

LEGAL ALERT

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ESTATE PLANNING: MORE CHANGES AHEAD

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Estate Taxes – You Need a Crystal Ball

There is still no formal word from Washington with regard to the *permanent* repeal of the federal estate tax. Faced with an ever-increasing federal deficit it is clear, however, that full repeal of the federal estate tax is highly unlikely after the fall election. In 2009, a “freeze” of the applicable estate tax exemption amount might occur as a political compromise. This year the applicable exemption amount is \$2 million per taxpayer. Next year it is scheduled to rise to \$3.5 million per taxpayer. A guess is that legislation will freeze the applicable estate tax exemption amount somewhere around \$3.5 million with a federal estate tax rate that ranges between 20% and 35% – although some have talked about tying the estate tax rate to the capital gain tax rate. Presently, there is a “flat” federal estate tax rate of 45%. Michigan has not (yet) adopted a state estate tax but don’t be too surprised if one shows up in the next couple of years.

Uniform Trust Code: It’s Coming

Michigan will probably not adopt the Uniform Trust Code (UTC) until sometime in 2009. The UTC provides a comprehensive body of law with regard to the administration and interpretation of Trusts. Like many probate laws, if a Trust contains specific provisions, then much of the UTC will *not* apply to existing Trusts. Consequently, a person who adopts a Trust can “override” many of the UTC’s more controversial provisions just by including specific

provisions in their Trust, and not rely on the UTC to “fill in the blanks” with its default rules.

Consider Long Term Care Insurance

Presently one benefit that cannot be purchased under a federally sanctioned “cafeteria plan” is long term care (LTC) insurance. This is surprising because of the express Congressional policy that endorses the purchase of long term care insurance.

As part of its 2005 Medicaid Reform legislation, LTC insurance was promoted by Congress as one solution to the Medicaid “crisis” that wreaks havoc with state and federal budgets. For example, LTC premiums are tax deductible while life insurance premiums are not. However, LTC insurance is still not available as a benefit that an employer can provide to its employees under a “cafeteria plan.”

It is possible, however, to indirectly acquire LTC insurance under a cafeteria plan. One statutorily permissible benefit under a cafeteria plan is a Health Savings Account (HSA). Long term care insurance can be purchased from an HSA that is funded through cafeteria plan contributions. Accordingly, while long term care is not technically available under a cafeteria plan, it can be indirectly purchased, using pretax dollars, if an HSA is an available benefit under an employer’s “cafeteria plan.” With the Medicaid funding crisis unresolved, many are well advised to seriously look at LTC insurance, and

using a HSA may be a cheap(er) way to pay for that coverage.

529 Accounts Abuses?

Recently, the IRS issued proposed rules with regard to IRC §529 higher education expense accounts. In general, the IRS' proposals are intended to prevent perceived tax abuses by clarifying the tax consequences that arise from changes to §529 account beneficiaries and to curb refunds to 529 account owners.

An IRC §529 account is established for the benefit of a person to pay for their higher education expenses. After-tax dollars are used to "fund" a 529 account. The investments inside the 529 account grow tax-deferred, and if those funds are spent on higher education expenses, the distribution is income tax free! The person who opens the 529 account is the *owner* who designates a *beneficiary* of that account.

Significantly, unlike other gifts, the transfer of cash to a 529 account can be reversed and the owner can recover the dollars contributed, but the owner will then pay income tax on the amounts distributed, plus a 10% excise tax because the funds were not used for higher education expenses. Equally significant is the fact that the owner can change the beneficiary of the 529 account, e.g., from one child to another, from one grandchild to another grandchild, usually without any tax consequence whatsoever.

If the designated beneficiary of the 529 account dies, the account balance is included in the designated beneficiary's estate, even though the person who is the named "owner" of the 529 account controls the account, and the beneficiary had no access to the 529 account without the owner's consent. This creates a potentially harsh estate tax result to the beneficiary.

These peculiar rules create some unusual tax consequences for the person who does not own or control the account and apparently they also tend to encourage some abuses.

- One example of an abuse of a 529 account is

with regard to the use of "strawmen" to make gifts. As an example, assume that grandparents have 10 grandchildren. The grandparents wish to make a gift to their child. The grandparents open a 529 account for each of their 10 grandchildren. The grandparents name the child as the account *owner* of each of those ten 529 accounts. The grandparents then use the five year "front-load" rules which enables them to make up to five years of annual exclusion gifts (\$60,000 from each grandparent) to each grandchild's 529 account at one time, without incurring any gift or generation skipping transfer tax liability. Since the child is the designated owner of the 529 accounts, the child can withdraw the balance of any of these 529 accounts at any time, without any tax. If the grandparents survive five years, all of the 529 account balances will not be included in the grandparents' taxable gross estates. Yet by virtue of having named their child as the *owner* of the ten 529 accounts, the grandparents will have transferred \$1.2 million to their child gift-tax free, while neither grandparent has used any of his or her \$1 million lifetime federal gift tax exemption.

- Another perceived abuse is that taxpayers try to use 529 accounts as surrogate IRA accounts with all of the income tax deferral benefits of an IRA, but with none of the restrictions and distribution requirements associated with IRAs.
- One proposed rule change suggested by the IRS is to permit only *individuals* to be account *owners* which prohibits the ability of an entity, such as a trust or a probate estate, to create a 529 account for the benefit of a designated beneficiary. The IRS' desire to limit account owners to *individuals* and not *entities* seems like overkill. For example, a Uniform Transfer to Minor's Act account should be able to open and hold a 529 account to accumulate funds on a tax deferred (if not tax-free) basis for its minor beneficiary. Similarly, trusts should be

in a position to be able to invest assets held by the Trustee in a 529 account, particularly if the Trustee is charged with the duty to accumulate and disburse assets to pay for the educational needs of a trust beneficiary. Why should a Trust have to pay income taxes on earnings that it receives and accumulates for future higher education expenses of its trust beneficiary, while an individual does not have to pay any income taxes if the money held in the account is ultimately to be used for the same purpose?

- There also is a concern held by the IRS when an individual creates a self-owned 529 account, where they are named as owner/beneficiary. Apparently one uncovered abuse is for a person to open a 529 account in their own name for their own benefit, and then subsequently change the designated beneficiary to another individual. When the 529 account is first opened no gift tax is incurred, because one cannot make a gift to one's self. Yet the subsequent change in the beneficiary results in a gift, but the current 529 rules are written in such a way that the account owner can claim that no gift tax is owed when only a change in account beneficiary occurs. The IRS' proposed rules will treat the

subsequent change in beneficiary to another individual by the account owner as if the owner made a *new contribution* to a *new* 529 account for the benefit of the *new* beneficiary, thus triggering a gift tax on the change of 529 account beneficiaries.

- One proposed change that actually produces a fairer result is if a grandparent opens a 529 account for the benefit of his child, but subsequently changes the beneficiary designation to his great-grandchild, which results in a generation skipping transfer (GST) tax, because the new beneficiary is two or more generations below the prior beneficiary, i.e., the child. Under current rules, that shift in beneficiaries results in a potential GST tax imposed upon the "old" beneficiary, the child who never had any control over the 529 account. The IRS now proposes to assign the GST tax liability to the account owner by treating the change of beneficiary that is subject to gift or GST tax "as a deemed distribution to the account owner followed by a new gift." 529 accounts are very popular. Perhaps the IRS is worried they are becoming too popular?

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