ESTATE PLANNING TODAY

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Year-End Gift and Estate Planning

Although you may hear a lot of tips about year-end income tax planning, don't forget about the equally important area of annual gift and estate tax planning. Even in light of potential changes to the estate and gift tax laws, it is essential that you focus on "use it or lose it" gift opportunities prior to December 31, 2000. In addition, now is a good time to follow up on Crummey notices and other important housekeeping matters.

Annual Exclusion Gifting

Estate planning for clients with taxable estates often involves making significant gifts to children, grandchildren and other loved ones. Mindful that people might reduce the size of their estate (and therefore, the size of the estate tax payable at death), Congress enacted a federal gift tax. The gift tax is payable by the giver ("donor"), not by the recipient ("donee"), and is designed to work in a unified way with the federal estate tax.

Congress does not require people to report every birthday and holiday gift that they make. Under current law, every individual is allowed to give up to $10,000 per person per year to any one or more individuals without the need to file a gift tax return. Further, these $10,000-and-under gifts do not use up any portion of your tax-free amount. That is, the $10,000 annual present-interest exclusion is in addition to the $675,000 lifetime tax-free amount.

For example, if you have three children, you can give each of them up to $10,000, for a total of $30,000 and, next year, you can do it again, and so on. If, in addition, you have five grandchildren, you can give each grandchild $10,000 per year, bringing the total to $80,000 per year, all without reducing your $675,000 amount. In addition, your spouse can make $10,000 per year gifts to the same people, thus doubling the amount that can be transferred tax free. (In the example, you and your spouse together could give $160,000 per year tax free--$10,000 from you plus $10,000 from your spouse to each of eight children and grandchildren.)

You needn't give cash, of course. You can give stocks, bonds, interests in land, interests in your family partnership, or other property. When non-cash gifts are made, the amount of the gift is the fair market value of the property on the date of gift. Unlike inherited property, the donee of a gift does not receive a new cost basis in the property received. Instead, the donee receives the donor's cost basis. If the donee later sells the property, he or she will report the same gain or loss that you would have if you had sold the property for the same price. You can use all or any part of your $10,000 exclusion each year, but there is no provision to carry forward the unused annual exclusion. Therefore, as December 31 draws near, remember that the $10,000 annual exclusion is a "use it or lose it" estate planning strategy.

Medical and Education Expenses–Another Opportunity for Tax-Free Gifts

Your ability to make tax-free gifts is not limited to the $10,000 per person, per year, annual gift tax exclusion. The same federal statute which permits annual exclusion gifts, also provides an exclusion for transfers for certain qualified educational and medical expenses. These exclusions are *in addition to* the annual $10,000 gift exclusion.

Qualified Educational Expenses. Qualified educational expenses are payments made directly to an educational organization which maintains a regular faculty, curriculum, and an enrolled student body. For example, the direct

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payment of $15,000 to your child's or grandchild's college or university for his or her tuition would be a qualified educational expense. If in the same year you also made a $10,000 annual exclusion gift to the student, you would have effectively transferred $25,000 for his or her benefit without making even $1 in taxable gifts. Direct tuition payments for primary or secondary private school also qualify.

Qualified Medical Expenses. Qualified medical expenses are payments made directly to a medical care provider. Under the Code, "medical care" includes not only the diagnosis, treatment, and prevention of disease, but also includes transportation essential to that care, certain long term care services, and insurance covering medical or long term care. Continuing our example above, assume your grandchild breaks his or her arm in an intramural sports activity and you pay, directly to the provider, the cost of ambulance transportation, the treating physicians, and the related emergency room charges–a total of $2,500. Now, in addition to the $10,000 annual exclusion gift and the $15,000 qualified educational expense transfer, you have made an additional $2,500 qualified medical expense transfer, bringing the grand total of non-taxable transfers for the year to $27,500.

Outright Gifts Do Not Qualify. The key to qualified educational and medical expense transfers is the direct payment of the expense to the provider of the educational or medical services. If in the preceding example you instead transferred funds into your grandchild's checking account so he or she could pay these expenses, then only your original $10,000 annual exclusion gift would be free from gift tax. In essence, the total transfers for the year would be $27,500, only $10,000 of which (or $20,000 for a married couple) would be gift tax-free.

Charitable Giving Strategies

The end of the year is a prime time to consider making significant charitable contributions. In addition to supporting a good cause and reducing the value of your estate, charitable gifts entitle you to obtain valuable income tax deductions. If you itemize deductions for income tax purposes, you can deduct charitable contributions of cash or property to a qualified donee. For most donors, contributions are fully deductible. If you plan on making significant contributions, however, a number of complex deduction limitations may apply.

Contribution Limits. Generally, you can deduct gifts to public charities such as churches, educational organizations and hospitals up to 50% of your adjusted gross income. Lower deduction limits may apply to contributions if you contribute property instead of cash, or if the donee is not a public charity. For example, if you contribute capital gain property to a public charity, your charitable deduction is limited to 30% of your income. However, if you elect to deduct only your basis in the contributed capital gain property (rather than its fair market value), the contribution is subject to the 50% limitation rather than the 30% limitation. Contributions of cash and nonappreciated property to private charities (such as family-controlled foundations) are subject to the 30% limitation. The deduction for contributions of capital gain property to private foundations is limited to 20% of your income. If your charitable contribution exceeds the applicable percentage limits, excess contributions can be carried forward and deducted over the five following years.

Charitable Bequests. Rather than making substantial lifetime gifts, many of our clients choose to make significant charitable bequests at death. This strategy generally means that no income tax deduction will be available. On the other hand, the donor is assured that the gift will be made only after the donor no longer needs the donated property. From a tax standpoint, your estate (and your heirs) are often better off if retirement assets and IRAs are directed to charity, rather than other assets you hold at death. Unlike a charity, noncharitable recipients of these assets must pay both income *and* estate tax on retirement plan assets. For example, if you give your $1 million stock portfolio to charity, and your $1 million IRA to your children, the charity will receive $1 million, but the children will receive only about $520,000 after tax. If instead you give the IRA to charity, and the portfolio to the kids, the charity still receive $1 million (it pays no tax) and the children receive about $866,000.

A Special Word of Caution. Before you name a charity as a beneficiary of your retirement assets, however, it is imperative that you visit with us or another qualified tax advisor. Naming a charity can have a dramatic negative impact on the schedule that applies to you and other beneficiaries of your retirement assets in taking minimum required distributions from your retirement accounts.

EDITORIAL

by Bernard E. Jones

Estate Tax Repeal or "Bait and Switch"?

Whether you support Bush or Gore, watching the twists and tactics of the presidential race over the last several weeks has probably left you amazed, occasionally angry, and downright confused. I can sympathize and I can assure you of this: the only thing more confusing than trying to guess the next president is trying to guess whether the next president is going to repeal the estate tax.

Is the estate tax going to be repealed? If Gore wins, my answer is "almost certainly not." If Bush wins (and as we go to press, it looks like he *will* win), my answer is, "probably yes but that changes nothing."

Don't get me wrong, repeal would be great news–for all my clients who are positive that they're going to live for at least 10 years. (That's because the bill to repeal the estate tax–the bill that Clinton vetoed and that will probably be reintroduced next year–slowly phases in the repeal over a ten year period. In the meantime, there is only a small reduction in the top marginal rates.)

Nevertheless, if you *know* you're going to live for at least 10 years, repeal solves your estate planning problems: When the estate planning boat sets sail, you can just stand contentedly on the dock, secure in the knowledge that you have the best estate plan available, i.e., *longevity*.

On the other hand, if you *know* that you're *not* going to live for 10 years, estate tax repeal is not great news, but it's not bad news either. It just means that, for you, nothing has changed. You should buy a ticket and climb aboard, implementing a good estate plan designed to save your family hundreds of thousands of dollars in estate taxes.

The catch is, how many people *know* when they are going to die? I suggest the answer is: only a tiny (and unhappy) fraction of us. If you're like most people, you have every intention of living for 10 years–probably a lot longer–but you recognize the risk that something could happen sooner. For you, estate tax repeal is problematic.

Do you take a cruise or stay on the dock? Do you go ahead and make an estate plan? Or do you cut down on fried foods, quit smoking, stop drinking, exercise daily, and hope you live longer? (Note: even if you don't actually live longer, it will definitely *seem* like it.)

I believe that, when you consider the relationship between the economy and the politicians, the answer is clear: *You should do your estate planning now, as if there were no chance of estate tax repeal, because even if it is repealed,* ***it probably won't stay repealed***.

Let's try to look 8 months into the future:

Bush is president. The Senate and House both remain Republican controlled (albeit by only the narrowest of margins). The two committees responsible for all tax reform (the Senate Finance Committee and the House Ways and Means Committee) both have new, inexperienced chairmen, but they are both Republicans.

Bush keeps his promise and offers legislation repealing the estate tax, and the House and Senate both pass the legislation. Of course, like prior proposals, repeal is phased in over 10 years (which appears to be necessary to comply with the so called "Graham-Rudman" rule that restricts all legislation that might create budget balancing problems). Nevertheless, we all cheer and thank our friends in Washington who have promised to free us from estate taxes in only 10 years.

Now, let's try to look 4 years into the future:

Bush is in his 4th year in office, during which the Dow Jones has dropped 20% and the U.S. economy has officially entered a recession. (Remember bear markets? Remember recessions?) Income tax revenues have taken a dive and the Congressional Budget Office now predicts significant budget deficits for the foreseeable future. The outraged citizens unfairly blame Bush for the recent downturn (just like they unfairly credited Clinton for the boom times while he was in office) and they demand a change.

So, in November 2004, the Democrats win back the White House and get control of Congress, having pledged to balance the budget with "no new taxes."

The Democrats now have a problem: They promised "no new taxes" yet the only way they can balance the budget is with increased tax revenues. (They're not likely to cut expenditures.) How do they get increased tax revenues with "no new taxes"? Simple: *They undo the repeal of the old estate tax*.

They start small. Initially, they simply "postpone" the repeal for a few years. A year later, they postpone it further. Then a national poll indicates that most Americans believe the so-called "rich" don't pay enough taxes, and all the "moderate" politicians (especially those up for reelection) rush to "restore equity" to the tax system by voting to completely rescind estate tax repeal. And instead of genuine estate tax repeal, we get "Bait and Switch Repeal."

I honestly cannot say whether I think my predictions will come to pass. The future is uncertain. But perhaps that is the most important point I can make: ***Don't let political posturing lull you into a "wait and see" false sense of security***.

A good estate plan–designed and implemented *now*–is a real solution. A politician's promise to do you a favor in 10 years is at best an alibi for procrastination.

Crummey Notices

As noted on page 1, outright gifts of cash and property qualify for the $10,000 per year exclusion from gift tax. If a gift is made to a trust, however, the rules are more complex. The $10,000 per year exclusion is available only with respect to gifts that qualify as "present interests." A gift of a "future interest" does not qualify. Most trusts are designed to provide future benefits to your family. To ensure that gifts to trusts are eligible for the gift tax exclusion, many trusts contain "withdrawal rights." By giving beneficiaries the present right to withdraw the amount of any gifts made to the trust (up to $10,000 per year), you effectively convert their future interests in the trust into qualifying present-interest gifts.

If the beneficiary is a minor, then his or her guardian exercises (or elects not to exercise) the right for the beneficiary. Thus, for example, when you make gifts in trust for the benefit of your own minor children, your spouse, as their natural guardian, is generally the one to decide whether to withdraw the gifts.

Adult beneficiaries with withdrawal rights may either exercise the right (i.e., take the money) or choose not to--in their own, absolute discretion. This is one aspect of withdrawal rights that can be troubling to clients; understandably, clients are concerned about giving their 19-year-old child the right to take $10,000 out of trust (or $20,000, if you and your spouse have both made gifts). However, in the vast majority of cases, the child will understand your estate planning goals (that is, that you are trying to minimize taxes and maximize the child's inheritance). As a result, he or she will choose not to make a withdrawal.

The IRS takes the position that merely having withdrawal language in a trust agreement is not enough to make gifts to the trust eligible for the annual exclusion. The trust beneficiary must *know* that the right exists. Therefore, each year that a gift is made to a trust the trustee should notify each trust beneficiary that a gift has been made, and that the beneficiary has a withdrawal right. If you are making gifts to a trust, you should make sure that the trustee gives the proper notice. Let us know if we can help ensure that the trustee is complying with this important legal requirement.

Contact Us:

If you have any questions about the material in this issue, or if we can be of assistance to you in your estate planning, feel free to contact us at the address and phone number shown below. You can also reach us by e-mail addressed to:

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