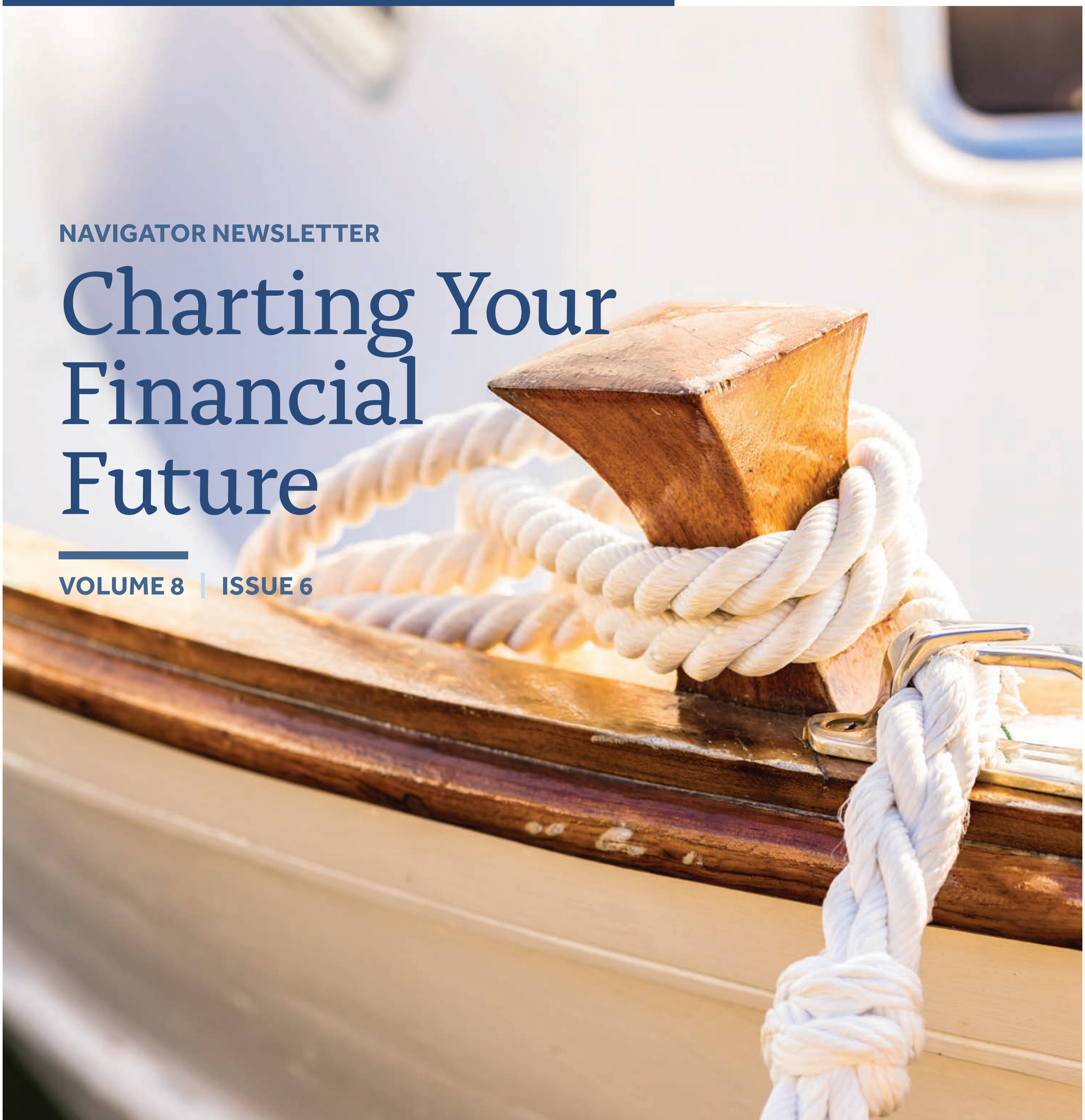

NAVIGATOR NEWSLETTER

Charting Your Financial Future

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Estate Planning

529 plans: The basics.

By Eva Stark, JD, LL.M.

With the rising cost of higher education, education funding has become one of the most important areas of planning for the parents and grandparents of future students. Many look to 529 plans as an important planning tool to address and help mitigate increasing educational expenses.

A 529 plan is a tax-advantaged savings plan designed to encourage saving for future education costs. 529 plans, legally known as "qualified tuition plans," are sponsored by states, state agencies, or educational institutions and are authorized by Section 529 of the Internal Revenue Code.

Background

While nearly every state now has some type of 529 plan, the plans differ greatly, and individuals should research the features, benefits, cost and other attributes of plans before making a planning decision. Some factors to consider include the child's age and number of years left before enrollment would commence, potential residency requirements, and specific educational and familial preferences related to the selection of a postsecondary institution. In addition to the more immediate funding considerations, potential tax benefits also should be considered.

Federal income tax considerations

Contributions to a 529 plan are typically not deductible for federal income tax purposes. Distributions are generally tax free as long as the distributions are used for qualified educational expenses. Whether a distribution from a 529 plan constitutes a qualified educational expense may also vary depending on the type of 529 plan selected.

State income tax considerations

Unlike the federal income tax regime which offers no immediate tax benefit for individuals who contribute to a 529 plan, many states reward donors with state income tax deductions or credits. While some states limit such tax benefits to donors contributing to the state's own 529 plans, other states provide a tax benefit regardless of which state's plan is selected. States also may differ from the federal income tax regime when it comes to distributions that are excludible from income. For example, while some distributions from certain types of 529 plans may be federal income tax free, they may be subject to state income tax.

Federal transfer tax considerations

Contributions to a 529 plan may trigger gift taxes; however, contributions are generally treated as completed gifts which may be eligible for the annual gift tax exclusion. If a donor gifts more than the annual gift tax exclusion amount, the donor may elect to take the contributions into account over a five-year period.

Effect on financial aid

Having a 529 plan may impact a student's eligibility for financial aid. What, if any, effect a 529 plan will have on financial aid could depend on a number of factors including who owns the plan, how much is distributed from the account and when the distribution is made, the institution attended and what type of aid the student may be applying for, among others.

Effect on other tax benefits for education

While a taxpayer may be eligible for other tax benefits such as the American Opportunity Credit or Lifetime Learning Credit while simultaneously excluding 529 plan distributions from income for the same student, "double dipping" is not allowed. In other words, qualified expenses covered by a 529 plan do not otherwise permit an individual to claim an education tax credit.

Flexibility

It may also be possible to change the designated beneficiary of an account without triggering federal income taxes if the new designated beneficiary is a family member of the designated beneficiary. A non-exhaustive list of family members generally includes a child, descendant of a child, a sibling, a parent, a niece or nephew, an aunt or uncle or a first cousin.

Changing a beneficiary or rolling over a 529 plan can have significant tax as well as non-tax consequences. Individuals should always consult with their tax and other advisors before opening, contributing to or making any change to a 529 plan.

Eva Stark, JD, LL.M., joined The Nautilus Group in 2014 to assist with the development of estate and business plans. She also performs advanced tax research. Eva graduated summa cum laude with a BS in economics and finance from The University of Texas at Dallas. She earned her JD, with honors, from Southern Methodist University, where she served as a student attorney and chief counsel at the SMU Federal Taxpayers Clinic. She received her LL.M. in taxation from Georgetown University Law Center. Prior to joining Nautilus, Eva worked in private practice in tax controversy, business law, and litigation.

The Roth IRA conversion decision.

By Robert Keebler, CPA/PFS, MST, AEP® (Distinguished)

Traditional Individual Retirement Accounts (IRAs) and Roth IRAs provide tax breaks in different ways. Contributions to traditional IRAs are generally tax deductible, and growth is tax deferred, but withdrawals are taxable as ordinary income.[1] By contrast, contributions to a Roth IRA are not tax deductible, but growth and qualified withdrawals are tax free.[2]

The Roth IRA Conversion Decision

There will often be an economic advantage in converting a traditional IRA to a Roth IRA, but not in all cases. In deciding whether to do a Roth IRA conversion, taxpayers must analyze the tradeoff between paying current tax on the amount transferred and avoiding tax on later distributions from the account. The analysis begins with a comparison of the taxpayer's marginal income tax rate at the time of the conversion to the taxpayer's expected marginal income tax rate when distributions are received. Note the following general rules.

- If the tax rate is lower at the time of conversion than at the time distributions are received, a Roth conversion will be favorable.
- If the tax rate is substantially higher at the time of conversion than the rate when distributions are received, a Roth conversion will be unfavorable.
- If traditional IRA assets are used to pay the conversion tax and the tax rate is the same at the time of conversion as at the time of distributions, converting will be neutral.
- If "outside assets" can be used to pay the conversion tax, a Roth conversion will be favorable even when the tax rate at the time of conversion is slightly higher than at the time distributions are received. The extent to which this is true depends on the difference between the pre-tax rate of return in the IRA and the after-tax rate of return of the outside assets.

These rules are illustrated in the following, somewhat simplified, examples. (All the examples assume that IRA assets are used to pay the conversion tax.)

Example 1: Art, a married taxpayer filing jointly, has $50,000 in a traditional IRA. Assume that the $50,000 will double in value by the time Art retires and that he takes a lump sum distribution at that time. Assume further that Art is currently in the 24% marginal income tax bracket. The chart on the following page compares the net after-tax wealth realized from converting with not converting, assuming his marginal tax rate:

- Drops to 22%,
- Stays the same, or
- Increases to 32%.

Paying the Conversion Tax with Outside Funds

As noted above, paying the conversion tax with outside funds significantly

1 It is possible to make a non-deductible contribution to a Traditional IRA as well, and such amounts may generally be withdrawn free of income tax, subject to certain ordering rules.

2 To be a qualified withdrawal from a Roth IRA, a distribution must generally be made after the later of: (1) when a taxpayer reaches age 59½, or (2) the end of the five tax-year period beginning with the year of the first contribution.

The Roth IRA Conversion Decision (Example 1)

	Marginal income tax rate drops to 22%		Marginal income tax rate remains 24%		Marginal income tax rate increases to 32%	
	Convert	**Don't convert**	**Convert**	**Don't convert**	**Convert**	**Don't convert**
Beginning value	$50,000	$50,000	$50,000	$50,000	$50,000	$50,000
Current tax	$12,000	0	$12,000	0	$12,000	0
Amount remaining	$38,000	$50,000	$38,000	$50,000	$38,000	$50,000
Value at retirement	$76,000	$100,000	$76,000	$100,000	$76,000	$100,000
Tax payable	0	$22,000	0	$24,000	0	$32,000
Net amount	$76,000	$78,000	$76,000	$76,000	$76,000	$68,000

improves the economic result of a Roth conversion. This might make a Roth conversion favorable even if the tax rate is higher at the time of conversion than it is when distributions are received.

Example 2. Beth is a single taxpayer with a 30% combined federal and state income tax bracket in 2018. She has $50,000 in a traditional IRA and $15,000 of liquid assets in a side fund, which are available to pay the taxes from a Roth IRA conversion if Beth chooses to do one. Assume that the assets in the IRA will quadruple in value by the time Beth retires in 25 years, but the side fund will only triple in value because it is subject to tax. At the end of the 25-year period, Beth will receive a distribution of the full amount in the IRA and will be in a 25% combined federal and state tax bracket. The chart below compares the net amount realized for the Roth IRA conversion decision.

Under these facts, a Roth IRA conversion results in $5,000 more of

Paying the Conversion Tax with Outside Funds (Example 2)

	No conversion Leave assets in Traditional IRA.	**Roth IRA conversion** Use side fund to pay conversion tax.
Beginning balance	$50,000	$50,000
Conversion tax	0	$15,000
Value of IRA after conversion tax	$50,000	$50,000
Value after 25 years	(4 x $50,000)= $200,000	(4 x $50,000)= $200,000
Tax on distribution	$(50,000)	0
Amount after distribution tax	$150,000	$200,000
Plus value of side fund	(3 x $15,000) = $45,000	(eliminated to pay conversion tax) 0
Total net after-tax wealth	$195,000	$200,000

after-tax wealth than not converting, even though the tax rate drops from 30% to 25%. In effect, the taxpayer is able to pack more value into the IRA by paying the conversion tax with outside funds, which grow faster inside the IRA than they would if they remained in the taxable side fund.

Other Factors Favoring a Roth IRA Conversion

Even if a Roth IRA conversion doesn't produce greater net wealth in the basic calculation as illustrated above, there may be other important advantages to a Roth:

- Can make contributions after age 70½ (if the taxpayer has earnings in the year of the contribution, §408A(c)(4)).
- No required minimum distributions (RMDs) starting at age 70½.
- Tax-free income in retirement (Adjusted Gross Income is therefore lower, which offers income tax benefits elsewhere).
- Facilitates wealth accumulation for heirs if the account owner doesn't need the money in the Roth IRA.
- Tax-free withdrawals for beneficiaries after the death of the IRA owner.
- Hedge against possible future increases in income tax rates.

Note that taxpayers with favorable tax attributes such as charitable deduction carry-forwards, investment tax credits or expiring net operating losses, may be able to efficiently utilize these attributes to reduce the effective tax rate on a Roth conversion.

The decision to effect a Roth conversion is complex and depends on a careful analysis of numerous factors. With the help of astute advisors, however, many individuals with traditional IRAs may stand to benefit significantly from considering such a strategy.

Robert Keebler, CPA/PFS, MST, AEP® (Distinguished) is a partner with Keebler & Associates, LLP, and a recipient of the prestigious Accredited Estate Planners (Distinguished) award from the National Association of Estate Planners & Councils. He frequently represents clients before the IRS in the private letter ruling process and in estate, gift and income tax examinations and appeals, and has received more than 250 favorable private letter rulings including several key rulings of "first impression." Keebler has been speaking at national estate planning and tax seminars for over 20 years and is a frequent presenter for New York Life's advisor webinars and company training conferences.

Estate Planning

Flexible estate planning: Disclaimer trusts and the Clayton QTIP election.

By Scott Garrison, JD

An important tenet of estate planning is that situations are always subject to change. The best estate plans will offer flexibility to enable family members to modify a plan when faced with changed circumstances. This becomes particularly important when Congress makes major modifications to tax laws, as recently occurred in late 2017.

In particular, trust arrangements that are regularly employed in estate planning deserve a second look to address such legislative changes and offer the opportunity to adapt to any future tax law changes.

Rather than adhering to complicated plans with complex structures, estate planners can add flexibility and simplicity and achieve tax advantages by utilizing qualified disclaimer trust planning and the Clayton QTIP election.

What is a disclaimer?

A disclaimer is a refusal to accept property or assets passing by gift or bequest, as under a will or similar document. For federal gift tax purposes, a disclaimer of property will not be treated as a taxable gift by the disclaimant (i.e., the individual disclaiming the property) to the individual or entity to whom the property passes if the disclaimer meets the following requirements:

1. The disclaimer is in writing;
2. It is made within nine months of the latter of (a) the day on which the transfer creating the interest in such person is made (generally, the date of death of date of gift), or (b) the day on which the disclaimant attains age 21;
3. The disclaimant has not accepted any of the benefits of the disclaimed property; and
4. As a result of the disclaimer, the interest passes without any direction on the part of the disclaimant and passes either (a) to the spouse of the decedent, or (b) to a person other than the disclaimant.

A disclaimer meeting all foregoing requirements is known as a "qualified disclaimer" pursuant to §2518 of the Internal Revenue Code.

How are disclaimers used in trust planning?

Qualified disclaimers can establish a "wait and see" approach to determine what is most suitable for a family based on state and federal estate laws, creditor protection concerns, and overall estate distribution objectives. A disclaimer by the surviving spouse can utilize the tax exemptions of the first spouse, remove subsequent growth from the taxable estate, and provide creditor protection if desired. Conversely, if circumstances warrant, the survivor may choose to accept a bequest to obtain maximum control and flexibility over the subsequent distribution of the estate. Additionally, the survivor may still be able to utilize the estate tax exemption of the first spouse under a concept known as exemption portability. This approach gives the surviving spouse maximum flexibility in terms of whether a disclaimer trust should be created, and if so, the extent to which the trust should be funded.

When would it be beneficial to utilize a "Clayton" QTIP election?

A qualified terminable interest property (QTIP) trust enables the grantor of the trust to provide for a surviving spouse and maintain control of how trust assets will be distributed once the surviving spouse passes away. Income generated from the trust is given to the surviving spouse to ensure that the spouse is taken care of for the rest of his or her life. Some of the requirements for a QTIP trust include that:

1. The surviving spouse is the sole lifetime beneficiary of the trust;
2. All income must be distributed to the surviving spouse every year at a specified interval; and
3. No person has a power during the surviving spouse's life to appoint any part of the property to any person other than to the surviving spouse. Additionally, the deceased spouse's executor must make an election to treat all or a specified portion of the trust property as qualified terminable interest property.

One of the benefits of the QTIP trust is that trust assets receive a step up in basis at the survivor's death, enabling heirs to avoid capital gains taxes. If estate tax exemption portability is available, estate taxes can be reduced or eliminated as well.

The Clayton QTIP approach, first authorized in *Estate of Clayton*, 976 F.2d 1486 (5th Cir. 1992), and later accepted by the IRS in Treas. Reg. 25-2518-2(e)(5), Example 5, is a variation on the conventional testamentary QTIP trust which can add additional flexibility in anticipation of future tax law changes. Rather than vesting the power solely with the surviving spouse (as under the disclaimer option), the Clayton QTIP gives the decedent's executor or personal representative the discretion to determine how much of the estate should pass to a QTIP, based on an assessment of assets and the tax landscape. The portion not elected to pass to the QTIP trust then passes to a non-marital trust share also established for the survivor's lifetime benefit.

The Clayton QTIP approach may have some slight advantages over using a disclaimer trust. With the Clayton election there is no danger of waiving the disclaimer by the surviving spouse's acceptance of the property, and there is no problem with giving the surviving spouse a power of appointment over the remainder interest, as there is in a disclaimer trust.

Additionally, the decision to make the Clayton QTIP election is typically made by an independent personal representative, avoiding any gift tax exposure to the surviving spouse, and placing the decision making in the hands of a third party to account for a blended family situation.

Conclusion

While tax laws may change and fluctuate with any given congressional cycle, it is important to remember that many conventional planning techniques may prove to be a workable solution to provide for estate planning flexibility. Conventional marital trust planning devices, such as using qualified disclaimers and the Clayton QTIP election, may help to determine the best course of action regardless of whatever future tax law changes occur.

Scott Garrison, JD, joined The Nautilus Group in 2015 as a member of the Case Development Team. Before joining Nautilus, Scott worked in private practice with a primary focus on estate, business and tax planning matters for high net worth individuals and small business owners. Scott attended Texas Christian University where he earned his B.A. in English, and earned his JD from Texas A&M University School of Law. His background includes over ten years of experience in estate, business and tax planning as well as real estate, oil and gas, civil litigation and probate administration.