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529 plans receive high grades as an estate planning tool

You've probably heard that 529 plans are one of the most powerful and flexible options available for college savings. But did you also know that 529 plans excel as an estate planning tool? No other vehicle can offer you the same combination of income, gift and estate tax savings while allowing you to retain almost complete control over the funds.

Prepaid tuition plans vs. college savings plans

529 plans can be established by states, state agencies and eligible educational institutions (typically postsecondary education institutions eligible to participate in a student aid program administered by the Department of Education). There are two types of 529 plans:

1. A *prepaid tuition plan* lets you pay for college in advance at today's prices by purchasing tuition "credits," providing a hedge against future tuition increases.
2. A *college savings plan* allows you to make cash contributions to a tax-advantaged investment account.

College savings plans offer some potential advantages over a prepaid tuition plan. Although there's some additional investment risk, they're more flexible and the potential benefits are greater. Prepaid tuition plans build in a modest investment return, while college savings plans allow more aggressive investment strategies. Also, while prepaid tuition credits can be used only at certain schools and only for tuition, college savings plan funds can be used at most accredited colleges and universities (and some vocational schools) in the United States and for qualified expenses in addition to tuition.

Tax considerations

Contributions to a 529 college savings plan are not tax deductible, but earnings aren't currently taxable if only qualified distributions are made. Earnings may be exempt from state taxes as well, but state tax consequences vary from state to state.

Qualified distributions include those used to pay for qualified higher education expenses such as tuition, fees, books, supplies and equipment, and certain room and board costs. Nonqualified distributions (only the earnings portion under current law) are subject to income tax and a 10% penalty.

Most college savings plans are open to residents and nonresidents alike, but many plans offer state income tax incentives to residents, such as a state tax deduction for contributions.

The Internal Revenue Code sets minimum requirements for a plan to qualify for tax advantages, but, otherwise, plan sponsors are free to choose their own investment options and other features. Investment options and restrictions can vary dramatically from plan to plan.

One of the biggest advantages of 529 plans over other education savings vehicles is their generous contribution limits. While limits vary from plan to plan, the only restriction is that plans not permit contributions beyond what's reasonably necessary to provide for the beneficiary's qualified higher education expenses.

Unique estate planning benefits

A 529 plan is a remarkably versatile estate planning tool. First, contributions and earnings are removed from your taxable estate even though you

Sunset provision creates uncertainty for 529 plans

The Economic Growth and Tax Relief Reconciliation Act of 2001 enhanced many of the benefits of 529 plans. Like the act's other provisions, these enhancements will disappear after 2010 unless Congress makes them permanent. If the changes "sunset" as planned, then beginning in 2011:

- 529 plan earnings will no longer be exempt from federal income tax. Qualified distributions will be taxed at the *beneficiary's* tax rate, which likely will be lower than your own.
- Cousins will no longer be considered "members of the family."
- You'll no longer be able to roll over funds into another state's plan without changing beneficiaries.
- States will be required to impose penalties on nonqualified distributions.
- Private institutions will no longer be able to sponsor 529 plans.

retain control over the funds. Most estate planning vehicles are ineffective unless you relinquish virtually all control over the assets. 529 plans are an exception. For example, subject to the specific plan's terms, you have complete control over the timing of distributions. You also can change a beneficiary to another family member at any time or roll over the funds into another state's plan (as often as once a year) without tax consequences. You can even revoke the plan and get your money back (subject to taxes and penalties).

529 plan contributions are considered taxable gifts to the plan beneficiary, but they're eligible for the $11,000 annual gift tax exclusion ($22,000 for gifts you split with your spouse). This is another exception to the general rule: Ordinarily a transfer isn't eligible for the exclusion if you retain the power to change beneficiaries or revoke the account.

Finally, a 529 plan lets you accelerate five years of annual exclusion gifts and make a single gift-tax-free contribution of up to $55,000 ($110,000 for married couples) per plan beneficiary. Keep in mind, though, that once you take advantage of this option, you can't make additional annual exclusion gifts to the plan beneficiary for five years. Also, if you die within five years of the gift, a portion of your contribution will be taxed as part of your estate.

Planning opportunities

The ability to accelerate annual exclusions and change beneficiaries presents some interesting planning opportunities. You can change beneficiaries without tax consequences so long as the new beneficiary is a "member of the family" of the old beneficiary.

Note that, if you change beneficiaries to someone who's one or more generations below the old beneficiary, the change constitutes a gift (or generation-skipping transfer — GST) from the old beneficiary to the new one, so be sure that the transfer will be shielded from gift and GST taxes by applicable exemptions.

529 plan drawbacks

Like most estate planning tools, 529 plans have a few disadvantages. First, you can make only cash contributions. Second, though you may be able to select the initial investment options, you have little control over how the funds are invested. Third, if the beneficiary dies, the assets may be included in his or her estate. Finally, some of the tax benefits may disappear in 2011 under the 2001 tax law's sunset provision. (See "Sunset provision creates uncertainty for 529 plans" above.)

Making the grade

Despite these drawbacks, 529 plans offer a compelling combination of estate tax advantages and flexibility. Using one benefits you because of its income, gift and estate tax savings, and helps defray the education costs for your beneficiary. ▮

Zero in on tax savings with a "zeroed-out" GRAT

A grantor retained annuity trust (GRAT) is a powerful tool for reducing gift and estate taxes. It lets you generate income for yourself while potentially removing significant amounts of wealth from your estate at a relatively low gift-tax cost. And a recent tax court case now allows you to use a "zeroed-out" GRAT to eliminate gift taxes altogether.

How do GRATs work?

To take advantage of a GRAT, you make a one-time contribution of assets to an irrevocable trust. The trust pays you an annuity for a specified term, and at the term's end any remaining assets are transferred tax-free to your children or other beneficiaries. The annuity can be stated as a fixed percentage of your initial contribution's value or a fixed dollar amount.

GRATs save taxes in two ways. First, you avoid estate taxes by removing assets from your estate if you outlive the GRAT's term. The technique is particularly effective for assets that you expect to appreciate rapidly or that produce substantial amounts of income. Why? Because future earnings and appreciation on GRAT assets in excess of the applicable IRS discount rate are shielded from gift and estate taxes. (You'll be responsible for reporting the trust's income on your individual income tax return, though.) Second, while the initial transfer of assets to a GRAT is a taxable gift, you can minimize or even eliminate gift taxes depending on how you structure the trust.

How do GRATs reduce gift tax?

For gift tax purposes, the gift to your beneficiaries is the residual assets they're expected to receive at the end of the trust term. To calculate the gift's value, the IRS takes the fair market value of the assets you contribute to the GRAT and subtracts the actuarial value of the annuity, which is based on IRS tables that incorporate an assumed rate of return (the Section 7520 rate). If the trust assets outperform the Sec. 7520 rate, the beneficiaries enjoy a tax-free windfall.

By increasing the trust term or the annuity payments, you can shrink the residual value, thereby reducing the gift tax. But selecting a trust term that is too long can backfire because, if you don't outlive the trust, the assets will be included in your taxable estate.

If you've already used up your gift tax exemption, a zeroed-out GRAT may be an attractive option.

For example, Monica is 55. She transferred $1 million in assets to a GRAT that paid her an annuity of $100,000 per year for the shorter of her life or 10 years. At the end of the 10-year term, the residual assets go to Monica's son, Billy. The Sec. 7520 rate in effect when Monica established the GRAT was 4.6%, but the trust's assets earn an actual return of 8%.

According to IRS tables, the value of Monica's gift to Billy was approximately $248,400. But Billy's actual residual interest, based on the 8% rate of return, is $710,269. Monica received annuity payments totaling $1 million over 10 years, while removing more than $700,000 from her estate. Assuming Monica has at least $250,000 of her $1 million lifetime gift tax exemption still available, the entire transaction is gift-tax-free.

When should you consider a zeroed-out GRAT?

If your estate is relatively small and you haven't used up your lifetime gift tax exemption, an ordinary GRAT is likely your best bet. It may allow you to transfer substantial amounts of wealth to your family free of gift and estate taxes,

while retaining a healthy income stream. But in so doing, you'll be required to use all or a portion of your gift tax exemption.

If you've already used up your gift tax exemption, a zeroed-out GRAT may be an attractive option. Why? Because it may allow you to achieve the same tax benefits as afforded by an ordinary GRAT, but without any gift tax consequences.

Suppose that, in our example, Monica received annuity payments of $127,000 per year, and the GRAT was designed so that, if Monica failed to survive the trust term, the remaining annuity payments would be made to her estate (a requirement for a zeroed-out GRAT to work). Based on the IRS tables, the annuity's present value was $999,998, resulting in a taxable gift of only $2.

Keep in mind that zeroed-out GRATs have a downside. Boosting the annuity payments reduces the amount of wealth you remove from your estate. In our example, shifting to a zeroed-out GRAT lowers the amount Billy receives from the trust to about $320,000.

Which GRAT is right for you?

To determine the appropriate structure for a GRAT, you need to review your estate planning goals and circumstances. Then strike a balance between your interest in reducing gift and estate taxes and your interest in making lifetime transfers to beneficiaries. ▮

Keeping an FLP afloat requires careful planning

It seems that every time it feels safe to test the family limited partnership (FLP) waters again, the IRS succeeds in capsizing another FLP. In *Turner v. Commissioner (Estate of Thompson),* for example, the U.S. Court of Appeals for the Third Circuit affirmed the Tax Court's decision to disregard two FLPs for federal estate tax purposes.

A few months before *Turner,* the Fifth Circuit, in *Kimbell v. United States,* upheld an FLP against a similar challenge. Although *Turner* may seem to take the wind out of FLPs' sails, the two cases aren't necessarily at odds with each other.

A properly structured and operated FLP still offers significant valuation discounts and other estate planning benefits. Comparing the facts in *Kimbell* and *Turner* provides valuable guidance on designing an FLP that's seaworthy.

Treacherous waters

The FLPs in *Turner* were sunk by what the Tax Court described as "an implied agreement or understanding that the decedent would retain the

enjoyment and economic benefit of the property he had transferred" to the FLPs. Under Internal Revenue Code Section 2036(a), when a transferor retains such rights the IRS can bring the undiscounted value of the transferred property back into the transferor's estate, unless the transfer was a "bona fide sale for adequate consideration."

What makes Sec. 2036(a) so dangerous is that, even if you structure an FLP properly and don't retain any legally enforceable rights to the property, an implied agreement to confer such rights

may be enough to blow the FLP out of the water. And, according to the Tax Court, such an agreement may be "inferred from the facts and circumstances surrounding both the transfer itself and the subsequent use of the property."

The capsizing of the *Turner* case FLPs

In *Turner,* 95-year-old Theodore Thompson transferred $2.8 million in marketable securities and other assets to two FLPs in exchange for roughly 95% of limited partnership interests. Other family members contributed cash, real property and securities in exchange for pro-rata interests. The family also formed two corporations to act as general partners.

A properly structured and operated FLP still offers significant valuation discounts and other estate planning benefits.

Thompson died at age 97, and his estate valued his FLP interests applying a 40% discount for lack of control and marketability. The IRS disallowed the discounts under Sec. 2036(a), and the Tax Court and Third Circuit agreed. Even though the FLPs were validly formed and properly recognized for federal tax purposes, the courts found that, at the time the assets were transferred to the FLPs, there was an implied agreement that Thompson would retain the assets' economic benefits for the rest of his life. This agreement could be inferred from the following:

- Thompson's family sought assurances from their financial advisors that he would be able to withdraw assets from the FLPs to make gifts to family members (and Thompson actually made such withdrawals).
- Thompson transferred most of his assets to the partnerships and didn't keep enough to pay his living expenses. This could be explained, the court said, only if Thompson "had at least an implied understanding that his children would agree to his requests for money."
- The fact that Thompson, at age 95, transferred the bulk of his assets to two FLPs that engaged in no business with anyone outside the family was more consistent with an estate plan than with a legitimate business investment.

The courts also concluded that the transfers didn't qualify for Sec. 2036(a)'s bona fide sale exception, because they weren't "motivated primarily by legitimate business concerns." The partners didn't pool their assets, for example. Rather, each partner's income was derived from the assets he or she contributed to the partnership. And loans the FLPs made were largely testamentary in nature: The partnerships didn't lend money to anyone outside the family and took no action against delinquent borrowers.

Finally, the assets transferred to the FLPs were mostly marketable securities that weren't actively traded. The courts saw little benefit, other than estate tax advantages, to holding these assets in an FLP.

Weathering the storm

A review of the key facts in *Kimbell* can help you avoid the hazards that scuttled the FLPs in *Turner.* At age 96, Ruth Kimbell transferred about $2.5 million in oil and gas working and royalty interests, cash, securities, notes, and other assets to an FLP in exchange for a 99% limited partner interest. The Fifth Circuit held that the transfer was a bona fide sale for adequate consideration based on the following facts:

- Kimbell retained sufficient assets outside the FLP to support herself for the rest of her life.

- The family didn't commingle partnership and personal assets.
- The partners respected all partnership formalities.
- Each partner's interest was proportionate to the fair market value of the assets he or she contributed.
- The working oil and gas interests required active management.
- The family was able to demonstrate several nontax business reasons for forming an FLP, including protecting assets from creditors, simplifying management and ownership succession, reducing administrative costs, and keeping assets in the family.

When you compare the facts in *Turner* and *Kimbell,* two critical factors emerge. To preserve an FLP's estate planning benefits, you must:

1. Retain enough assets outside the FLP to support yourself for the rest of your life, and
2. Have legitimate business reasons, apart from tax savings, for transferring assets to an FLP.

Other factors are important as well, but these two seem to have the potential to make or break an FLP.

Charting your course

If you've established an FLP or are considering doing so, be prepared to demonstrate the FLP's legitimacy to the IRS. To avoid an "implied agreement" claim, calculate and document the cash flow you'll need for your remaining life expectancy, and establish that you have the resources, apart from the FLP, to meet those needs. Also, be sure to document the FLP's business purposes.

The FLP isn't dead in the water, but you can expect the IRS to fire some shots across your bow. Solid planning and documentation should help keep your FLP afloat in turbulent waters.

Estate planning red flag

Your medical directive or health care power of attorney isn't HIPAA-compliant

Your estate plan likely includes a medical directive or health care power of attorney that authorizes your spouse or another representative to make medical decisions on your behalf in the event you're incapacitated. Typically, these documents require a physician to certify in writing that you're unable to make your own medical decisions before your representative can step in.

Some physicians are concerned that providing this certification may violate the Health Insurance Portability and Accountability Act (HIPAA). HIPAA imposes strict requirements on health care providers regarding patient privacy and prescribes stiff penalties for the unauthorized release of a patient's "protected health information."

Even though a well-drafted medical directive or health care power should be legally sufficient to authorize a physician to provide medical information to your representative, some physicians may refuse. If this happens, your representative can petition a court for the appointment of a guardian, but this can be time-consuming and expensive, not to mention extremely stressful for your family.

To avoid this situation, update your medical directive or health care power so that it expressly authorizes your representative to receive your protected health information in accordance with HIPAA.

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