Insight on estate planning

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School funding daze

Educate yourself on combining
college funding with estate planning

Sharing the wealth

Estate planning with business ownership interests

Liquidity issues?

Consider buying a second-to-die
life insurance policy to pay estate taxes

Plus!

Estate Planning Pitfall:
You don't take required minimum distributions

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School funding daze

Educate yourself on combining college funding with estate planning

Would you like to combine paying for your grandchildren's or other loved ones' college educations with your estate plan? When it comes to choosing a funding plan that also will help you achieve your estate planning goals, a little knowledge can go a long way. Three tax-advantaged options include Section 529 plans, Coverdell Education Savings Accounts (ESAs) and direct payment of tuition.

529 plans

These plans, named for the Internal Revenue Code (IRC) section that governs them, come in two types: the prepaid tuition plan and the college savings plan.

A prepaid tuition plan involves making payments today to guarantee that tuition (or a specific portion of tuition) will be covered in the future. Prepaid tuition plans may be offered by states or private educational institutions. State plans are usually good for any college or university in that state's system.

Regardless of whether you choose a state or private plan, it may be possible to transfer your prepayment from one school to another. Doing so may not be without cost, however, because some plans charge a "penalty" equal to a percentage of the tuition's value. Further, even if the plan doesn't charge anything for the change, the school of choice may be more costly than the school for which you've prepaid, leaving a funding shortfall.

529 plans offer significant estate planning opportunities. For example, gifts to 529 plans are eligible for the gift tax annual exclusion.

A 529 college savings plan often is the better option. Contributions go into a tax-deferred account that generally is invested in mutual funds (though investment choices are limited to those offered by the plan). Withdrawals used for "qualified higher education expenses" at "eligible institutions," as defined in IRC Sec. 529, are federal income tax free. Examples of qualified costs include not only tuition and fees, but also:

- Books, supplies and equipment required for attendance,
- Room and board, subject to limits, for a student enrolled on at least a half-time basis, and
- In the case of a special needs beneficiary, expenses for special needs services incurred in connection with enrollment or attendance.

The list of eligible institutions includes virtually every accredited college and university in the United States, as well as many foreign institutions.

State tax treatment varies, and some states offer income tax incentives for contributing to their plans.

529 plans offer significant estate planning opportunities. For example, gifts to 529 plans are eligible for the $12,000 per beneficiary gift tax annual exclusion. This means that you avoid gift tax liability without having to use up any of your $1 million lifetime gift tax exemption. It also means that you avoid any generation-skipping transfer (GST) tax liability that may otherwise be incurred when, for example, a grandchild is the plan beneficiary — without using up any of your $2 million GST tax exemption.

And, you can front-load five years' worth of annual exclusion gifts ($60,000) in one year. Married couples splitting gifts can double this amount to $120,000. And that is *per beneficiary*. However, if you die within five years of the gift, a portion of the upfront gift will come back into your estate.

For instance, let's suppose Al and Charlotte have five grandchildren and want to set up plans for each of them. They can transfer $600,000 this year and not use any of their lifetime gift tax exemptions or their GST tax exemptions.

But if either spouse dies before 2012, his or her estate will include a portion of the gift made in 2007. If Al dies later this year, his estate will include the gifts in excess of $12,000 per beneficiary. Thus, Al's estate will include an extra $48,000 per grandchild, for a total of $240,000. The $240,000 also will be considered a GST, reducing the GST tax exemption available at Al's death.

Coverdell Education Savings Accounts

Coverdell Education Savings Accounts (ESAs) are similar to 529 plans in that they allow money to be saved tax deferred for college expenses, and withdrawals used to pay qualified expenses are tax-free. But they have two additional advantages: 1) They also can be used for expenses related to primary and secondary education, and 2) you almost always have more options for how the account is invested.

However, contribution restrictions generally make ESAs less attractive as an estate planning tool. First, the maximum annual contribution is $2,000 per account beneficiary. Second, your contributions may be further limited — or prohibited altogether — if your income exceeds certain limits. Third, you can't contribute to an ESA after the beneficiary turns 18 years old.

Another consideration is that any funds in the ESA at the time the beneficiary turns 30 (except in the case of a beneficiary with special needs) must be distributed to that beneficiary — and will be included in taxable income if not used for qualified education expenses or transferred to another qualified beneficiary (who must be related in a specified way to the original beneficiary).

Financial aid and 529 plans

An oft-asked question is how financial aid is affected by the various college savings plans and by other gifts. There are two aspects of financial aid: 1) federal assistance, and 2) assistance generated through the institution itself. Institution-based aid calculations can vary greatly.

With federal assistance, student-owned assets generally are included at a higher percentage than assets a student's parents own. There are exceptions. For example, a recent law now exempts student-owned 529 plans from inclusion in the calculation. 529 plans in the parents' names, however, aren't excluded.

One caveat before you rush to put your 529 plan in your child's name: Some estate planning professionals believe that the exclusion was an oversight by Congress, which had intended to include 529 plans at the parent's rate regardless of the owner, and that the oversight will be corrected. Of course, if a grandparent owns the 529 plan, the plan will be excluded.

Direct payment of tuition

One of the best ways to combine estate planning and college funding is to pay tuition on behalf of the student. Gifts of tuition *paid directly to the institution* are exempt from gift tax without counting as annual exclusion gifts or using any of your lifetime gift tax exemption. They also are exempt from GST tax without using any of your GST tax exemption.

In fact, a recent IRS ruling permitted the prepayment of future tuition as being included as a gift.

Do your homework

You can use education funding tools to also achieve estate planning goals. But choosing the combination that is right for you requires careful study.

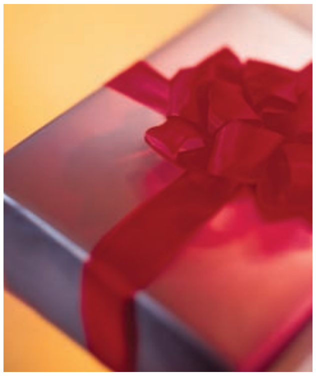
Sharing the wealth

Estate planning with business ownership interests

You've worked hard to build a successful business. Now it's so valuable that there's likely to be a tremendous strain on your family's liquid resources when it comes time to pay estate taxes at your death. To lessen the estate tax burden, consider reducing the value of your estate by divesting yourself of some of your business interests during your lifetime.

Annual exclusion gifts

One way to start divesting yourself of your business interests is to gift them to loved ones. With proper planning, you can save significant taxes and retain control of your company.



The first step is to use your $12,000 per beneficiary annual gift tax exclusions. For example, Jim, a widower, owns a business worth $4 million. He has five children and nine grandchildren. Using his annual gift tax exclusions, Jim can transfer $168,000 worth of shares of stock in his S corporation annually without incurring any gift tax.

Minority interest discounts

Minority, noncontrolling interests in a business generally are considered to be worth less than majority, controlling interests. To reflect this difference, appraisers typically apply a valuation discount when valuing minority interests. Such discounts allow you to leverage your gifts to transfer more value.

For instance, in the previous example, Jim is retaining more than 50% of the company, so he's giving away minority interests. Assuming a 30% discount, Jim can increase the underlying value of his gifts to $240,000 of stock each year but be treated as having made only $168,000 in annual exclusion gifts. This translates to removing 6% of the $4 million value of his company from his taxable estate in one year.

Your lifetime gift tax exemption

You can further increase the size of your gifts by tapping your $1 million lifetime gift tax exemption — assuming you haven't already used it. In the previous example, factoring in the 30% valuation discount, Jim can gift nearly $1.43 million, or an additional 35% of his company shares, to his children and grandchildren gift-tax-free with his lifetime exemption. All told, he can divest himself of nearly 47% of the company in just two days — if he makes annual exclusion gifts on Dec. 31 of one year and Jan. 1 of the next.

An added benefit is that future appreciation on the gifted business interests won't be included in your estate. For example, as the value of Jim's company increases, almost half of the increase will inure immediately to his children and grandchildren. Of course, Jim's plan can backfire if the company's value decreases.

It's also important to note that any lifetime gift tax exemption you use will reduce the estate tax exemption available at your death. But the benefit of removing future appreciation from your estate likely will outweigh the loss of some of your estate tax exemption.

Selling your business interests

Gifting is perhaps the easiest way to transfer your business interests to your family during your life, but another option is to sell the interests to them.

A direct sale probably would be inadvisable because you'd owe income tax on the gain. But by using an intentionally defective grantor trust (IDGT), you can structure a transaction that allows you to transfer business interests to your children at today's value without having to recognize gain on the sale.

This specially designed trust works because it is excluded from your estate for estate tax purposes but is treated as yours for income tax purposes. And, you'll use significantly less of your lifetime exemption than you would have used had you gifted the interests outright.

In fact, if you've already created an IDGT that holds assets, you can complete the transaction without using any additional gift tax exemption amount. By virtue of the fact that you no longer own the business interests, any appreciation attributable to them will go to the trust and, ultimately, your children as beneficiaries of the trust without being included in your estate.

As an added bonus, an IDGT provides an opportunity to make additional gifts without using any more of your annual exclusions or lifetime exemption. When the trust is properly structured, you, as grantor, are responsible for paying the tax on the trust income.

That income, though, remains in the trust. Thus, the trust assets are not reduced by the tax. The IDGT value, therefore, increases and, because you're paying tax on the IDGT's income, your taxable estate will decrease.

Of course, you may get to the point where you're no longer interested in paying the tax on the trust income. In that case, you have two options: The trustee can reimburse you for income taxes paid on trust assets, or you can "cure" the defective nature of the trust, and the trust will thereafter be responsible for the tax on any income it earns.

Treading carefully

Even though the strategies discussed here focused on transferring S corporation shares, these principles apply to most other business entities as well. One important caveat to keep in mind is that shareholder agreements or other documents may be in place that can restrict your ability to transfer business interests.

Making the decision to give away interests in the company you built up over your lifetime can be difficult, but it also can be one of the best things you do for your family. Knowing there are many ways to accomplish your objectives, be sure to choose the one or ones that will best fit your needs.

Liquidity issues?

Consider buying a second-to-die life insurance policy to pay estate taxes

Even armed with a solid estate plan, if your and your spouse's estate is worth more than your combined lifetime exemptions, estate tax likely will be owed on the survivor's death. The problem will be exacerbated if your and your spouse's assets are mostly illiquid. Why? Because to pay the estate tax your executor may need to sell assets you intended to pass to heirs.

If you're in this situation and you're married, consider purchasing second-to-die life insurance.

Examining the policy

In essence, second-to-die life insurance is one policy that covers two lives. When you or your spouse dies, the policy continues to cover the surviving spouse, and no proceeds are paid until the surviving spouse dies. Because generally no estate tax is due when the first spouse dies (thanks to the unlimited marital deduction), a second-to-die policy can be a perfect instrument to pay estate taxes.

Second-to-die policies can be an attractive alternative to individual policies because the insurer spreads the risk over two lives instead of one; thus, the premiums typically are significantly lower. Or, if one spouse is in poor health, a second-to-die policy may be the only way he or she can get coverage. In this case, the premiums will probably not be much different than they'd be for a policy on the healthier spouse's life.

Paying the premiums

Before buying a second-to-die policy, consider the premium payments. For instance, are payments fixed or interest sensitive? If investment performance will cause premiums to fluctuate, worst-case scenario projections can help gauge your ability to afford the policy.

Also, are the premiums projected for only a limited period of time? In this case, the insurance company assumes that eventually annual dividends, cash value or interest will replace your premium payments. In other words, you won't need to pay your premiums with out-of-pocket cash. Make sure that assumptions aren't too aggressive or you could end up paying premiums out-of-pocket longer than expected.

It's also important to plan *before* buying the policy for how premiums will be paid *after* the first spouse dies. If the deceased spouse earned the income needed to pay premiums, the surviving spouse must be able to continue paying them. One solution is to add a rider to the policy providing money to pay the surviving spouse's premiums. Or if you buy a policy that builds cash value, that may be sufficient, depending on when the premiums will no longer need to be paid.

Avoiding estate tax liability with an ILIT

When you or your spouse owns (or you jointly own) a second-to-die policy, the policy's proceeds will be included in the surviving spouse's taxable estate, which could create greater estate tax liability. To avoid this outcome, you may opt to keep the policy outside of the estate by holding it in an irrevocable life insurance trust (ILIT).

If you transfer an existing second-to-die policy to an ILIT, be aware that you must make the transfer at least three years before the surviving spouse's death to realize the estate tax savings.

You can fund the premiums by making annual exclusion gifts to the ILIT. With proper planning, you and your spouse can jointly give up to $24,000 (your combined annual exclusion amount) times the number of trust beneficiaries annually — plus, if necessary, tap your $1 million lifetime gift tax exemptions — and not incur any gift tax liability. Remember that, after your or your spouse's death, the annual exclusion is limited to the survivor's individual annual exclusion amount, currently $12,000, times the number of beneficiaries.

Is a second-to-die policy right for you?

If you and your spouse have a substantial estate but illiquid assets, your executor may need additional funds to pay the estate tax due on the surviving spouse's death. Using a second-to-die life insurance policy to cover the estate tax can be a powerful estate tax strategy.

Estate Planning Pitfall

You don't take required minimum distributions

If you don't need your traditional IRA funds to live on during retirement, you may be focused on building up this nest egg for your children and be tempted to avoid taking any withdrawals from it. After all, the larger your IRA is, the larger your children's inheritance will be, right?

Unfortunately, this isn't necessarily the case. After age 70½ you must take required minimum distributions (RMDs) annually. If you don't, you'll owe a 50% penalty on the amount you should have taken but didn't — in addition to any ordinary income tax you owe. So, for example, if your RMD was $12,000 for a given calendar year, you would owe a $6,000 penalty. That's $6,000 that would go to Uncle Sam rather than to a loved one.

A better option can be to take the RMD, pay the ordinary income tax on it and make a $12,000 annual exclusion gift to your child. Not only do you avoid the penalty and remove $12,000 from your taxable estate, but your payment of the income tax on the distribution is effectively a transfer-tax-free gift to your child. Why? Because if your child instead withdrew the $12,000 after inheriting the account, he or she would owe income tax on the withdrawal.

With proper planning, you can make RMDs work for, not against, you and your family. So be sure to consult with your tax professional to determine the amount of your RMDs.

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Comprehensive Estate Planning Services

Founded in 1960, Weinstock, Manion, Reisman, Shore & Neumann offers estate planning, probate and trust administration, general business and corporate law, taxation, real estate and litigation services. Because 13 of our 15 attorneys are actively involved in estate planning, we specialize in helping clients meet objectives like these:

- Dispose of assets in a tax-efficient manner by using revocable living trusts.
- Minimize estate taxes by using sophisticated lifetime giving techniques, such as Grantor Retained Interest Trusts and Charitable Remainder Trusts.
- Provide liquidity and save estate taxes by using life insurance and irrevocable life insurance trusts.
- Efficiently administer probate and trust estates.
- Transfer business interests to younger family members in a tax-efficient manner.
- Minimize generation-skipping transfer tax on transfers to grandchildren and great-grandchildren.
- Implement deferred compensation and qualified retirement plans, including pension and profit sharing plans.
- Reduce income and estate taxes on the receipt of benefits from retirement plans.
- Avoid court intervention if disability strikes.
- Maximize employee productivity through the use of stock options and other incentive programs.
- Dispose of business interests among co-owners.
- Save on income taxes, both now and in the future.
- Select and form business entities, such as corporations, limited liability companies and family limited partnerships.
- Protect the interests of beneficiaries or fiduciaries in estate, trust or conservatorship matters.

The professionals at Weinstock, Manion Reisman, Shore and Neumann bring over 250 years of combined experience to the services we provide. The stability of our firm enables our lawyers to work closely together with business specialists to give clients outstanding individualized attention.

Many of our lawyers are instructors at UCLA Extension and highly sought after as speakers for professional organizations in the community. Because we are at the forefront of current developments in law, we excel in designing strategies which help clients balance their business and financial interests with their personal and professional objectives in order to preserve and transfer their wealth.