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Life Insurance vs. Section 529 Plans

By Thomas J. Mohan, J.D.

There is no doubt that saving for a child's education is a top priority of many parents. The recent changes in the tax code have made Section 529 Plans the "vehicle of choice" for college funding purposes.

Following are the tax advantages of a Section 529 College Savings Plan:

1. Starting in 2002, distributions for qualified education expenses from Section 529 Plans will be tax-free.
2. Neither the contributor nor the beneficiary is taxed currently on the earnings of the contributions to the Plan.
3. A gift of $50,000 in one year ($100,000 if married) can be made to a Section 529 Plan on behalf of the beneficiary and it will be treated as spreading out the $11,000 annual gift tax exclusion over five (5) years. These tax free gifts are removed from the donor's estate.
4. Transfers of amounts from one qualified tuition program to another qualified tuition program are tax free if they are for the same beneficiary. This improves the portability of assets from one state plan to another, but only one such transfer is allowed per beneficiary for any 12-month period.

While the above tax advantages are all great reasons to look into Section 529 Plans, parents must keep in mind that the tax free withdrawals described above expire (i.e., sunset) in 2011 unless Congress extends them. In addition, if the beneficiary (or successor beneficiary) does not use the Section 529 Plan proceeds for qualified higher education expenses, then the gain, when withdrawn, not only is taxed to the owner, but is also penalized (usually an additional 10% depending on the particular plan).

For many parents a permanent life insurance policy may be a more attractive college funding vehicle than a Section 529 Plan. By heavily funding a life insurance contract and being careful not to go over the MEC limits, the following advantages over a Section 529 Plan are achieved:

1. The owner of the contract can access the policy's cash values with no current income taxes (by using the policy's loan and/or withdrawal provisions) – regardless of the purpose.
2. If the policy is on the parent's life, it will guarantee the child makes it to college whether the parent lives to send the child off or not. Moreover, by adding a disability waiver of premium rider to the policy, the child's education expenses can still be covered even if the parent is totally disabled and can no longer work.
3. If the policy is on the child's life, the child is guaranteed insurability that he/she will likely need after college to meet financial responsibilities.

There is another potential pitfall with Section 529 Plans. Some Section 529 Plans invest in a pre-set asset allocation model which becomes almost exclusively bonds as the beneficiary ages. Moreover, the owner cannot modify these asset allocations. Given the past two years, that may be a good thing, but based on historical returns, that generally means less total money available due to much less compounding of returns.

The kind of policy used, whether whole life, universal life or variable life, should be based on the client's risk tolerance. Most likely, it will be desirable to maximum fund a permanent policy with as low a death benefit as possible. Because life insurance plans are long-term accumulation vehicles, it is best to start as early as possible to allow the cash values to grow to the desired level. Finally, proper policy selection, funding and review are vital to making this strategy work.

For more information regarding this article, please e-mail your requests to Tom at tjm@disinherit-irs.com or call Tom at (248) 457-7202.

You're Invited!

January 16, 29, 31, 2002

We will be conducting a four hour seminar entitled **"Estate Planning After the Economic and Tax Relief Reconciliation Act of 2001"** to be held on the above dates.

These seminars will be held on the first floor of Columbia Center I (West Tower), from 8:00 am. to 12:00 pm. Registration begins at 7:30 am.

Four (4) CE credits are available for attending the course.

If you would like to attend one of these seminars, please call Jackie Davidson at (248) 457-7216 to reserve your seat.

Seating is limited and will be on a first come, first served basis.

INSIDE

Recent Developments

By Robert A. Bryant, J.D., M.B.A.

Irrevocable Life Insurance Trust Assets Used To Pay Estate Taxes

The recently issued PLR 200147039 may provide additional flexibility in drafting and administering irrevocable life insurance trusts (ILITs), and eliminate the need for ILITs to purchase assets or lend money to the insured's estate in order to create liquidity to pay estate taxes. Instead, the trustee of the ILIT may directly pay the insured's estate tax obligation.

In this ruling, a husband and wife created an ILIT and funded it with a second-to-die policy. The trust provided that the trustee was not required to apply any amounts to the estate of the husband and wife in satisfaction of their debts and liabilities. The trust also provided that the trustee could in its sole discretion pay the estate tax due by reason of the insured's death, but was "under no compulsion to do so."

The Revenue Service considered that neither state law nor the terms of the ILIT ***required or obligated*** the trustee to pay any amount to either estate in satisfaction of their debts and liabilities. Any such payment would be in the sole discretion of the trustee. The Service thus held that because of the absence of a binding legal obligation, the proceeds are not includible in the gross estate under I.R.C. Section 2042.

Therefore, the Service may be providing the opportunity to draft ILITs to directly pay estate taxes rather than requiring the ILIT to purchase assets or loan funds to the insured's estate so as to provide the necessary liquidity.

Discount for Built-In Capital Gains

The analysis in the *Estate of Jameson v. Com'r*, 267 F.3d 366 (5th Cir. 2001) supplies us with an important piece of the capital gains discount puzzle.

Stock of a closely held timber company was valued as of the majority owner's date of death. This valuation was discounted for imbedded built-in capital gains; the tax liability that would be generated if business assets were sold within ten years of transfer. The appraiser calculated the valuation discount assuming a buyer would immediately liquidate the assets generating the built-in capital gains tax rather than waiting ten years to sell the assets and avoiding the tax. The IRS, however, argued that no such discount was appropriate. They reasoned that the discount relies on a faulty assumption that one entity would turn around and immediately sell what it had just purchased. The Tax Court held that the discount should reflect a buyer who would sell only 10% of its assets, thus reducing the built-in capital gains discount but not eliminating it.

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Gift or Sale of GRAT Remainder to Dynasty Trust

By Julius H. Giarmarco, J.D., LL.M.

A grantor retained annuity trust ("GRAT") is commonly used by high net worth individuals and business owners to "leverage" their gift tax exemption. By retaining a high enough annuity for a long enough period of time, the value of the remainder interest, which is subject to gift taxation, will be little or nothing. For example, if a 60 year old grantor transfers $500,000 of S corporation stock to a 10 year GRAT when the Federal discount rate is 7%, a 12% annual annuity (i.e., $60,000 per year) will result in a remainder interest (i.e., taxable gift) of only $78,584!

To protect the GRAT assets from the generation skipping transfer ("GST") tax, the grantor would normally allocate all or part of his/her GST exemption (equal to the remainder interest) to the GRAT. However, because of the estate tax inclusion period ("ETIP") rules of IRC §2642(f), any allocation by the grantor of GST exemption to the GRAT will *not* become effective until the annuity term ends. If the GRAT is successful, the value at that time will be considerably more than the gift tax value at the time the GRAT was created. Thus, the ability to leverage the GST exemption appears not to be available. For this reason, most GRATs name the grantor's children as the remainder beneficiaries.

Many practitioners, however, believe that the way around this problem is for the remainder beneficiaries (i.e., the children) to gift or sell their remainder interest to a Dynasty Trust for the benefit of their descendants. The value of the remainder interest in the GRAT is valued for purposes of a gift or sale to a Dynasty Trust in the same manner as it is valued for purposes of determining the initial gift when the GRAT was created. As such, the remainder interest to be sold or gifted will have little or no value.

The unanswered question in all of this is whether the gift or sale of the remainder interest breaks the link between the grantor and the Dynasty Trust for GST tax purposes. Up until PLR 200107015, dealing with a charitable lead annuity trust ("CLAT"), there had been no official comment from the IRS on this issue. A CLAT is similar to a GRAT except that the annuity is paid to charity instead of to the grantor. In PLR 200107015 the remainderman (the grantor's child) intended to immediately transfer his vested remainder interest in the CLAT to his children (the grantor's grandchildren). The IRS was asked to rule that no generation skipping transfer would occur at the end of the annuity term.

As might be expected, the IRS ruled unfavorably for the taxpayer. The IRS ruled that there would be two (2) transferors. The child would be the transferor of that portion of the CLAT equal to the present value of his remainder interest, and the grantor would remain the transferor of the balance of the CLAT. As a result, when the annuity term ends, the trust assets (in excess of the child's gift) would be subject to GST tax.

The rules for allocating GST exemption to a CLAT differ from the ETIP rules for a GRAT, but still prevent a grantor from allocating GST exemption based on the value of the gift at the time the CLAT is created. Accordingly, the same reasoning applied in PLR 200107015 would most likely apply to a *gift* of remainder interest in a GRAT. If a *sale* of the remainder interest to the Dynasty Trust is used instead, the child could not be a "transferor" in the same way as with a gift. However, the IRS would then likely say the grantor is the transferor of the *entire* trust.

While the logic of the IRS' ruling in PLR 200107015 appears flawed, practitioners should be wary of gifting or selling GRAT remainder interests. Hopefully, there one day soon will be a judicial or legislative clarification of this issue. For those clients who still wish to proceed with this strategy, the draftsperson must make certain that the GRAT does not contain

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a spendthrift clause that would preclude the remaindermen from gifting or selling their remainder interests to a trust established for the benefit of the grantor's descendants.

For more information regarding this article, please e-mail your requests to Julius at jhg@disinherit-irs.com or call Julius at (248) 457-7200.

Simple Charitable Estate Planning Techniques That Are Not Used Enough

By Salvatore J. LaMendola, J.D.

Gifts to charity made during lifetime are generally better than gifts made to charity at death because the lifetime gift both generates an income tax deduction *and* removes the property from the estate. A testamentary bequest generates only an estate tax deduction.

An individual's income tax deduction for charitable contributions is subject to limitations based on the donor's "contribution base", defined as the individual's adjusted gross income computed without regard to any net operating loss carryback. Generally, deductible contributions to public charities cannot exceed 50% of the donor's contribution base. For contributions to non-public charities, the deduction cannot exceed 30% of the donor's contribution base. For contributions of capital gain property, the 50% and 30% limitations described above are reduced to 30% and 20%, respectively.

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We are in the process of updating our website to make it both easier to access and to provide you with even more valuable information to use in your practice. Please look for these changes by the end of January, 2002.

Accordingly, efforts should be made where possible to make certain the income tax deduction is not lost.

Make Lifetime Gifts

There are several easy techniques for doing this. First, if a client has a charitable bequest in his or her will, have a durable power of attorney in place authorizing the attorney-in-fact to "prepay" or anticipate charitable bequests during lifetime. If it appears the donor's life expectancy is reduced, the attorney-in-fact can prepay charitable bequests so as to obtain the income tax deduction, as well as remove the property from the estate. Thus obtaining two deductions for the price of one.

If the donor has a revocable trust, the trust can authorize the trustee to prepay these distributions during lifetime. The usual trust provision only authorizes continuation of a pattern of charitable giving, which such bequests may not fit into. Therefore, it is important to specifically authorize (in the trust agreement) the prepayment of bequests that are to be made at death.

Second, a typical situation is a bequest of a small amount to charity with everything else to a spouse. This generates no income tax benefit and also no estate tax benefit since no tax will be paid anyway because of the unlimited marital deduction. A better technique is to leave the bequest to the spouse with a *non-binding* request that the spouse make the gift to charity. In this way, the spouse will receive an income tax deduction that would otherwise be lost. The document can provide that, if the spouse does not make the gift for any reason, the bequest to charity will occur at the second death from the marital trust if there is one or, otherwise, from the credit shelter trust.

Third, another simple technique involving lifetime gifts to charity can be helpful in reducing the size of a transferor's estate. Take the case of a wealthy family where the parents and the children all make annual charitable gifts. Have the parents approach the children and suggest that the parents will, that year,

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On appeal, the Fifth Circuit remanded the discount issue back to the Tax Court, and was critical of the Tax Court's independent valuation work. The Fifth Circuit explained the assumptions the Tax Court relied upon were internally inconsistent since a hypothetical buyer of the stock would not engage in long-range timber production if the timber property's annual rate of return was substantially lower than the investor's required return.

The taxpayer and the IRS argued over how long it should be assumed to take to sell the asset. When the IRS argues for a lower discount, it argues for a longer time for sale, which causes the estimated capital gains tax to be reduced by the time value of money. When the taxpayers want a higher discount, they argue for an immediate sale of the asset, which creates an immediate tax. So, how did the Fifth Circuit evaluate whether the assets would sell sooner or later?

The Court found that if the property produces combined annual income and appreciation in an amount lower than the hypothetical investor's required discount rate, then the hypothetical buyer would immediately sell. Thus, the tax on the imbedded capital gains would be accelerated and the discount; therefore, would be greater.

Obtain an Appraisal, or Not

When making gifts of closely held stock or LLC membership interests where the value will be less than the $10,000 / $20,000 exclusion, must an appraisal be obtained? This was the issue of a recent on-line discussion.

Some professionals weighed in saying that an appraisal was not necessary because a gift tax return, most likely, was not required to be filed. Without a gift tax return, there would be no necessity for substantiating value. However, presently, an issue that should be considered is whether the IRS will respect discounts taken on the estate tax return when not taken on the gift tax return.

On the other hand, numerous professionals concluded that an appraisal or a valuation letter should be obtained. A document that was prepared contemporaneously with the gift will be more persuasive to prove value than an appraisal prepared years after the gift. Whether the valuation substantiation is filed depends on if a gift tax return is filed. Filing a gift tax return with documents complying with the adequate disclosure rules will provide a three year statute of limitations for the valuation of the gift.

Thus, even though a gift tax return may not be technically required, it may be beneficial to file the gift tax return with valuation documentation to avail the client of the three year protection and prevent the IRS from later revaluing the gifts.

For more information regarding this column, please e-mail your requests to Bob at rbryant@disinherit-irs.com or call Bob at (248) 457-7207.

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make the children's charitable gifts for them and in their name. The economic effect is the same as if the parents made a direct gift to children, except that there is no use of the parents' gift tax annual exclusion or gift tax exemption.

Life Insurance Funded Director's Perk

Corporations, seeking to attract bright and creative people to serve on the board of directors should consider offering the following benefit. Each director, in addition to normal director's fees and perks, is allowed to select the charity of his/her choice as the recipient of between $250,000 and $1,000,000. That money will be paid by the corporation to the charity in honor of the director at his/her death while serving on the board. To finance its obligation, the corporation becomes the owner and beneficiary of a permanent life insurance policy on the life of each covered director. The corporation's premium payments are not taxable to the director. At the director's death, the corporation receives the proceeds income tax free (except for any possible corporate level AMT). The corporation then "leverages" the death proceeds by making a *deductible* corporate contribution to the charity of the director's choice. If the director leaves the Board prior to the agreed upon term, the corporation can retain the insurance coverage and apply it against future charitable contributions on behalf of other directors. In this manner, the corporation's charitable image and its ability to recruit top people, are enhanced.

For more information regarding this article, please e-mail your requests to Sal at sjl@disinherit-irs.com or call Sal at (248) 457-7204.

E Monthly Update!

Would you like to keep abreast of new developments affecting estate planners? If so, each month we will e-mail you a summary of pertinent court cases and IRS rulings concerning estate and gift tax issues, along with state of the art planning ideas. To subscribe to our free monthly estate tax law update, simply send an e-mail message (no subject or body text required) to the following address:

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