of your retirement assets, life insurance, and trust assets. An increase in your asset base may suggest an ability to engage in philanthropic planning. While it may be that no alterations to your plan are needed, a regular review can help to ensure that your intentions are fulfilled, regardless of the ever-changing landscape of the tax code.

Family Limited Partnerships under New Attack: Things to Know

Limited partnerships* long have been used as vehicles for accomplishing many specific family-oriented goals. These goals include enabling family members to take advantage of the efficiencies resulting from the collective investment of family assets, providing a level of asset protection from a family member's personal liability or failed marriage, and increasing the effectiveness of future gifts of family assets through the availability of valuation discounts associated with the gift of a limited partnership interest.

However, there have been several developments in limited partnership case law that not only have attacked the purposes behind the partnership's creation and the valuation for gift tax purposes of transfers of limited partnership interests, but also the manner in which the partnership is managed and operated. Broadly speaking, these cases have held that if a transferor of assets to a limited partnership retains too much use of or control over the partnership assets, those assets will be included in the transferor's estate for estate tax purposes upon the transferor's death. As an example, assume that Mr. Smith has formed a limited partnership, funded it with $1,000,000 in assets, and gifted all 99 percent of the limited partnership interests to his family members, retaining only a 1 percent general partnership interest. If the IRS finds that Mr. Smith has retained too much use of or control over the partnership assets during his lifetime, at the time of his death the IRS would declare that his taxable estate would include the entire $1,000,000, not just the $10,000 seemingly attributable to his 1 percent interest in the partnership at that time.

The IRS justifies the inclusion of all the partnership assets in the transferor's estate under the theory that, since the transferor has retained such significant use of those assets, any transfer for estate tax purposes should be treated as having been made upon the transferor's death. In order for the IRS to respect any prior transfer, the transferor must respect the legal existence of the partnership, both in form and substance, and treat all partnership assets as assets actually belonging to the partnership and not still owned by and/or easily accessible to the transferor.

After reviewing the various cases dealing with this issue, we recommend that transferors adhere to the following general checklist in operating and administering a family limited partnership:

- The partnership should be validly formed under state law, and legal title to all assets transferred to the partnership should be held in the partnership's name.
- Partnership and personal funds should not be commingled.
- Each partner should retain, outside of the partnership, sufficient assets to satisfy his or her living expenses.
- To the extent a partner uses partnership assets for personal use, the partner must pay fair market value for such use.
- All partnership distributions should be made at the same time and on a pro rata basis.
- The general partner should be the only manager of the partnership and he or she should receive a reasonable management fee.
- The partnership should continue to operate after the transferor's death, and distributions from the partnership should not be made to pay any estate taxes associated with the transferor's death.

Given the increased scrutiny by the IRS, if you have previously formed a family limited partnership, it may be appropriate to review both the documentation controlling it and its actual operations over the years. Please contact us if you would like us to conduct an audit of these elements to ensure that your limited partnership is optimally positioned to withstand IRS scrutiny.

* This discussion also applies to limited liability companies.

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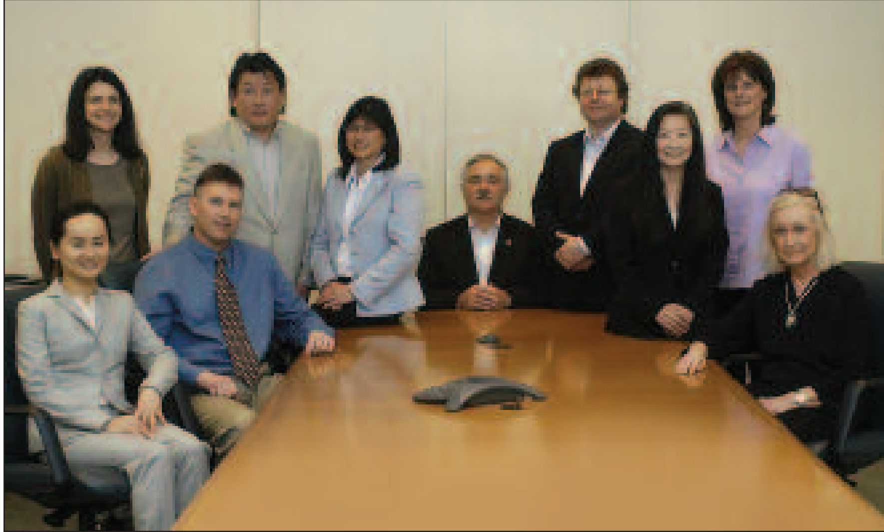

The Estate Planning & Wealth Management Practice

Left to right: Christina Hwang, Bereniki Emerson (standing), Matthew Belval (seated), Richard Schachtili (standing), Laurie Look, Pete LaBoskey, Darin Donovan, Diane Fong, Pat King, and Arlene Rinaldo (seated). Not pictured: Pamela Alford and Jamie Bruno.

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