ESTATE PLANNING TODAY

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Estate Planning in the New Millennium

Estate Tax Changes for 2000

The new year brings several changes to the estate tax rules. Most notably, the "applicable exemption amount" (the amount of the estate that is exempt from estate tax) increases from $650,000 to $675,000. Many of you will remember that the exemption was set at $600,000 from 1986 to 1996. Since 1997, the exemption has slowly increased. The following chart shows the remaining schedule for increasing the applicable exemption:

Year	Exemption
2000 and 2001	$675,000
2002 and 2003	$700,000
2004	$850,000
2005	$950,000
2006 and thereafter	$1,000,000

The law also provides for inflation adjustments for several key values commonly used in estate planning. The $10,000 annual gift tax exclusion is scheduled to be adjusted for inflation, but rounded down to the next lowest $1,000. As a result, no adjustment is anticipated for the next few years. The $1,000,000 generation-skipping transfer ("GST") tax exemption is also inflation adjusted, rounded down to the nearest $10,000. The GST exemption for 2000 is $1,030,000.

For most of our clients, these changes do not require any action on your part. Wills prepared by our firm are designed to take into account the impact of these changes automatically, to "optimize" the funding of trusts in the year of the testator's death. For clients who are involved in gifting programs that involve giving away all of their applicable exemption amounts, the increase in the exemption presents an opportunity to make additional gifts. Please give us a call if you would like to discuss how these rules may impact your estate plan.

Repeal of the Estate Tax?

As campaign rhetoric heats up for the November elections, many are looking for a repeal of the "Death Tax." Is the estate tax soon to be a thing of the past?

Federal transfer tax collections constitute a relatively small amount of the federal budget. In 1998, for example, estate and gift taxes accounted for only about 1.2 percent of all taxes collected. Only a small fraction of the U.S. population has a net worth in excess of $675,000. As a result, although most people when asked about the "death tax" support its repeal, the people whose estates are subjected to the tax are a small minority of the overall population.

Unfortunately, estate taxes are imposed upon estates of decedents that most voters would characterize as "rich." This fact makes outright repeal of the estate tax politically difficult: If repeal of the tax is viewed as "tax relief for the rich," its prospects for success are limited.

Time will tell whether the estate tax is on its death bed. More likely in the short term is additional estate tax relief for owners of family farms and businesses. These groups attract the considerable political support necessary to obtain tax relief in an era when deficit reduction still keeps much of Congress's focus. Thus, although outright repeal may be unlikely, we cannot rule out the prospect of getting some limited relief. Stay tuned for future developments. We'll do our best to keep you posted.

In this, our Inaugural Issue...

Big Changes to the Community Property Rules

Effective January 1, 2000, a husband and wife living in Texas have the ability to convert any separate property owned by either (or both) of them into jointly owned community property. Texas is a "community property" state. Under Texas law, your separate property is: (i) property you owned prior to your marriage; (ii) property you acquired during your marriage by gift or inheritance; and (iii) property you obtained while living in a "separate property state" (such as New York or Illinois). Everything else is jointly owned community property.

Prior to January 1, 2000, spouses who wanted to change their community and separate property rights could sign a marital property agreement (or pre-marital property agreement) converting community property into separate property; however, spouses could *not* convert separate property into community property. That is, spouses could "opt-out" of the community property system but they could not "opt-in." The new law remedies this imbalance by allowing marital property agreements to go both ways.

Why would spouses elect to convert separate property into community? Perhaps you live in a home that is your separate property but your spouse wants it to be "our home," not "your home." Perhaps you and your spouse have been married a long time and most of your property is community, but there is some separate property (e.g., because one of you inherited property during marriage, or because you came to Texas from a separate property state) and you want to help ensure that the surviving spouse will never have to go to court to defend his or her claim that your property was all community. In these cases, a "conversion to community" may be the solution.

Community property also offers some significant tax benefits. One is the so-called "basis step-up": upon your death all property you own gets its cost basis adjusted ("stepped-up") to the market value as of the date of your death. In effect, all capital gains taxes you would have paid if you had sold the property just before your death are forgiven. The step-up applies to your separate property and both halves of the community property, but not to your spouse's separate property. Therefore, a conversion to community can effectively double the capital gains forgiveness when one spouse dies. There are other significant estate tax advantages, especially where one spouse is a non-citizen or where one spouse is substantially wealthier than the other.

There are some disadvantages to creating community property as well. If there is a divorce, you keep 100% of your separate property; however, community property is divided between the parties in whatever proportion the court feels is "just and right." This might mean 50-50; it might also mean 70-30. Likewise, at death, your Will controls 100% of your separate property but only 50% of the community property. If you have concerns about retaining complete ownership of your property, you might be better off using other planning techniques. On the other hand, if you have a long, stable marriage, converting your separate property into community property could be a great idea.

The Texas legislature has also enacted a new equitable interests statute, which can have a dramatic effect on your marital property. For example, let's assume you bought a house for $10,000 down and a $90,000 mortgage, then you got married, and then you paid off the mortgage with your community property wages. Under the old law, you should still own the house free and clear of any community property claims. Under the new law, the house is 10% your separate property and 90% community property.

Simplified College Funding

With trembling hands and wrinkled brows, parents of college students find themselves writing ever larger checks for their children's college tuition and related expenses. With the cost of a college education growing at rates two to three times the rate of inflation, it is imperative that parents of tomorrow's college freshmen do one thing: *be prepared!*

To assist parents in planning for future educational expenses, several states have established qualified state tuition programs ("QSTP"). QSTPs are tax favored educational savings plans; they come in two varieties--Prepaid Tuition Plans and Savings Plans.

Prepaid Tuition Plans are state operated trusts which allow parents to freeze tuition costs by prepaying tuition at current levels. These plans are normally restricted to tuition rates at in-state public universities; however, if children decide to attend a private institution or leave the state, the funds (and possible growth) are available for use at those institutions. *Savings Plans* are essentially state operated investment funds which rely on the growth inside the plan to keep pace with the growth rate of educational expenses. When children begin college, the funds are withdrawn to cover educational expenses. Savings Plans offer more flexibility in college choice and potentially greater investment returns to keep pace with tuition expenses at both public and private universities.

These plans offer income, gift and estate tax advantages to parents (and grandparents) interested in saving for college. While contributions are not income tax deductible, the earnings on the plan accumulate tax free and are taxed only when withdrawn. Each withdrawal is made up of a non-taxable return of principal and a taxable distribution of income. The income portion of each withdrawal is taxed to the student (to the extent used for educational expenses) at the student's (normally low) tax rate. Plan gifts qualify for gift and generation-skipping transfer tax annual exclusions; and by an election unique to these plans, a single contribution may be treated as if made over a five year period (i.e., a one time $50,000 gift may be counted against your next five years' worth of annual exclusions). Equally unique, plan assets are shifted out of the donor's estate despite the donor's retained ability to change beneficiaries or even reclaim plan assets.

While Texas offers only a Prepaid Tuition Plan (the "Texas Tomorrow Fund"), many other states offer Savings Plans which are available to non-residents. Several brokerage firms offer access to Savings Plans to their clients in Texas.

Texas Legislature Updates Prescribed Impaired Judgment Documents

The Texas Legislature recently updated what we refer to as impaired judgment documents – Directives to Physicians (or "Living Wills") and Durable Powers of Attorney for Health Care. These legislative changes apply to documents signed on or after September 1, 1999. For those of our clients who signed these documents before September 1, 1999, your documents are still valid, and are controlled by prior law. For clients who are considering updating their estate plans in the near future, or who may wish to change the persons named as agents in their current Durable Powers of Attorney for Health Care, the new form of these documents will apply.

The *Directive to Physicians and Family or Surrogates* replaces the former Directive to Physicians. The new Directive has been completely rewritten. It now divides medical conditions into two categories–"terminal conditions" (from which you are not expected to survive by more than six months) and "irreversible conditions" (which are incurable, but for which more than six months of life is expected). As to each category, the patient has the choice of whether to have life sustaining procedures withheld or applied. The new form also simplifies the rules somewhat as to who may serve as witnesses.

The *Medical Power of Attorney* replaces the former Durable Power of Attorney for Health Care. The only change made to the document (other than the obvious change of name) is that only one of the two witnesses must satisfy the statute's witness qualification requirements. However, the statute governing the form has been clarified to provide that an agent named under a new Medical Power of Attorney has the authority to make life sustaining treatment decisions where no Directive has been signed (this was not the case under the former Durable Power of Attorney for Health Care).

Etc. Etc. Etc.

- *Rights of Survivorship*. If you have trust planning in your Will, you should make certain that none of your accounts or other assets are registered in the form of "joint tenants with right of survivorship," "JTWROS," "Jt. Ten.," "POD," "TOD" or as "Trustee." Instead, the accounts should be registered as "tenants in common," or in your individual name(s) without any indication of a survivorship right. Proper titling of accounts ensures that your Will, and not the account agreement, controls the disposition of all of your assets.
- *Coordinating Beneficiary Designations*. Assets like life insurance proceeds, pension plans and IRAs pass to others at the time of your death pursuant to a "beneficiary designation." In other words, when you die, these assets do not go to the people (or trusts) named in your Will, but to the person named in the beneficiary designation. Therefore, it is vitally important that your beneficiary designations be reevaluated and properly coordinated with your estate plan each time your estate plan is revised.
- *Filing Gift Tax Returns*. Gift tax is paid by the giver, not the recipient. Each person is entitled to exclude the first $10,000 per recipient per year from the computation of taxable gifts. For gifts to trusts, the rules are more complex. Depending on the wording of the trust agreement, the excluded amount might be zero, $5,000, or $10,000 per trust beneficiary. If amounts in excess of the available exclusion are given, a gift tax return is required. If you have created a trust that lasts for the *lifetime* of a child or younger beneficiary, it is possible to exempt the value of property in the trust from death taxes at the beneficiary's death, by allocating a part of your Generation-Skipping Transfer Tax

exemption to the trust. The IRS uses the gift tax return form (Form 709) to keep track of the use of this exemption. Therefore, in order to take advantage of this exemption, you should file a gift tax return (due at the same time as your income tax return). Form 709 is filed even if no taxable gift has been made, since it contains a special section to allocate your GST exemption. Please contact us or your CPA to discuss this matter further if you made gifts to a lifetime trust last year.

Let Us Hear From You

Do you want to find out more about how something in this issue affects your estate plan? Do you have a question that you would like to see addressed in an upcoming issue? Do you have a new mailing address? Would you like to be removed from our mailing list or do you know someone who would like to receive a copy of our newsletter? Please write or send a fax to the address below. Or you can e-mail any of us as listed at the right, or send general e-mail to "admin@drjg.com."

Coming Soon to a Web Site Near You

Our site on the World Wide Web is currently under construction. We hope that it will be up and running in the next few weeks. Once it is activated, you will be able to visit us at **drjg.com**. In the meantime, you can reach us by phone, fax or traditional mail at the address and phone number shown below. You can also reach any of us by e-mail addressed to:

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