



Advanced Planning Strategies

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Dear Reader,

The economic stimulus bill appeared to be derailed indefinitely at the time this letter went to print. Any broad-based tax reform bill will require significant compromise, given the current composition of the Senate. However, several smaller measures may be considered. The Charity Aid, Relief, and Empowerment (CARE) Act of 2002 was introduced by Senators Santorum and Lieberman last month. This bill contains many of the provisions discussed in earlier versions of the bill. The bill contains a provision to allow nonitemizers to deduct charitable contributions while claiming the full standard deduction amount. However, we expect other proposals to be considered. It is expected that President Bush will back any charitable proposals that substantially follow his faith-based initiatives.

The President called for reforms to protect retirement plans of American workers. This was largely spurred by the Enron Sec. 401(k) plan scandal. The President created a task force to examine this problem. Currently, about 42 million employees participate in Sec. 401(k) plans and have over \$2 trillion in their accounts. Under present law, employees can be forced to hold employer stock for lengthy time periods and blackout periods can be imposed during which employees cannot control plan investments. The protection proposal would

- provide employees with greater freedom to diversify investments. Employees with 3 years of participation would be permitted to sell employer stock received in matching contributions.
- treat senior executives and other employees the same during blackout periods with respect to trading employer stock
- charge employers with fiduciary responsibility for plan investment decisions during blackout periods
- require advance notice of blackout periods, along with quarterly account statements

Knowledge is not power. Only knowledge in use is power.

FUNDING YOUR CHILD'S OR GRANDCHILD'S COLLEGE EDUCATION

College funding, including the most effective method to provide such funding, is a significant concern for parents and grandparents. According to a recent survey, the average annual cost of private college tuition is \$25,000. Over the past 10 years, the college inflation rate has averaged 5 percent, according to a College Board study in 2000. From the period 1990 to 2000, public educational institutions have increased their tuition rates by 50 percent (adjusted for inflation), and private colleges and universities have increased their tuition by 35 percent.

The increase in college education costs is an important issue for many families, who view higher education as the key to unlocking future opportunities for their children or grandchildren. Several planning options have traditionally been available, such as the use of Series EE Bonds, employer-provided education assistance, and income exclusions for qualified scholarships. The best planning opportunities, however, have emerged over the past 5 years. In response to the increasing cost of college tuition and reductions in state aid for educational expenses, the federal government has created new ways for private individuals to fund college education. Two techniques that are getting greater attention are the Coverdell Education Savings Account (formerly referred to as the Education IRA) and Sec. 529 plans. This letter addresses these two planning options.

COVERDELL EDUCATION SAVINGS ACCOUNT

Education IRAs were first introduced in 1997. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) enhanced this planning tool and changed its name to the Coverdell Education Savings Account (ESA).

Under current law, up to \$2,000 per year can be placed in an ESA for the benefit of any child. The \$2,000 limit applies per beneficiary, not per donor, thereby preventing several family members from contributing the maximum amount to an account for the benefit of one child. Contributions cannot be made to an ESA after a beneficiary reaches age 18.

The ESA's primary advantage is that, although contributions do not generate an income tax deduction for the donor, the earnings on the account are excluded from income (they are tax free) as long as the distributions are used to pay for qualified educational expenses. Qualified education expenses include tuition, fees, books, supplies, and equipment required for enrollment or attendance at a qualified educational institution. Amounts distributed from an ESA do not, however, qualify for the Hope or Lifetime Learning Credits. Under EGTRRA, distributions from ESAs can be withdrawn tax free if used for their intended purpose in the year a Hope or Lifetime Learning Credit is claimed, provided that the distribution is not used to fund the same expenses for which the credit is claimed.

One of the ESA's limitations is a requirement that any excess funds be distributed to the named beneficiary within 30 days of attaining the age of 30. The distribution will be subject to ordinary income tax and a 10 percent penalty but can be avoided by transferring the account to a family member. Family members of the named beneficiary for this purpose include a spouse, son or daughter, brother or sister, father or mother (or an ancestor of either), niece or nephew, aunt or uncle, son-in-law or daughter-in-law, father-in-law or mother-in-law, and brother-in-law or sister-in-law. If the account is in existence for a long time, however, the 10 percent penalty does not pose a major planning hurdle because its impact is offset by the advantages of tax-deferred compounding in the account (similar to the analysis that used to be conducted for IRAs and pension plans subject to the 10 percent penalty).

An ESA is considered an asset of the child for financial aid purposes. This should be a consideration in planning if the family intends to take advantage of financial aid for college funding.

SEC. 529 PLAN

Sec. 529 plans were first introduced in 1996 and have been enhanced in both the 1997 and 2001 tax legislation. Currently, 48 states sponsor Sec. 529 plans, and EGTRRA 2001 allowed educational institutions to begin to sponsor plans. The number of plans available should spark competition and offer a wide range of options for families considering the use of this college savings vehicle. Information on the various state plans can be obtained at <http://www.savingforcollege.com>.

Sec. 529 plans come in two forms: prepaid tuition plans and savings plans. Although the jury is still out on this issue, it appears that prepaid tuition plans will reduce financial aid eligibility on a dollar-for-dollar basis, while a savings plan will be considered an asset only of the parent (and therefore reduce financial aid by only a fraction). As a result, most new plans, and many older plans, are moving to the "savings" approach.

Pursuant to the 2001 tax law changes, accumulations in a Sec. 529 plan, like accumulations in an ESA, are tax free if used for qualified educational expenses. Unlike the ESA, funds in a Sec. 529 plan do not have to be distributed to the named beneficiary when he or she turns age 30. The beneficiary on a Sec. 529 plan can be changed to a member of his or her family.

Perhaps the most significant advantage of the Sec. 529 plan is the ability to make an immediate gift of \$50,000 to the plan. The gift is treated as a series of five annual-exclusion gifts and therefore does not trigger any gift tax liability. If the donor dies during the 5-year period, however, any annual-exclusion amounts for years after the year of death are included in the donor's gross estate.

Another estate planning benefit available to the donor is the ability to maintain control over the account without triggering estate tax inclusion. A donor to a Sec. 529 plan can be designated the owner of the account and retain the right to change the named beneficiary without violating the estate tax retained-interest rules. This provides a significant benefit over UGMA/UTMA custodial accounts and Sec. 2503 (minors) trusts, which require inclusion of trust assets in the donor's estate if the donor is the custodian or trustee. In addition, the donor/owner of a Sec. 529 plan can have the funds revert back to him or her if necessary, but he or she will be subject to income tax on the gains in the account plus a 10 percent penalty. This is an advantage over the ESA, which requires a distribution of excess amounts to the named beneficiary.

Multiple people can contribute to a Sec. 529 plan for the benefit of one individual. Some actuarial limitations apply, however. According to the proposed regulations issued by the IRS, the maximum amount that may be contributed to a Sec. 529 plan for the benefit of any individual is the actuarial value necessary to fund 5 years of undergraduate education. Individual plan rules may differ, however. Before investing in a Sec. 529 plan, families should investigate the maximum permissible contribution.

Sec. 529 plans are quickly becoming the funding vehicle of choice for college savings. The flexibility that they provide, in combination with the ability to make significant contributions to the account, make the Sec. 529 plan an attractive college-funding option.

RECENT CASES AND RULINGS

IRS FIELD SERVICE ADVICE CONTINUES DEBATE OF VALUATION DISCOUNTS FOR GIFTS OF FAMILY BUSINESS ENTITIES

The recent court cases involving gift and/or estate tax valuation discounts for transferred interests in family business entities have largely resulted in taxpayer victories. The majority of such cases involved family limited partnerships (FLPs). The IRS apparently has not backed off, in spite of its setbacks in litigation. In FSA 200143004, the IRS examines a fact pattern in which a mother transferred municipal bonds and treasury notes to her corporation. Subsequently, gifts of stock were made to children, grandchildren, and great-grandchildren. The gift tax annual exclusion was applied to these gifts after the stock was discounted in value as a result of the minority and marketability discounts.

The IRS suggests that the gifts lacked economic substance and that the corporation has no business purpose and functions solely as a conduit for family wealth-transfer planning. In addition, the argument can be raised under Sec. 2703 that any restriction on the right to transfer such assets can be ignored for the purposes of valuing the gifts of stock. Finally, the IRS questions the amount of the discount in consideration of the fact that all assets of the corporation are publicly traded securities. An FSA is not authority and is a recommendation to counsel by the IRS with respect to proposed litigation. However, it does indicate the IRS's opinion with respect to arguments that should be raised concerning the fact pattern.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

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for the future*



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