

BOSSO WILLIAMS

A PROFESSIONAL CORPORATION

LEGAL LINES

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We provide sound and practical legal advice for the challenges confronting our clients. Our depth of practice and breadth of experience assure our clients of a wide range of high-quality legal representation. We are committed to providing an excellent work product to our clients and to our community.

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WHAT'S NEW

We are proud to announce that Michelle E. Anderson became a shareholder in the firm, effective in January, 2006. Michelle practices in the areas of estate planning, probate and trust administration and is a Certified Specialist in Estate Planning, Trust and Probate Law by the State Bar Board of Legal Specialization. She received her Bachelor of Arts degree with highest distinction in 1993 and her law degree in 1996, both from the University of California and was selected Phi Beta Kappa. She is actively involved in the Rotary Club of Santa Cruz, and is President-Elect of the Santa Cruz County Bar Association.

Attorney Robert E. Bosso of the firm is one of a group of authors of the newly released book, "A Legal History of Santa Cruz County". The work is the result of over seven years of research and has received favorable reviews. Copies are available for purchase at The Museum of Art & History (MAH). All proceeds of the book sales go to the MAH and the local law library.

Our newest attorney is Christopher C. Kirk, who joined our firm in January. Christopher concentrates his practice in taxation, business and estate planning. He is working closely with Peter L. Sanford and Michelle E. Anderson.

Christopher received a Bachelor of Arts degree in 1997 from McGill University in Montreal, Canada, and graduated *cum laude* from Tulane University School of Law in 2000. In 2005, Christopher graduated from New York University School of Law with a Master of Laws (in Taxation). Prior to pursuing his Master of Laws degree, Christopher practiced in San Francisco, representing clients in matters including business and project finance. He volunteers with One Brick, a national non-profit organization.

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TAXATION UPDATE

Because taxes affect all of us, every day, our clients regularly request advice on a variety of tax matters. Due to the many changes and updates to the tax laws, this newsletter is dedicated to updating our clients on some of the many federal and state taxes that affect them.

TRANSFER TAXES

Annual Gift Tax Exclusion: The annual gift tax exclusion remains \$12,000 for 2007. Commonly thought of as the “\$10,000 per year” exclusion, Congress enacted legislation several years ago to index the amount that each taxpayer may give to a recipient. This annual gift exclusion permits you to make gifts of up to \$12,000 of cash or property to any person, without requiring a gift tax return, and without affecting your lifetime gift tax exclusion or estate tax exclusion. Married couples may effectively combine their

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gifts, allowing gifts of up to \$24,000 from the couple to an individual. By making gifts up to the annual exclusion amount over a period of years, it is possible to transfer large amounts of wealth to younger generations free of tax, and can be used to transfer significant assets, such as a house or a family-owned business, over a reasonable period of time. For example, if structured properly, a married couple making annual gifts to their four children can transfer \$480,000 over a five-year period without requiring a gift tax return.

Lifetime Gift Tax Exemption: The lifetime gift tax exemption equivalent remains \$1 million. This exemption was once coupled with the estate tax exemption, but was separated from the estate tax exemption when Congress raised the estate tax exemptions in

2001. A gift tax return must be filed for any year in which the total value of gifts by a taxpayer to a single recipient exceeds the annual gift tax exclusion, currently \$12,000. Amounts reported on a taxpayer’s gift tax returns are tracked over the taxpayer’s lifetime; once a taxpayer’s lifetime gifts exceed \$1 million, the donor-taxpayer must pay gift tax on any gifts above the annual exclusion amount. For gifts of property, the amount of the gift is the fair market value of the property transferred, less any mortgages or other debts that the transferred property carries with it. As discussed below, any property that is transferred by gift has a carryover basis for tax purposes.

Estate Tax Exemption: In 2006, the estate tax exemption increased to \$2 million. This exemption amount will remain in effect for the estates of decedents dying in 2007 and 2008. The exemption amount will increase to \$3.5 million in 2009. Under current law, the estate tax will be eliminated for 2010. For the estates of decedents dying in that year, there will be no estate tax, and any person receiving property from the estate will take that property with a carryover basis. The estate tax is scheduled to return in 2011, with the exemption amount reverting to \$1 million.

Efforts in Congress to eliminate the estate tax permanently have continued, without success as of the writing of this update. While we cannot predict changes to the estate tax system, most analysts anticipate that there will be some form of estate tax for the foreseeable future, with exemption amounts increasing to as high as \$5 million per person. One proposal would allow married couples to combine their estate tax exclusion, permitting a combined estate of up to \$10 million to pass to heirs and beneficiaries free of tax. The uncertainties as to the future of the estate tax is one of the reasons that we recommend that all our estate planning clients check in with us at least every five years to determine whether their estate plans meet their current needs.

Basis: Basis is the cost of an asset, or its cost less depreciation. Under the current estate tax system, property that passes from a decedent to his or her heirs receives a “step-up” in basis, equal to the property’s fair market value on the date of death. For example, if a decedent owns a house purchased in 1975 for \$50,000, and dies in 2007 when the house has a fair market value of \$1 million, her heirs would have

a basis of \$1 million, and could sell the property soon after inheriting the property with no capital gains. Under the system that is currently scheduled to go into place in 2010 for decedent's estates, property that is transferred has a "carryover" basis, with the recipient stepping into the shoes of the donor. Gifted property also has carryover basis. If the person in the previous example made a gift of her house while she was still alive, the recipients would have a basis of only \$50,000 even though the house was worth \$1 million on the date of the gift, and the recipients would have capital gains of \$950,000 if they turned around and sold the property. You should carefully consider the tax effect of any significant lifetime gifts, especially if such gifts are made in anticipation of death, as an analysis of tax benefits may indicate that it is better to postpone the gift and have it pass as an inheritance.

Advanced Tax Planning Techniques: If your estate has significant value, and includes assets such as a vacation home or income-

producing property, it may be worthwhile to consider some advanced tax planning techniques, including Qualified Personal Residence Trusts ("QPRTs"), Grantor Trusts, and Charitable Remainder Trusts ("CRTs"). QPRTs enable a taxpayer to make a gift of a personal residence at a (sometimes significant) discount from the property's fair market value. Grantor Trusts can enable the taxpayer to make a gift of property such as commercial real estate, with a stream of income from the property going back to the donor. Charitable remainder trusts enable a taxpayer to give highly appreciated property to a charity, to avoid capital gains, while keeping an income stream coming back from the property. If you have highly appreciated assets, such as rental property or stock in a closely held business, or if you have a second (or third) home, one or more of these planning techniques may be right for you.

REAL PROPERTY

Sale of Principal Residence: In 1997, Congress changed the rules regarding recognition of capital gain when selling a principal residence. Previously, taxpayers could defer recognition of capital gain when selling their home to trade up to a more valuable one, and could take a one-time exclusion of capi-

tal gain when trading down into a less valuable property after reaching age 55. Now, all taxpayers may exclude up to \$250,000 of capital gain (\$500,000 for married couples) on the sale of a home. To qualify for this exclusion, the taxpayer must have used the home as a principal residence for at least two of the five years preceding the sale. This exclusion from capital gain is no longer limited to seniors, and is not limited to a single use, although it cannot be used more frequently than every two years.

Tax-Deferred Exchanges: Taxpayers may defer gain on the sale of real estate held for investment or busi-

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ness purposes by exchanging it for other real estate. By engaging in such "1031" or "like-kind exchanges," it is possible to trade up into larger and more valuable properties, or to transfer investments from one market to another in order to maximize returns on investment. By exchanging, one may sell one property and reinvest the proceeds into a new property, without recognizing current gain. Like-

kind exchanges are not limited to real estate, but the acquired property must be the same general type as the disposed property—real estate must be exchanged for real estate, a truck must be exchanged for a truck, and so on. With respect to real estate, what is considered "like-kind" is extremely broad; a taxpayer may exchange a single residential rental unit for a commercial building, or a piece of raw land outside of Fresno for a long-term lease in a building in New York City. However, if you exchange real property for any property that is not "like-kind," such as furniture or cash, you must recognize gain on the value of the non-like-kind property received; additionally, you cannot exchange property held for investment or business use for property held for personal use. There are important time limits to the purchase of the replacement property, and special rules apply when engaging in tax-deferred exchanges involving related parties.

Doubling Up: Deferral and Exclusion: If you have a dedicated home office, or moved out of your house less than three years ago and kept it as a rental property, you may be able to sell the property and take advantage of both the principal residence exclusion and the like-kind exchange rules. The IRS issued a procedural ruling in 2005 providing instructions for

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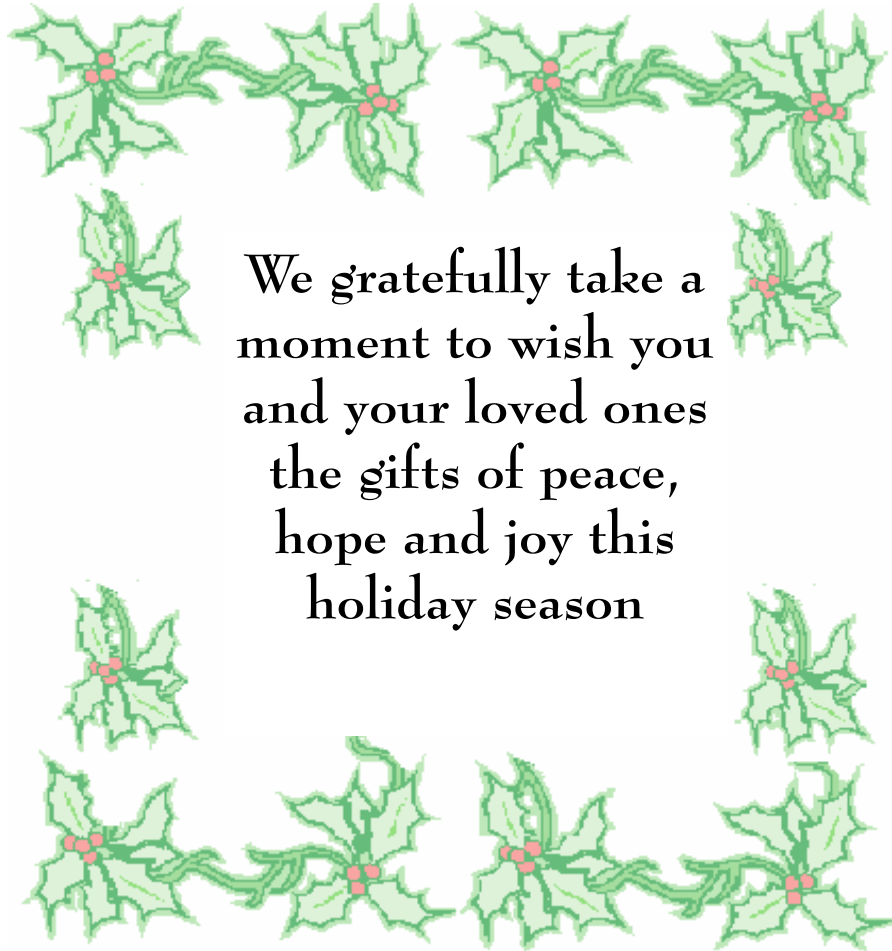
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We gratefully take a
 moment to wish you
 and your loved ones
 the gifts of peace,
 hope and joy this
 holiday season

the exchange of property that was used as both a principal residence and a property held for investment or business purposes (such as a rental cottage). A taxpayer may receive cash on other non-like-kind property in an exchange up to the \$250,000/\$500,000 limitation without being taxed.

Property Taxes: While property values in California may be leveling off, many people still have highly appreciated real estate. Under Proposition 13, real property is reassessed when transferred. Nevertheless, some transfers between family members are excluded from reassessment.

The prospect of a property tax re-assessment can discourage seniors from downsizing into a smaller home. A common concern is that if the senior sells the big family home, and buys a smaller house or condominium, the property taxes on the new house

will be greater than the taxes on the old one. Fortunately, it is possible for seniors to sell their home with a low assessed value, buy a new, less expensive home, generally in the same county, for less than they received for their old home, and transfer the assessed value of their old home to their new one, preserving their low property tax payments. If conditions are right, due to the \$250,000/\$500,000 exclusion discussed above, the taxpayer will also be able to exclude most or all of their gain on the sale. This transfer of assessed value is generally only available once to each taxpayer.

We look forward to the opportunity to assist you during this time of rapid change and uncertainty in the area of taxation of estates and real property.

*By: Michelle E. Anderson
 Christopher C. Kirk*