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FEDERAL TAX LAW

With the Republicans gaining a majority in both the House and the Senate after the November elections, there has been a great deal of speculation about a permanent repeal of the gift and estate tax. We will continue to watch with great interest.

Current Exemption Amounts

This year, the gift tax exemption increased substantially, from \$675,000 in 2001 to \$1 million. Under current law, the gift tax exemption will remain fixed at that amount. The gift tax annual exclusion amount increased to \$11,000, and is subject to annual indexing. The generation-skipping transfer tax exemption increased to \$1,100,000, and will go up to \$1,120,000 in 2003. In 2004, the GST exemption will be tied to the estate tax exemption. For those wishing to make tax free gifts, these increases provide planning opportunities.

The estate tax exemption also increased to \$1 million in 2002. The next increase in the estate tax exemption will be to \$1.5 million in 2004.

Generation-Skipping Transfers

Like most tax laws, the rules governing the allocation of the GST exemption have always been complicated. In some cases, taxpayers have failed to allocate their GST exemption properly or in a timely manner, leading to the possibility of increased tax liabilities. Changes to these rules were made along with the changes to the gift and estate tax laws that became effective last year. The changes include new automatic allocation, retroactive allocation, and late allocation rules intended to alleviate the negative consequences associated with missed allocations. However, these rules could have some unintended consequences for those making transfers to certain trusts. If you make a gift that must be reported on a federal gift tax return, the professional responsible for the preparation of that return will be able to make sure these rules are properly applied in your case. For gifts to trusts that will not be reported on a gift tax return, we recommend that you contact us to ensure that the transfer will be treated properly under the new rules.

FAMILY LIMITED PARTNERSHIP UPDATE

With respect to the valuation of transferred interests in family limited partnerships, in some cases the IRS continues to challenge valuations reported in gift and estate tax returns. The IRS has still not prevailed on any argument that would, as a matter of law, allow it to disregard all family limited partnerships for transfer tax purposes. Recent cases illustrate the importance of setting up a partnership properly. The cases also illustrate the importance of proper administration during the term of the partnership.

We recommend that every client who has a family partnership review some administrative matters. After the partnership has been legally formed, the following steps must be taken:

1. Your letterhead, invoices, and other business stationery should be ordered or modified to reflect the full name of the partnership.
2. A bank checking account should be established to reflect the partnership's name. Call your bank and ask for several copies of their partnership account signature cards and other required authorizations.
3. If any loans are to be transferred to and assumed by the partnership, make sure that your accountant determines that no adverse tax consequences will result from such assumption of liability. New loans made in connection with the partnership's business should be made in the name of the partnership.

4. All leases, contracts, obligations and other arrangements which you have previously entered into in connection with the partnership business should be modified, assigned, or rewritten in order to reflect the fact that the partnership is the contracting party to each lease, contract, or obligation.
5. Any assets so transferred become the property of the partnership. Therefore, title to these assets must be transferred to the name of the partnership, by the method appropriate for the particular assets. For example, real estate contributed to a partnership should be transferred by deed.
6. Any insurance related to the partnership's business must be acquired by the partnership, either by assignment or binder. Accordingly, your insurance agent should be instructed to make such transfers or purchases of new coverages as soon as it is conveniently possible upon the commencement of business by the partnership.

When assets that once were titled to an individual are transferred to an entity, it is sometimes easy to forget to comply with certain formalities. However, we cannot overemphasize the importance of maintaining the formal integrity of the partnership entity, which is a separate "person" from any of its partners for legal purposes. Good business practice will require proper observation of limited partnership formalities. Accordingly, it is important that all partnership transactions be conducted in the name of the partnership and that the partners comply with the terms of the written partnership agreement. For instance, it is important to realize that you are going to be required to operate in the following manner:

1. All legal documents, including contracts, insurance plans, loans, leases, purchase contracts and investment accounts should be made in the name and on behalf of the partnership.
2. Business conducted by the partnership should be conducted in the partnership name. Actions taken on behalf of the partnership should be taken by "[Name of general partner], General Partner."
3. Any change in partnership interest (for example, as a result of additional capital contributions being made by a partner) should be reported to your accountant and to us.
4. Any change of partnership name, registered office or registered agent should be reported to us so that appropriate filings can be made.
5. Distributions made from the partnership to the partners must be made in the manner provided in the agreement. Most agreements state that distributions are to be made to partners pro rata based upon their respective ownership percentages. It is therefore not appropriate to make distributions to only one or two partners.

If the partnership proposes to engage in a transaction affecting its basic structure or existence, such as an acquisition of another entity or a dissolution of the partnership, you should consult with us to ensure that all of the necessary documents are prepared, executed and, where necessary, filed with the appropriate governmental authorities. Failure to execute the proper documents and make the filings required by law could result in any such transaction being void and ineffective.

"529" COLLEGE SAVINGS PLANS

Some clients have expressed an interest in establishing "529" savings accounts for children and grandchildren. A "529" account refers to an account established pursuant to a qualified tuition program established by a state and operated in accordance with section 529 of the Internal Revenue Code. Texas offers the Texas Guaranteed Tuition Plan (formerly known as the Texas Tomorrow Fund), and Tomorrow's College Investment Plan. The programs are attractive for a variety of reasons.

Any individual can establish a 529 savings account. Unlike certain trusts and TUTMA accounts, which become the property of the beneficiary, the person who establishes the 529 account retains control over the account. He or she has the right to designate a beneficiary, to change the beneficiary, to direct the payment of account funds, and even to reclaim the funds (subject to a penalty). Income accumulated in a 529 savings account is not subject to federal income tax, and neither are withdrawals for "qualified educational expenses". Contributions to 529 savings plans are considered to be completed gifts for gift and estate tax purposes. Such contributions qualify for the \$11,000 gift tax annual exclusion. A donor can elect to make five years worth of annual exclusion gifts to such an account in one year and have it treated as if it had been made over a five-year period.

Although these plans offer many advantages, there are disadvantages, including the taxation and penalties associated with withdrawals that are not for "qualified educational expenses", and the fact that the donor may not personally invest the funds. If you interested in learning more about qualified tuition programs, please contact us or your investment advisor.