the Estate PLANNER

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Section 529: Financial aid for your estate plan

When it comes to estate planning and college savings vehicles, Section 529 plans are at the head of the class. These plans receive high grades for their tax advantages, generous contribution limits and flexibility.

529 plans — which can be sponsored by a state, a state agency or an eligible educational institution — come in two forms: prepaid tuition plans and college savings plans. College savings plans are more popular because they usually offer greater flexibility and tax benefits.

529 plan lesson

A 529 college savings plan allows you to make cash contributions to a tax-advantaged investment account. Contributions aren't tax deductible, but the account grows tax-free, and earnings may be withdrawn free of federal income tax provided they're used to pay qualified higher education expenses. Qualified expenses include tuition, fees, books, supplies, equipment and some room and board costs. Earnings used for other purposes are subject to income tax and a 10% penalty.

Keep in mind that there are fees, charges and tax ramifications associated with 529 plans, and the underlying investment options are subject to market risk and will fluctuate in value.

Investment options and features vary from plan to plan, as do contribution limits.

Most college savings plans are open to both residents and nonresidents, but many states offer state income tax incentives to residents, such as deductible contributions or tax credits based on contribution amounts. Consult with your tax advisor about your particular situation.

Investment options and features vary from plan to plan, as do contribution limits. Most 529 plans have generous contribution limits — generally ranging from the low $200,000s to the low $300,000s per beneficiary. All assets, including earnings, under a 529 plan established for the benefit of a particular beneficiary must be aggregated when applying the limit. New contributions will not be allowed after this limit is reached, and earnings will continue to accrue.

Learning the estate planning benefits

The primary purpose of a 529 plan is to save for college, but don't fail to overlook its unique estate planning benefits. Typically, to shield assets from estate taxes you must permanently give up control over them. But when you create a 529 plan for your child, your grandchild or another beneficiary other than yourself, the contributions and earnings are removed from your taxable estate even though you maintain control over the funds.

3 recent laws bolster 529 plans

Thanks to three bills signed into law in 2006, Section 529 plans are even more attractive:

1. Pension Protection Act of 2006 (PPA). Despite a 529 plan's advantages, until recently there was a shadow hanging over it: Many of its most significant benefits — including tax-free withdrawals for qualified college expenses and the ability to change plans without changing beneficiaries — were set to expire at the end of 2010.

PPA makes these changes permanent. It also allows private institutions to continue sponsoring 529 plans after 2010 and makes cousins permanent "members of the family" for rollover purposes.

2. Deficit Reduction Act of 2005 (DRA). DRA clarifies that a 529 plan is considered an asset of the plan owner. This is significant for financial aid purposes because, in determining how much a family can afford to pay for college, the federal formula factors a student's assets much more heavily than the parents' assets.

3. Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). The "kiddie tax" provides that a child's unearned income — including interest, dividends and capital gains — is taxed at the parents' marginal rate once it reaches a specified threshold ($1,700 for the 2007 tax year). Previously, the kiddie tax applied only to children under age 14, but TIPRA expands the tax to apply to children under 18. As a result, tax strategies involving vehicles such as Uniform Transfers to Minors Act (UTMA) and Uniform Gifts to Minors Act (UGMA) accounts have become less effective, making 529 plans even more attractive.

Unlike irrevocable trusts and other estate planning vehicles, a 529 plan allows you to retain control over the timing of distributions as well as the right to change beneficiaries. You also can roll the funds into another 529 plan as often as once a year without adverse tax consequences. In addition, you can revoke the plan and get your money back (subject to taxes and penalties).

529 plans also offer unique gift tax advantages. Although contributions are considered taxable gifts to your beneficiary, they're eligible for your $12,000 annual gift tax exclusion ($24,000 for gifts you split with your spouse). (If you're a grandparent, this also means you can avoid any generation-skipping transfer tax when funding a 529 plan to benefit your grandchild.) Ordinarily, you can't take advantage of the annual exclusion if you retain the power to change beneficiaries or revoke an account.

Even better, you can accelerate five years of annual exclusion gifts and make a single tax-free contribution of up to $60,000 ($120,000 for married couples) per beneficiary. Bear in mind that, once you accelerate your annual exclusions, you can't make additional annual exclusion gifts to the same beneficiary for five years. So before you take advantage of this benefit, be sure to consider how it will affect other gift, estate and succession planning strategies. Also, if you die within five years, a portion of your gift will be brought back into your estate.

Making the grade

529 plans have a few disadvantages. For instance, you can make only cash contributions, and your investment options are limited to those offered by the plan. But with a unique combination of tax and estate planning benefits, they should be at the top of your list of estate planning options. ▮

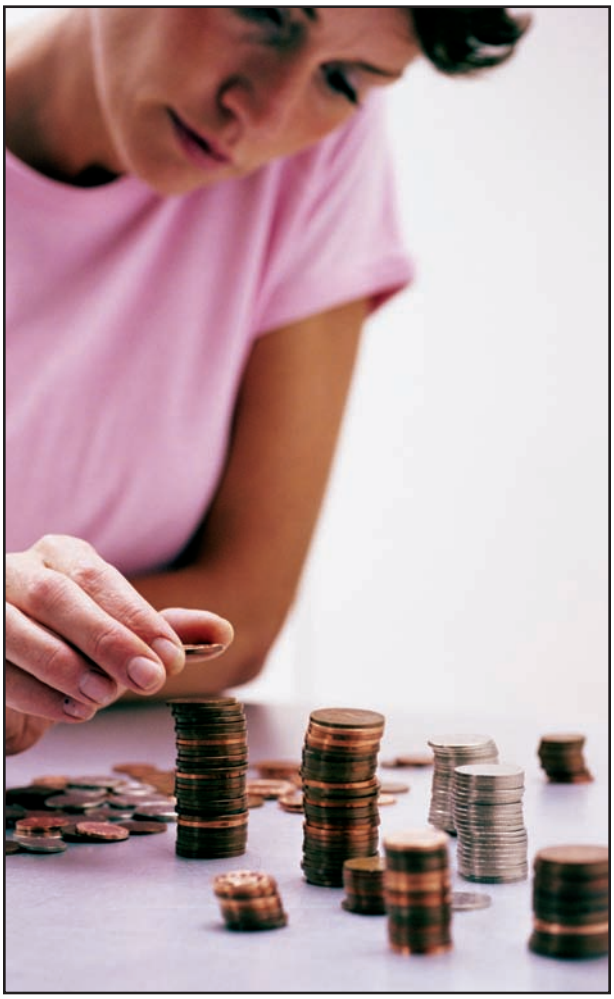
Please contact your investment professional for more information on 529 plans and to obtain the appropriate disclosure statements and the applicable prospectuses for the underlying investments. Investors are asked to consider the investment objectives, risks, charges and expenses of a portfolio carefully before investing or sending money.

Should you convert to a Roth IRA?

Roth IRAs can offer significant estate planning advantages over traditional IRAs. But until recently, these advantages have been unavailable to higher-income taxpayers who often stand to benefit the most. Under tax legislation passed last year, anyone — regardless of income level — can convert a traditional IRA to a Roth IRA starting in 2010.

Know the difference

Traditional IRAs can offer current tax deductions and tax-deferred growth, but withdrawals are subject to ordinary income taxes at rates as high as 35%. A Roth IRA takes the opposite approach: Contributions aren't deductible, but qualified withdrawals of contributions and — best of all — earnings are income-tax free.



From an estate planning perspective, the Roth IRA is the clear winner. With a traditional IRA, you have to take required minimum distributions starting at age 70½, whether you need the money or not. But a Roth IRA can continue growing income-tax free indefinitely, allowing you to build a larger nest egg for your family.

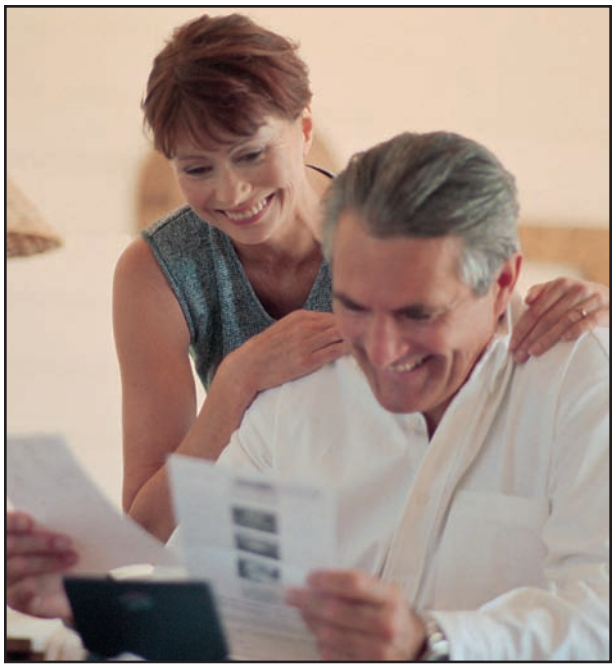
Also, when you leave a traditional IRA to your children or other heirs, income taxes may take a big bite out of their inheritance because they'll have to pay income tax on all distributions. Roth IRAs provide a dual estate planning benefit: Not only are distributions to your heirs income-tax free, but the amounts you pay in taxes on the income you contribute to the Roth IRA are removed from your estate. In other words, by paying the taxes associated with a Roth IRA, you essentially make a tax-free gift to your heirs.

Know your limits

There's no income limit for making contributions to a traditional IRA. So long as you receive enough compensation from a job to cover your contribution, you can set aside up to $4,000 in 2007 ($5,000 if you're 50 or older). If you're married and your spouse has little or no income, you may also be able to contribute similar amounts to a spousal IRA.

The tax deductibility of your contributions, however, depends on your participation status in employer-provided retirement plans and your income. If, for example, one or both of you participate in a plan at work, your IRA contributions become nondeductible above specified income limits, which are quite low.

Roth IRAs are subject to the same contribution limits as traditional IRAs, but higher-income taxpayers are ineligible. If you're a joint filer, for example, your ability to contribute to a Roth IRA in 2007 is phased out beginning at $156,000 of modified adjusted gross income (MAGI) and eliminated once your MAGI reaches $166,000. If you're single, the phaseout range is $99,000 to $114,000 of MAGI.



It's also possible to convert an existing traditional IRA into a Roth IRA. Previously, this option was reserved for taxpayers with MAGI of $100,000 or less. But the income limit for conversions will be eliminated — beginning in 2010 — under the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), which was signed into law in May 2006. This is good news if you've built up large balances in traditional IRAs, either through annual contributions or by rolling over funds from a 401(k) or other employer-sponsored retirement plans.

Know your options

TIPRA opens the door for higher-income taxpayers to take advantage of the Roth IRA's estate planning benefits. By converting a traditional IRA into a Roth, you can avoid required minimum distributions and allow your savings to continue growing income-tax free.

You'll have to pay income tax on the amount you convert, but in many cases the benefits of tax-free growth outweigh the tax hit. Plus, if you make the conversion in 2010, TIPRA allows you to defer the tax and include half of the conversion income on your 2011 return and half on your 2012 return.

Be sure to analyze the tax consequences before you convert. Depending on the size of your IRA and your income level, a Roth IRA conversion can bump you into a higher tax bracket. If that's the case, you may want to convert your IRA gradually over several years to minimize the tax impact.

TIPRA doesn't lift the income restrictions on contributions to a Roth IRA. But it creates a "back door" option for high-income earners.

For example, Nancy, age 50, doesn't have an IRA. With MAGI in excess of $200,000, she's ineligible to contribute to a Roth IRA but can make nondeductible contributions to a traditional IRA. Nancy sets up a traditional IRA in 2007 and contributes $5,000 per year. Assuming an 8% rate of return, the IRA's balance in 2010 is $22,531. Nancy converts the entire amount into a Roth IRA. Because her contributions (totaling $20,000) weren't deductible, Nancy pays taxes only on $2,531 in earnings. She can include the entire amount on her 2010 return, or report half that amount on her 2011 and 2012 returns.

Roth IRAs are subject to the same contribution limits as traditional IRAs, but higher-income taxpayers are ineligible.

After 2010, Nancy continues contributing $5,000 per year to her traditional IRA, avoiding taxes on the earnings by immediately converting the funds to her Roth IRA. When she retires at age 65 (again, assuming an 8% rate of return), her Roth IRA has grown to more than $150,000, all of which can be distributed income-tax free.

Assuming that the law isn't changed, the new conversion rule effectively allows Nancy to enjoy the benefits of a Roth IRA even though she's ineligible to make Roth IRA contributions.

Making the switch

Under the right circumstances, the new conversion rules create valuable estate planning opportunities for high-income earners. Be sure to check with your tax advisor before opening a Roth IRA account. ▮

Looking a gift horse in the mouth

Qualified disclaimer can be a powerful estate planning tool

At first glance, turning down an inheritance may seem like a foolish move. But in many cases, doing just that may be the best strategy. You (or your heirs) can use a qualified disclaimer to redirect property to another person while reducing the tax burden on your family.

What's a disclaimer?

A disclaimer is an irrevocable and unqualified refusal to accept an interest in property. When you make a disclaimer, the disclaimed property is treated as if it had never been transferred to you. The property then passes — according to the terms of the transferor's will or trust — as if you had died before him or her.

If your disclaimer is "qualified" (see "What qualifies a disclaimer?" below), you can redirect the property to a family member or other recipient without negative gift or estate tax consequences.

A qualified disclaimer is a flexible estate planning tool with a variety of uses. Here are a few examples:

- Marie's will leaves all of her property to her three daughters or, in the event a daughter predeceases her, to that daughter's children. When Marie dies, one of her daughters, Julie, is terminally ill. If Julie disclaims her inheritance, the property automatically passes to her children without being included in her taxable estate. Depending on how much is being disclaimed by Julie, Marie's estate may be subject to generation-skipping transfer (GST) tax.
- Same facts as the first example, except that when Marie dies all of her daughters are healthy. One of the daughters, Jill, however, is quite successful and has already built up a substantial estate. Rather than expose her inheritance to unnecessary estate taxes, Jill makes a qualified disclaimer and allows the property to pass directly to her children. Similarly, there may be GST tax consequences to Marie's estate by virtue of Jill's disclaimer.
- Jim dies in 2007, leaving a $4 million estate. Jim's will leaves everything to his wife, Lori, or, if Lori doesn't survive him, to their children. The problem with Jim's estate plan is that it wastes his $2 million federal estate tax exemption. The assets he leaves to Lori are sheltered from federal estate tax by the unlimited marital

What qualifies a disclaimer?

Under Internal Revenue Code Section 2518, a disclaimer of an interest in property is qualified if it meets these requirements:

1. The disclaimer is in writing.
2. The disclaimer is delivered to the transferor, or his or her representative, within nine months after the transfer is made (or, if later, within nine months after the disclaimant turns 21).
3. The disclaimant hasn't accepted the disclaimed property interest or any of its benefits.
4. As a result of the disclaimer, the property interest passes — without any direction from the disclaimant — to the transferor's spouse or to someone other than the disclaimant.

deduction. Lori dies in 2008, when the estate tax exemption remains at $2 million and the top marginal estate tax rate is 45%. Assuming the assets she inherited from Jim represent her entire estate and they are still worth $4 million, her estate will owe $900,000 in estate tax on those assets — or more if subject to state estate taxes.

If, instead, on Jim's death Lori makes a qualified disclaimer with respect to half of Jim's assets, or $2 million, that amount will pass directly to their children federal-estate-tax free, making full use of Jim's $2 million exemption. When Lori dies, the remaining $2 million is sheltered from estate tax by her exemption, and no federal estate tax will be due at her death. Her estate tax liability will be reduced by at least $900,000.

Plan your estate with disclaimers in mind

Be sure to consult your estate planning advisor before making any disclaimers. You shouldn't make a disclaimer unless you're confident that it will achieve your objectives and that you understand the tax consequences. Remember that you can't control the disposition of disclaimed assets. If you make a disclaimer, the assets will pass automatically according to the terms of the transferor's estate plan.

Likewise, in planning your own estate, you can provide your family with the flexibility to make the most of your legacy by carefully spelling out who will receive disclaimed property. ▮

Estate planning red flag

You haven't discussed your plan with your family

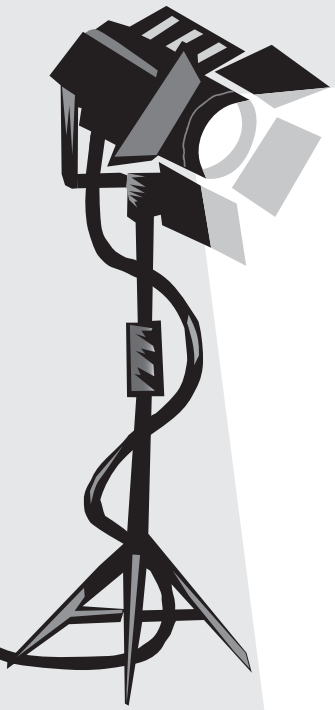
In the movies, the "reading of the will" — which typically takes place in a book-lined study — makes for good drama: The "black sheep" of the family explodes with rage upon discovering that he or she has been disinherited.

In real life, there should be few surprises when it comes to your estate plan. By discussing your plans with your family, you can avoid hurt feelings and disagreements and help avert challenges to your will.

Keep in mind that, even if your plan treats all of your heirs fairly, it may not be perceived that way without an explanation. In estate planning, "fair" doesn't necessarily mean "equal." For example, suppose your adult children from a previous marriage are financially independent. Fairness may dictate that you leave most of your wealth to your younger children from a second marriage. But your older children may not see it that way unless you explain your reasoning to them.

When a family business is involved, parents often struggle to strike a balance between treating their children equally and preserving the business. The parents may feel that children who are committed to working in the business should receive a greater share. But if most of the parents' wealth is tied up in the business, this may not leave much for the other children. One potential solution is to issue voting stock to the children involved in the business and nonvoting stock to the others. This way, all of the children receive equal ownership interests while those working in the business retain control.

Regardless of the approach you take, your efforts to design an estate plan that is fair will be for naught if your family doesn't understand your motives. The simplest way to avoid misunderstandings — or, worse, litigation — over your estate plan is to explain your thought process to your heirs, either face-to-face or through a "family letter."



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Spotlights

Transfer on Death (TOD) Designation

Many people wish to avoid the probate process at their death, but do not have the need or complexity of assets to justify the creation of a trust, and do not want to incur the possible liability of jointly owned property. For these people Transfer on Death (TOD) designations may be a good alternative. It is established practice that cash and securities accounts can be transferred through TOD designation.

It may also be possible to transfer real property through the use of a TOD Deed. While there is currently no specific statute in Michigan regarding the use of a TOD Deed (although there is legislation pending to codify this process), most attorneys agree that Michigan law allows the use of TOD Deeds to transfer real property outside of the probate process. With a TOD Deed the Grantor stays as the owner of property throughout life, but only on death does the property transfer to the beneficiary. During the Grantor's life, the Grantor can mortgage or sell the property. Some advantages of a TOD Deed are:

- No uncapping of property tax during the Grantor's lifetime
- No rescission of the Principal Residence Exemption
- Retain control during life (can transfer, mortgage, lease, etc.)
- Avoids the cost and delay of probate
- Retains the income tax step up in basis at death
- Retains capital gain exclusion under Internal Revenue Code 121
- No divestment for Medicaid purposes
- Beneficiary can not partition or interfere with the use of the property

The disadvantages of a TOD Deed are:

- The property is a countable asset for Medicaid purposes unless it is the primary residence
- The property is an asset for Federal Estate and Generation Skipping taxes
- No posthumous control after death unless conveyed to Trust

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