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NEW DEVELOPMENTS FOR DONATIONS

By John F. Petrini

January of 2007 has ushered in a slew of new and improved tax laws that benefit people in many different ways. That is, if you can understand them. From inclusions to Roth IRAs, to donor-advised funds, it is easy to get caught up in terminology and get lost in these new laws. You don't need to be an accountant to be able to understand them; they just need to be explained clearly.

Some of the advantages we will see in 2007 began in 2006. The annual gift-tax exclusion- which is the maximum amount you can give to a donee in one year without incurring gift taxes—is up to \$12,000 from \$11,000. It is important to note that this is the amount each individual can give. For example, if you and your spouse want to make a gift to three different grandchildren individually, you could potentially give up to \$72,000 a year without gift taxes. In addition, any gifts used solely for medical or educational purposes will not count against this inclusion, so long as you pay the college or medical facility directly.

This is just one change that occurred in 2006, but there are several more. One of these is a change to the Pension Protection Act of 2006 that will go into effect in 2007. Take 401(k)s for example, which will be affected by this Act. For many, a 401(k) is their only means of retirement. Under current rules, the IRS has made it extremely difficult for people to bequeath the funds to a beneficiary. For example, a person can designate a child as a 401(k) beneficiary. But, when he or she dies, many plans require the child to then withdraw all the assets from the account immediately and pay taxes on them as income.

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John F. Petrini is a Partner in the Bakersfield office of Borton Petrini, LLP. He has been an attorney for over 30 years and is AV Peer Review Rated by Martindale-Hubbell. He is experienced in estate planning, trust administration and probate. His particular expertise in business contracts and business disputes gives him a unique perspective in this area. He has spoken to groups in the area about estate planning and keeps up in the field by his attendance at advanced estate planning institutes. He is the editor of the Estate Planning Quarterly Report.

Mr. Petrini served as President of the Kern County Bar Association (1987), and sits on the board of the Petroleum Club of Bakersfield and the Southern San Joaquin Emmaus Group.

TRUST & ESTATE TAX BASICS

By Grant W. Peters

Many people are understandably confused by the multiple layers of taxation that can be encountered in administering a decedent's estate. This article attempts to clarify some of the distinctions between the various types of federal trust and estate taxation.

Trust or Estate Income Tax

A decedent's estate comes into existence when the individual dies, regardless of whether there is probate. Death marks the termination of the individual as a separate taxpayer and the creation of the decedent's estate is a new taxable entity. For income tax purposes, a decedent's estate includes all of the assets and liabilities that comprise the probate estate under state law. When a revocable trust becomes irrevocable, as on the death of the settlor, it also becomes a separate taxpayer.

As separate legal entities for federal tax purposes, trusts and estates must file a separate tax return on form 1041. All of the income, gains, losses and deductions of the decedent's estate or trust should be included. An estate must file a return if it has a gross income of \$600 or more during a tax year. A trust income tax return may be required if the trust has gross income for the year of \$100 or more.

Transfer Tax

A second level of taxation is the estate or transfer tax. In addition to taxing the income received by the estate or trust, there is a tax imposed on the transfer from the decedent to the heirs or beneficiaries if the size of the estate exceeds the exemption amount, which is currently \$2 million. The exemption amount increases to \$3.5 million in 2009, the tax is abolished in 2010 and the tax is reinstated with a \$1 million exemption in 2011. Currently, the estate tax rate is 45 percent of the amount exceeding the exemption.

Gifts during life can reduce the amount of estate tax exemption available to the trust or estate after death. The current lifetime gift tax exemption is \$1 million. The exemption is reduced by gifts that exceed the annual exemption amount in place at the time of the gift. The current gift tax annual exemption is \$12,000 per recipient, per year for each donor. For example, property valued at \$100,000 may have been given to a child during the decedent's lifetime. Assuming that the annual gift tax exemption was \$12,000 at the time of the gift, a gift tax return would be due and \$88,000 of the \$1 million lifetime exemption amount would be used. If the decedent died in 2007, the available estate tax exemption would be reduced by the portion of the lifetime gift tax exemption that

had been used during life, so the available estate tax exemption would be \$1,912,000 (\$2,000,000 less \$88,000).

Decedent's Income Tax

The third level of taxation that an executor or administrator needs to consider is the final income tax return for the decedent. The executor or administrator is responsible for reporting the decedent's income (and any applicable deductions) for the last year of the decedent's life.

Importance

The beneficiaries and the administrator or executor may be liable for unpaid taxes from the estate or trust. For this reason, it is very important that the executor or trust administrator obtain professional counsel regarding any tax returns that need to be prepared and filed and any taxes that should be paid from the assets of the estate or trust.

A trust can be a wonderful tool to avoid probate and reduce the burden of administering a decedent's estate after death. Like death, however, some taxes cannot be avoided and the administrator or executor needs to be aware of their obligations under the law. Our office is available to assist administrators and executors in trust administration. We also provide estate planning to minimize the total tax burden.

Grant W. Peters



Grant W. Peters is an attorney in the Bakersfield office of Borton Petrini, LLP. He received his undergraduate degree in Chemistry and his M.D. from Loma Linda University. He earned his J.D. at University of California, Berkeley, Boalt Hall School of Law. Grant also holds an M.S.A. in Healthcare Administration.

Grant's estate planning practice focuses on helping individuals and families develop a realistic plan for their assets that benefits the people and causes that are important to them. Many plans include asset protection and tax reduction strategies; others simply assure that assets are passed to the designated family members at the appropriate time. An important part of each plan is planning for the possibility of infirmity, ill health, or accidental injury.

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NEW DEVELOPMENTS FOR DONATIONS*continued from Page 1*

Surviving spouses, on the other hand, are allowed to roll over accounts to their own names, thus avoiding having to pay taxes until the funds are withdrawn, which can be done over time.

The Pension Protection Act will allow non-spousal beneficiaries to roll over the given 401(k) assets into what is called an inherited individual retirement account. Thereby, children of the deceased person who are beneficiaries can withdraw money gradually, based on their expected lifespan. All those people who expect to inherit 401(k) assets from parents will now be able to preserve the money in an IRA decades longer than they could previously, and withdraw it over time, thereby spreading out the tax burden.

Individual Retirement Accounts (IRA) are also feeling the benefit from the changes in the tax rules. Under current laws, a worker who owns a traditional IRA is not permitted to convert the tax-sheltered retirement account into a Roth IRA if his or her gross income exceeds \$100,000. Now, thanks to the Tax Increase Prevention and Reconciliation Act, this income restriction will be lifted beginning in 2010. Workers will now be able to leave large amounts of tax-sheltered money to their children and other heirs through a Roth IRA.

Let's back up for a second. A Roth IRA is money invested in dollars on which you have already paid taxes. Therefore, the government is not putting any pressure on you to withdraw these assets. At retirement, you can make Roth IRA withdrawals tax free. Regular IRAs are funded using pretax dollars, so the tax laws required owners to make annual "required minimum distributions" starting at age 70 1/2. These withdrawals are taxed as ordinary income. Therefore, the older you are, the bigger the share of money you are required to withdraw every year. Taxable distributions are designed to force IRA owners to deplete their accounts, though not entirely, before they die. As you age, there will be less and less in your tax-deferred IRA to pass on to your heirs.

What do you do if you don't need your Roth IRA money? Retirees who don't need their money can keep it sheltered in these accounts until they die, then their beneficiaries can withdraw the money gradually. If the beneficiary of your Roth IRA is a child, he or she can withdraw the funds for as long as four or five decades. This maximizes the account's tax benefits over two generations.

Despite the fact that this act doesn't go into effect until 2010, there are things you can do now to prepare for this shift. Even if you don't qualify for a deductible IRA because your income is too high, you can always put your money into

a traditional nondeductible IRA. These IRAs are funded with after-tax dollars; investment gains are taxed at withdrawal as ordinary income. Therefore, if you fund nondeductible traditional IRA accounts, starting in 2010 you could convert them to Roth IRAs with very little tax impact, since you have already contributed the money.

Another, perhaps simpler, solution would be to name a charity as the direct beneficiary of your IRA. Not only would the charity be able to withdraw money tax-free, but also the IRA would be removed from your estate, making it much less likely that you would be subject to estate taxes. You could also name a charitable remainder trust as the beneficiary of your IRA. This would allow individuals to pass along any assets to a qualified charity while still taking care of a loved one.

It works like this: Upon the IRA owner's death, the trust would inherit the IRA assets. The trust would be directed to pay out a set income to a beneficiary. When the beneficiary dies, the principal of the trust would go directly to a named charity.

For those who tend to be charitably minded, there is even more good news. For 2006 and 2007, the government has made it possible for IRA owners to use these accounts to make direct donations to charities. Under the old laws, if an IRA owner withdrew money from his or her account to make a donation, that amount would be taxed. Now, under the Pension Protection Act, this year and next, IRA owners 70 1/2 and older can direct their required minimum distribution up to \$100,000 per year tax free to qualified charities. The charitable funds you withdraw from your IRA, including your required minimum distributions, will not be included in your adjusted gross income.

One popular type of charitable investment vehicle is the donor-advised funds. This acts somewhat like a private foundation, with the added advantage that you don't have to hire any lawyers or planners to set it up. Instead, these funds have already been established by financial service providers. You have the option of making charitable gifts to a donor-advised fund, but a financial planner might suggest you donate using appreciated securities. This then avoids capital gains tax on the appreciation. Individuals can then deduct the value of appreciated stocks, up to 30% of their annual adjusted gross incomes. Once the money is in the accounts, you can specify where the money goes. While the money technically belongs to the fund, in almost all cases, the charity will adhere to your wishes.

These are some examples of the new tax laws that are already taking shape and how to prepare to take full advantage of them. For more information, please contact your financial advisor.

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