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Dear Clients and Friends,

In this Newsletter, we will continue to update you by briefly covering topics that we've found to be of the most current interest to our clients.

1. <u>Non-Traditional Couples</u>. The percentage of Californians in "Father-Knows-Best" nuclear family households dropped during the past decade to only 23% of all households. During the same period, households occupied by unmarried couples, including opposite sex and same-sex couples, rose significantly.

With many couples living together outside of marriage or without registering as Domestic Partners, estate planning documents have become even more important to legally recognize and protect a loved partner. For instance, an Advance Health Care Directive can give the partner rights to direct medical treatment and even to just have access to the hospital room. A Will or Living Trust can define what bequests the loved partner will receive, including disposition of household furnishings and personal effects, if one partner becomes incompetent or dies. This could avoid nasty and expensive disputes between the surviving partner and the family of the deceased partner (e.g. the "legal heirs", if there is no Will). Life insurance can be just as important for these couples as for the nuclear family situation, in that both partners generally are working, and life insurance on each of them can allow the survivor to continue to pay bills and have the same lifestyle. Similarly, retirement plans should also be reviewed with regard to named beneficiaries.

Many unmarried couples are buying houses together. In this situation, we recommend a clear legal document, such as a Co-Ownership or Tenancy in Common Agreement, to set out each partner's rights and obligations with respect to the property. This includes each partner's responsibility for the down payment, monthly carrying and maintenance expenses, and most importantly would address what should happen if one partner dies or the relationship terminates.

2. <u>Estate and Gift Tax Update</u>. The Estate Tax exemption amount for individuals dying during 2012 is $5,120,000 (up with a cost of living adjustment from $5M). This figure is also the maximum one can gift, tax-free, during life, as well as the new Generation-Skipping Transfer Tax exemption amount. Annual tax exclusion gifts will remain at $13,000. The tax rate for individuals who give away or die with an estate in excess of $5,120,000 is 35% for the excess amount.

The estate and gift tax lifetime exemption is reduced substantially in and after 2013, down to only $1M, with a tax rate of 55% on the excess. Although our personal expectation is that Congress will act to maintain at least a $5M exemption, there is no certainty about what actions, if any, Congress will take.

So, gifting during 2012 will be attractive to some of our clients, who: a) can afford to give assets away and still retain enough for their personal lifetime care and comfort; b) have children who are responsible and would appropriately use and invest those extra funds in a manner

that doesn't destroy their work-ethic; and c) that the client won't regret later, since gifts are irrevocable.

For our clients who do have the right situation and who are considering making large lifetime gifts to children and grandchildren, the best time to do it would be during 2012 (rather than waiting until 2013), to take advantage of the higher gift tax exemption and the lower tax bracket of 35% (rather than 55%) on any gifts in excess of the exemption amount.

By making a gift now, all appreciation and income on the gifted asset will be removed from the estate tax-free. With gifts of minority interests in a business or real estate, a valuation discount can be applied in reporting the gift value. And, if the gift is made to a grantor trust so that the grantor (the parent) pays the income taxes on the trust's income, while the beneficiary gets to keep all of the actual income, the income tax paid also is removed from the grantor's estate tax-free!

As to how to make a gift, there are many attractive options for wealth transfer to younger generations, ranging from the simple to the complex, such as qualified personal residence trusts, grantor trusts, partial gifts or sales of family business stock or real estate, and loan forgiveness, as well as outright gifts.

For more on the 2011 and 2012 estate and gift tax laws and structuring wills and trusts to take best advantage, you can refer back to our 2011 Newsletter, which can be found on our website www.magasinn.com.

3. Inter-Relationship between Prop 13 Property Tax Rules and IRS Gift Tax Audits

Normally, California's Prop 13 directs that transfer of real property will result in a property tax reassessment, whether to a stranger or to family members. One exception, which we refer to as "Prop 58", is that a family residence can be transferred to children with no reassessment of property tax. There is also an exception for transfers of any other kind of real property from a parent to a child, so long as the total value of the property transferred has an "assessed" value (rather than a market value) of $1M or less. Since property owned for a long time can have an assessed value for property tax purposes of far less than its current market value, this allows parents to transfer real estate worth much more than $1M to children, without the property being reassessed under Prop 13. All requests for exclusion under Prop 58 are collected by California's State Board of Equalization (BOE).

The IRS believes that people are making real property gifts to their children, without reporting the gifts to the IRS for gift tax purposes. On December 15, 2011, the US District Court issued a decision that grants the request of the IRS to issue a summons to the BOE to obtain the names of all California residents who transferred their real estate by gift or for less than market value to their children or grandchildren between 2005-2010. The IRS is not bound by any statute of limitations for unreported gifts. For most of those years, when the gift tax exemption amount was $1M, and tax rates ranged between 41-47%, the non-reporting donors may face gift tax, interest and a possible 25% failure to file and pay penalty. We are sometimes asked how the IRS will know if a gift was made if not reported, and this case holding and new BOE response is a partial answer.

4. Prop 58 - Potential Loss of Parent/Child Property Tax Exemption with Business Entity Transfers

We continue to weigh with our clients the pros and cons of holding real property in an LLC, Family Partnership or Corporation, resulting in the potential loss of the $1M exemption

from tax reassessment for transfers between parents and children for investment property. While LLC's may provide some important creditor protections, tax savings and management advantages, the Prop 58 Parent/Child Exemption does not apply to properties held in an entity.

Generally, property owned in an entity is not subject to property tax reassessment, except in two situations. First, the real property will be reassessed if there is a change in control of the entity (generally, when any one person or entity obtains a majority interest in the entity in question). Second, if the property is initially contributed by the owners to the entity free of reassessment, tax reassessment will occur when cumulatively more than 50% of the entity changes ownership. For example, if parents initially contribute the property to the entity and over time more than 50% of the interest is transferred to children by gift or inheritance, then 100% of the property would be reassessed to the current value. Entities are required to file a Statement of Change in Control and Ownership of Legal Entities (Form BOE-100-B) with the BOE within 45 days of the change in control or ownership. The penalty for not filing timely is 10% of the taxes applicable to the new base year value of the real property.

Through careful planning and timing, our clients can sometimes avoid a change of ownership for property tax purposes by taking the property out of the entity prior to any change of more than 50%, followed by the parents transferring an interest in the actual property to their children, and sometimes ultimately returning the property back to an entity.

5. Are You Up-to-Date on Your 5-Year Estate Plan Review?

Even with all of the Living Trusts that we continue to use with our clients, we continue to have a busy Probate practice. Probates are still expensive for the beneficiaries, with the attorney and the executor entitled by law to fees of around 2-4% of the gross estate, and now a probate proceeding takes even longer, at least 15 months because of back-ups in the court calendars due to budget cuts. Most of our Firm's probate cases come from new clients. Sometimes, though, even our clients have become lax in following our advice to own property in their Trusts, e.g. failing to return title to their home to the Trust following a refinance, or forgetting to transfer title to new property or investment accounts to the Trust. In our regular client review meetings, we review title to real property, bank accounts, investments, and beneficiaries of retirement accounts and life insurance. Frequently, we discover at least a few items to update. In addition, of course, in these meetings we review family changes, discuss whether trustees and guardian nominations are current, and whether any changes in tax and probate laws affect the client. So, please call us if you are overdue.

6. Warning: ADA Lawsuits Against Commercial Property Owners Proliferate.

We have experienced during recent months what we would call frivolous lawsuits being filed against some of our clients who own small commercial shopping centers or buildings. There appear to be a few lawyers representing a handful of disabled clients who are suing large numbers of landowners who do not comply with the exact letter of the law under the Americans for Disabilities Act (ADA). The recent spate of suits are mostly related to allegations of parking lot or access regulations (such as handicap signage and spaces not being clearly marked or of a proper size), and handicap access into the building. The problem is that "almost complying" is not sufficient, since the law demands exact compliance by landlords. Some of these plaintiffs are not even going to or driving by the premises; rather we hear that they are looking on Google Maps for noncompliance so they can sue. There are statutory minimum damages that landlords are subject to, i.e. $4,000 per violation (such as, lack of a correct sign is one violation, incorrect parking lot striping is a second violation, etc.) and the landlord may need to also pay the legal fees of the plaintiff's

attorney. So, these cases, which we believe are primarily "attorney driven", are filed to extort and settle, are nevertheless still costly. Once an ADA case goes to trial, judges are forced to enforce the ADA law, even if the judge is certain that the lawsuit is otherwise frivolous, with the purpose to shakedown the small business owner. In the end, the landowner is forced to pay to settle the lawsuit and also comply with the ADA statutory requirements.

Thus, we warn all of our real estate clients that the best legal advice we can give them is to be proactive, take action now, before any law suit is filed. Read the ADA laws, especially as they regard parking and access areas, hire a consultant versed in ADA requirements, and "fix" your property to exactly comply with the law. (Call if we can help you with this, or if you'd like us to send you a recent magazine article about these ADA plaintiffs's lawyers.) Let these litigants pass by your "perfect" property, and instead go on to your next door neighbor to file suit.

7. Own a House in Mexico?

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. If you own property in Mexico through this manner, you'll know it. Be aware now that the IRS has informally taken the position that there are mandatory U.S. filing requirements for fideicomisos. Failure to file Forms 3520 and 3520-A can result in significant tax penalties.

8. Helpful Reminders.

(a) The California Secretary of State requires that corporations file Statements of Information annually and that limited liability companies file Statements of Information biennially. The failure to timely file these statements results in the suspension of the entity and the loss of its authority to do business. Clients should keep an eye out for Secretary of State reminder postcards but should be very wary of solicitations from private companies which look official. Statements of Information for corporations can now be filed online at https://businessfilings.sos.ca.gov/. At this time, there is no online filing for limited liability companies.

(b) Most small non-profits must now file IRS Form 990-N, which is referred to as an "e-postcard." All non-profits with gross receipts "normally" under $25,000 must file this form. Gross receipts will satisfy the "normally" requirement if they averaged $25,000 or less during its most recent three consecutive tax years, including the year in which the return would be filed. As good news, filing is very easy and is done online at http://epostcard.form990.org/ or through the IRS website. Failure to file could result in the loss of tax exempt status.

(c) Many clients come to us to review or document a deal to buy or sell real property or a business only after the client has negotiated the deal and has signed a letter of intent or similar document. Unfortunately, many of these preliminary agreements omit important terms for the client or contain provisions which the client did not understand fully. It is often more difficult to change the terms of a signed LOI than it would have been to include the proper provisions initially. We therefore recommend that all agreements, even preliminary and so-called non-binding agreements, be reviewed before they are signed.

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