



Advanced Planning Strategies

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Dear Reader,

President Bush signed the “Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (H.R. 1)” into law last month. Although the prescription drug coverage portion of the bill was well discussed in the popular press, the law also contains a provision for health savings accounts (HSAs) that replace and enhance medical savings accounts (MSAs). Under this provision, individuals or families with certain high-deductible health coverage can make tax-deductible contributions to an HSA. Income earned by the account is not taxable to the owner, and withdrawals for eligible medical expenses are tax free. The purpose of the HSA is to bridge the gap between the cost of medical expenses and the deductible amount under the qualifying health policy. A high-deductible health plan must have a deductible of at least \$1,000 for an individual (\$2,000 for family coverage). These amounts are indexed for inflation. The coverage also cannot have out-of-pocket expense limits that exceed \$5,000 for individual coverage (\$10,000 for family coverage).

The maximum deductible annual contribution to the HSA is the lesser of (1) 100 percent of the annual deductible under the qualifying plan or (2) the maximum deductible under the current MSA provisions as adjusted for inflation. This limitation is \$2,600 for individuals and \$5,150 for family coverage in 2004. This limit is increased by \$500 for individuals who will attain age 55 by the end of the tax year. An employee’s HSA can also be funded by an employer who can make deductible contributions on behalf of a qualifying employee who is not taxed on the contributions. The HSA provisions are a permanent part of the Internal Revenue Code, unlike the MSAs. Rollovers to an HSA will be permitted from another HSA or MSA.

The following are some of the inflation-indexed tax numbers for federal estate and gift tax provisions for 2004: (1) The annual gift tax exclusion is \$11,000, (2) the tax-free annual limit on gifts to a noncitizen spouse is \$114,000, (3) the maximum estate tax reduction for qualifying real property used in a family farm or business is \$850,000, and (4) the portion of a closely held business interest included in an estate eligible for a special 2 percent interest rate for deferred estate taxes is \$1,140,000. In addition, some estate planning tax figures have statutorily scheduled increases for 2004, which are discussed in the inside report.

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

WHEN TO UPDATE AN ESTATE PLAN

An estate plan that is never updated works about as well as a car that is never serviced. They're both in great condition when they're new, but the wear and tear of the intervening years can take an enormous toll. Since even the most well-conceived plan cannot predict *every* contingency, a careful review of an existing estate plan is critical to making sure that it will continue to meet evolving needs.

The best time to review? Many people find it convenient to conduct an annual estate plan review after they file their income tax return. That way the review becomes a yearly exercise while financial information is easy to access. Other people prefer to use an important date (their birthday, for instance) to trigger an estate plan review. It doesn't matter which method is selected, as long as the plan is reviewed periodically.

KNOWING WHAT QUESTIONS TO ASK

As a starting point for reviewing an estate, determine if any of the following changes have occurred since the estate plan was created:

- Has there been a change in marital status—marriage, divorce, separation, remarriage?
- Are there more children in the family? More grandchildren? Has the number of dependents increased or decreased? Have any children moved out of (or back into) the home?
- Have any relatives or beneficiaries died?
- What about the relationship among family members and beneficiaries? Has it changed significantly between any of them?
- Have there been any changes in anyone's health—both physical and mental—that would materially affect the estate plan?
- Has there been a change in occupation?
- Has there been an address change, particularly a change to another state?

Now determine if there have been any of these other personal or professional changes:

- Have there been any changes in property ownership? Has any property been purchased either jointly or separately? Has any property been transferred to joint ownership? To a dependent? To a trustee? Has a residence in a different state been purchased?
- Has there been any other substantial change in family assets or liabilities? For example, have major assets been acquired, any gifts or inheritances been received, a significant sum of money been borrowed or loaned, or a tax-deferred annuity opened? Have investments been augmented?
- Was a business purchased? Has a business been mortgaged, sold, or liquidated? Has there been any other material change in business circumstances?
- Have there been any changes in the amounts or sources of retirement benefits (pensions, IRAs, profit-sharing plans, and so forth)?

Finally, ask these questions regarding the overall financial plan:

- Have any changes been made to a will, trust agreement, buy-sell agreement, or any other document that will have an impact on the estate plan?
- Has the person named as executor of the estate died? Has any trustee died? Or, has the health of these individuals changed?

- Has any insurance changed? Besides life insurance, this includes health insurance, group insurance, any other employer plan, property insurance, and casualty insurance. Have insurers changed? Have any policies been surrendered? Have any policies lapsed?
- Have charitable intentions developed (or altered)?

Changes in any of the above areas might indicate that an estate plan has become outdated.

KEEPING UP WITH CHANGES IN THE LAW

Federal or state legislation might also have a significant influence on an existing plan. For example, increases in the applicable credit amount (sometimes called the unified credit) mean larger estate tax breaks. In 2004 the amount excluded from payment of estate taxes will be \$1.5 million (up from \$1 million in 2003). The gift tax exclusion amount will remain at \$1 million. In addition, the generation-skipping transfer tax exemption is \$1.5 million (up from \$1,120,000). These increases could reduce the federal estate or generation-skipping transfer tax liability but will affect the provisions of an estate owner's will or living trusts. For instance, the amount left under the marital deduction and applicable exclusion (unified credit) shares of the estate will be significantly altered. It is important for anyone with a will or living trust containing a tax formula clause to fund these shares with his or her estate to have the documents reviewed to determine the impact of the changes in these exemption limits on the needs and expectations of the heirs.

With respect to nontax issues, many state probate laws, as well as laws affecting trusts, living wills, and powers of attorney, have undergone substantial changes in the past few years. For example, many states have adopted new flexible definitions of income and principal of a trust that could affect the distributions to various trust beneficiaries. Depending on the goals of the estate plan, changes at the state level could point to an estate plan overhaul.

MAINTAINING ACCURATE PERSONAL DATA

In addition to updating the estate plan itself, care must be taken to ensure that the addresses and phone numbers of all the individuals named in the plan (beneficiaries, executors, trustees) are current. It is a good idea to take an inventory of all estate planning documents—do family members know exactly where to find all these documents? There should be a written list of the location of all important financial information, along with a list of the financial advisers to contact in the event of death. Having this information readily at hand will make settling the estate that much easier.

Conducting regular estate plan reviews can pinpoint personal, professional, and legislative changes that will have an impact on the estate plan. Annual reviews will ensure that loved ones will be taken care of and property distributed according to an estate owner's wishes—in spite of unforeseen circumstances (good or bad) that have occurred since the plan was first drafted. Procrastinating can be a costly mistake.

RECENT CASES AND RULINGS**VALUATION OF LOTTERY ANNUITIES REMAINS UNCLEAR**

Over the past several years, there have been several cases involving the estate tax value of remaining payments from lottery annuities at the time of the ticket holder's death. (Obviously, some lucky winners weren't so lucky with the mortality tables.) The disputed issue is whether the annuities are valued conclusively by discounting techniques provided by IRC Sec. 7520 (providing interest and mortality factors) or whether discounting for marketability issues concerning the winning tickets is permissible. In *Gribauskas v. Commissioner*, 92 AFTR 2d 2003-5914 (342 F3d 85), the appellate court determined that the Connecticut Lotto winnings could be discounted by over \$900,000 below the Sec. 7520 table value. The IRS agreed that the discount for lack of marketability was determined accurately but disallowed the discount under the argument that the actuarial tables controlled. The lower court had indicated that the tables should control unless the facts demonstrate that using the tables would produce a "substantially unrealistic and unreasonable result." The appellate court did not find that the need for consistency outweighed the consideration of valid marketability discounts. The court quoted language from a ninth circuit case that marketability is an appropriate factor because "the right to transfer is one of the most essential sticks in the bundle of rights that are commonly characterized as property." (*Shackleford v. U.S.*, 88 AFTR 2d 2001-5658 (262 F.3d 1028)).

In a recent case (*Cook v. Commissioner*, 92 AFTR 2d 2003-7027 (5th Cir. 11/13/2003)), two sisters pooled their money to purchase the winning lottery ticket. The sisters converted their oral agreement to split the money into a limited partnership. The estate took a substantial discount at the first sister's death. The 5th circuit agreed with the tax court that the right to receive a fixed annuity is valued independently of market factors—that is, under the Sec. 7520 actuarial valuation tables. The court determined that the tables did not reach a result "too unreasonable or unrealistic" to merit a different valuation method. The issue of valuation of lottery annuities now qualifies for Supreme Court review because circuits have reached differing conclusions.

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.

***Positioning our clients
for the future***



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