Estate Planning Insights

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TAX NUMBER UPDATES

This newsletter will provide various updated tax numbers. It is important to note that when some of these numbers change, your estate plan automatically changes. This may or may not be what you want. As always, it is your responsibility to make sure that your estate plan still works the way you want it to, not only in view of tax changes, but also in view of changes in your family and financial situation.

2006 Tax Numbers.

1. Estate Tax Exclusion Amount. The estate tax exclusion amount has increased to $2,000,000 for persons who die in 2006. Unless changed by Congress, the estate tax exclusion amount will remain at $2,000,000 through 2008 (it is scheduled to increase to $3,500,000 for 2009 and then the estate tax is "repealed" for persons who die in 2010). In essence, a person who has not previously made any "taxable" gifts during lifetime who dies in 2006 may transfer assets having an aggregate fair market value of $2,000,000, free of estate taxes.

How Does the Increase in the Estate Tax Exclusion Amount Affect Your Estate Plan? If your estate plan uses a formula that leaves the estate tax exclusion amount (often labeled as the "Tax Free Amount" or referred to by a formula–the formula might be one defining the "Marital Deduction Amount" instead, but the effect is the same) to a certain person or persons, and the balance of your estate (your remaining property after subtraction of the estate tax exclusion amount) to someone else, you should be aware that *if your estate plan is more than 5 years old*, the amount passing to each of your beneficiaries has drastically changed. That is because the estate tax exclusion amount was only $675,000 in 2001 (and even less than that in prior years). Thus, your "primary beneficiary" (the person who is designated to receive your remaining property–supposedly, the "bulk" of your estate) may now receive nothing from you upon your death.

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2. Gift Tax Annual Exclusion Amount. The amount that a person (a "donor") can give to another person in one year as a "tax free gift" has gone up to $12,000 for 2006. Thus, a married couple can give $24,000 in cash or other assets to each recipient in 2006 and not make a taxable gift.

Who Should be Making Tax Free Gifts? Individuals or married couples with "taxable estates" should take advantage of the gift tax annual exclusion each year by making tax free gifts to children and other loved ones. These gifts can help reduce the amount of estate taxes payable at death. For example, a married couple with 3 children and 6 grandchildren can give a total of $216,000 in assets away to them in 2006, tax free ($12,000 x 2 x 9). A regular practice of making annual tax free gifts can really save estate taxes down the road. In view of future scheduled changes to the estate tax exclusion amount (an eventual drop back down to $1,000,000 in 2011 and thereafter), persons with estates greater than $1,000,000 can be said to have a "taxable" estate. Of course, there are only certain ways to transfer assets to minors, such as placing funds in "custodial" accounts (accounts established pursuant to the Texas Uniform Transfers to Minors Act) or setting up 529 plans (both discussed later). Older persons should avoid being listed as the custodian for a minor because those assets will be included in their estate upon death. Gifts to minors and to adults who are not capable of good financial management can also be made to trusts for their benefit. The Trustee of the trust invests the gifted funds and make distributions to or for the benefit of the beneficiary pursuant to the particular terms of the trust. In this way, the gifted funds provide benefits to the child or grandchild but someone else (the Trustee) has control over the funds.

3. Non Citizen Spouse Annual Gift Tax Exclusion Amount. The aggregate amount that one spouse may give to a spouse who is *not a U.S. citizen* as a tax free gift has increased to $120,000 for 2006 (unlimited gifts may be given each year tax free to a spouse who is a U.S. citizen). Spouses who are not U.S. citizens do not enjoy the same estate and gift tax treatment as spouses who are U.S. citizens.

4. Amount of Annual Income Causing Estate/Trust to Reach Highest Income Tax Bracket. When an Estate or (non grantor) Trust has taxable income exceeding $10,500, it reaches the 35% marginal income tax bracket. If the Estate or Trust distributes all of its net income to one or more beneficiaries, then it will not pay any income taxes. In that case, each beneficiary will pay income tax on the amount of income he or she received from the Estate or Trust, in the beneficiary's own tax bracket.

5. Generation-Skipping Transfer Tax Exemption ("GST Exemption") Amount. The 2006 GST exemption amount is the same as the estate tax exclusion amount: $2,000,000. Of course, lifetime allocations of GST exemption reduce the amount of GST exemption available at death to allocate to generation-skipping transfers occurring or created at death. In some cases, lifetime transfers made to trusts are treated as tax-free gifts for gift tax purposes (because the trust beneficiaries have "Crummey" withdrawal powers), but are not "tax-free" transfers for generation-skipping transfer tax purposes. In those cases, a Form 709, U.S. Gift and Generation-Skipping Tax Return, is filed to allocate GST exemption to the transfers, so that future transfers by the trust will be exempt from the GST tax. In a case like this, where no amount of the grantor's lifetime gift tax exemption has to be allocated but some amount of his GST exemption must be allocated to the transfer, the estate tax exclusion amount and the GST exemption amount available at death will differ. This can make a difference when it comes to the funding of trusts created at death. Relatively new GST tax regulations allow certain grantors to rely on "deemed allocation" rules which automatically allocate the grantor's available GST exemption to "GST trusts" without necessitating the filing of a Form 709. While this is convenient, good records need to be maintained of all transfers made to "GST trusts" because the GST exemption available to the grantor's estate at death must be reduced by these deemed allocations.

6. Note that the Lifetime Gift Tax Exemption HAS NOT CHANGED. The amount that a person can transfer, in the aggregate, during her lifetime prior to incurring a federal gift tax still remains at $1,000,000. Use of any part of the lifetime gift tax exemption decreases the estate tax exclusion amount available at death to reduce federal estate taxes on amounts transferred at death. Of course, gifts having a value greater than the annual gift tax exclusion amount are considered "taxable" gifts, reportable to the Internal Revenue Service in a Form 709. In this way, the donor's use of her lifetime gift tax exemption amount is tracked, because a portion of her lifetime exemption is allocated to the "excess gift" (the amount above $12,000, for example, for gifts made to one person in 2006).

Transferring Funds to Minors.

Minors–persons under age 18--are not able to hold legal title to assets. People have always been able to create a trust to hold assets for the benefit of a minor. In fact, most people include a trust like this in their Will (called a "Contingent Trust") to hold amounts passing upon their death to beneficiaries who are too young to manage assets. With respect to making gifts to minors during life, however, many donors do not want to go to the trouble and expense of creating a trust now in order to make gifts of relatively modest amounts.

To address this problem, many states, including Texas, originally adopted the Uniform Gifts to Minors Act ("UGMA"). UGMA provided a simple way for persons to make gifts to minors. Basically, an adult was named as "custodian" of a certain account or other asset for the benefit of the minor. The custodian managed the UGMA assets and made all the investment, distribution and other decisions with respect to them until the child reached age 18. In the mid-1990's, many states, including Texas, switched from UGMA to the Uniform Transfers to Minors Act ("UTMA"). The main difference is that UGMA arrangements terminate at age 18 while UTMA arrangements terminate at age 21. Technically, accounts or other assets held pursuant to UGMA or UTMA belong to the minor, subject to control and management by the custodian. The minor's social security number is reflected on the UGMA/UTMA assets, and the minor is taxable on the income earned by the UGMA/UTMA assets. The minor is said to be "vested" in the UGMA/UTMA assets for tax purposes. When the minor reaches age 18 (UGMA assets) or 21 (UTMA assets), the custodial arrangement terminates and the assets must be turned over to the young person. Some custodians, unhappy about this result, attempt to place assets from an expired UGMA/UTMA arrangement into a trust. Technically, the custodian has no power to make such a transfer once the child reaches the applicable age (and, in fact, may not legally have the authority to make such a transfer even prior to the child reaching the termination age of the custodial arrangement). Clearly, there are disadvantages with having large amounts pass to a person who is only 18 or 21 years old.

Our law firm has helped several young people create their own trust to hold the assets they received from the custodial arrangement upon termination. The trust is usually irrevocable for a number of years, and the child's parent (or other financially responsible adult) is usually named as the Trustee. While the trust cannot provide true "spendthrift" protection for the child (protecting the assets from creditors' claims), it may help preserve the assets as the child's separate property in the event of a failed marriage and, due to control by the Trustee, it should prevent profligate spending or poor investing by the young person. The lesson, however, is for donors to be careful regarding the amounts placed in custodial accounts for minors, in view of the early termination age of the arrangement and loss of control by the custodian.

One relatively new way to make gifts to minors to provide for their future education will be discussed next.

A Look at 529 Plans. By Kathryn Connelly.

Twelve friends of mine have either had a baby or announced their pregnancy in the past year. Twelve! The arrival of these babies brings two things to mind: first, gifting opportunities for proud grandparents (and parents); and second, the need to start saving for college. These two forces can come together beautifully in the form of tax-favored tuition payment programs called 529 Plans, so called for the tax code section that governs them. Contributions to 529 Plans qualify for the annual gift tax exclusion, and earnings within the plan currently are not subject to income tax when used for qualified educational expenses.

There are two types of 529 Plans. One is a Prepaid Educational Arrangement or Contract, under which *future* college tuition and required fees (and sometimes room and board) can be purchased now, at today's prices. Eighteen states sponsor a prepaid tuition plan. For some, you must be a resident of that state to participate, and the tuition may be applied toward attendance only at schools in that state; for others, the plans are more flexible, allowing non-residents to participate and allowing the transfer of prepaid tuition to plans in other states. What makes prepaid plans attractive is that your investment is guaranteed. Unfortunately, these plans in some states (like Texas) are closed to new participants. If your designated beneficiary is considering private schools, one alternative available is the Independent 529 Plan, an institution-sponsored plan that allows you to prepay tuition for hundreds of private colleges across the United States.

The second and more prolific type of 529 Plan is the Educational Savings Account. Virtually every state (along with the District of Columbia) sponsors one or more of these plans, in which generally residents and non-residents alike can establish a savings account for any individual beneficiary (such as a grandchild) for the cost of tuition, required fees, books, and room and board at any accredited college or university in the country (plus some foreign institutions). The amounts contributed to the plan are allowed to grow tax-free.

Both kinds of 529 Plans provide estate and gift tax advantages. Contributions to 529 Plans, which can be made only in cash, are gifts to the designated beneficiary of the plan, eligible for the annual exclusion from gift tax (now $12,000 per donor, per beneficiary). Up to $60,000 may be contributed free from gift tax in one year, if accounted for ratably over the next five years. Distributions made from 529 Plans to or for the benefit of the beneficiary are not gifts and therefore are not subject to gift tax. Further, no part of a 529 Plan of which you are the donor is included in your gross estate at your death for federal estate tax purposes, even though you retain control over the plan. (Contrast this with being the custodian of an UGMA/UTMA account.) The exception to this rule is this: if you elect the five-year pro-rata gift tax annual exclusion and die within the five-year period, the amount yet unaccounted for will be included in your estate. Further, earnings within 529 plans can be shifted to the beneficiary with no transfer tax consequences.

Earnings on a 529 Plan are not subject to income tax for the donor or the beneficiary while maintained within the plan. If used for qualified higher education expenses, distributions from the plan (through December of 2010) are not includible in the gross income of the donor or the beneficiary. Congress has not yet acted to extend the tax-free treatment of qualifying distributions beyond this deadline (although it likely will do so). Therefore, (unless Congress takes action) beginning in January of 2011, beneficiaries of 529 plans will have to include in gross income the portion of any distribution that represents earnings that occurred within the plan. While this clearly reduces the tax benefits of 529 plans, you still save taxes if your designated beneficiary is in a lower tax bracket than you (which is likely when you consider the gross income of a typical college student).

A remarkable aspect of 529 Plans is the amount of control retained by the donor, even though effective ownership of the funds has been transferred. Donors may direct the timing and amount of distributions and may even change the designated beneficiary of a plan, for any reason. Such change has no tax consequences if the new beneficiary is a family member of the old one (including spouses and first cousins) and in the same generation for generation-skipping transfer tax purposes. Donors can also "rollover" the funds in one 529 Plan to another 529 Plan, tax-free. If you need to, you can get a refund of funds you contributed at any time, but the earnings in the plan will be taxed as income to you and are subject to an additional 10% penalty.

Donors have no control over how the funds in the plan are invested, although you can usually select from two or more investment strategies when the plan is established. Most plans offer (i) an age-based strategy, allowing for a stock portfolio in the early years and switching to bonds or cash as the beneficiary reaches college age, and (ii) a static strategy, providing a fixed asset allocation. Investment options should be considered carefully, since returns are not guaranteed, and a 529 savings plan could lose value.

Another fact to investigate is limits to the amount a donor can contribute to each 529 Plan. These vary by plan and are determined by an actuarial estimate of the cost of qualified education expenses for five years at an undergraduate institution located in the sponsoring state; some states have limits as high as $250,000. Also, fees for plans vary and can be from 1% to 2% and higher. For more information, consult your financial advisor, review sample 529 Plans managed by companies such as Fidelity, Vanguard, and Charles Schwab, and do your own research online at www.savingforcollege.com. If you are a proud new grandparent, now is a good time to start giving towards your grandchild's future education, while giving yourself tax savings, with a 529 Plan.

Contact Us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown below.

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