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529 Plans:

Optimal for Many, but Is It Right for You?

ANDREW B. SMITH, JD
Client Relationship Officer

"529 PLANS" HAVE BEEN THE CORNERSTONE OF COLLEGE education expense planning since Section 529 was added to the Internal Revenue Code during the Clinton administration. They are commonly promoted by financial planners and in the media. However, despite their popularity, 529 plans may not be the optimal planning strategy for affluent families.

Story continued inside.

529 plans come in two forms: prepaid plans and savings plans. Prepaid plans allow the donor to purchase tuition credits for specific institutions. Savings plans, which are the focus of this article, allow a donor to invest contributions and use the funds at any accredited college, university or vocational school in the United States and at some foreign universities.

Income Tax Benefit

The key benefit of a 529 plan is that investment earnings are federal income tax free. Plan distributions for qualified higher education expenses, including tuition, room and board, books, and supplies, are not subject to federal tax. The plan also may distribute tax-free an amount equivalent to any scholarships received by the beneficiary. Distributions in excess of these amounts generally are taxable under the annuity rules (meaning that the portion attributable to the original plan contributions is not taxable), plus a 10% penalty.

Plans are operated by states and educational institutions. State plans are generally open to anyone, including non-residents, and offer state income tax savings for their residents. They may be used to pay expenses at any eligible institution without regard to which state's plan holds the funds. The following plans frequently rank among the best plans for their low fees and good investment choices: T. Rowe Price College Savings Plan (Alaska), Maryland College Investment Plan, The Vanguard 529 College Savings Plan (Nevada), and the Utah Educational Savings Plan.

Control and Flexibility

529 plans are unusual compared to other tools used in the estate tax planning world because a donor can make a completed gift for federal gift and estate tax purposes despite retaining complete control over the assets. That control includes:

- distribution decisions,
- the ability to transfer the account to another family member of the beneficiary without tax if, for example, the original beneficiary does not attend college or doesn't need all of the funds (However, if the new beneficiary is in a younger generation than the first, the generation skipping tax may apply.), and
- the right to designate a replacement account holder (who will then have these powers).

A 529 account holder can even withdraw the funds for personal use, although the earnings will be subject to ordinary income tax and a 10% penalty. The donor also has control over investments, but the choices are limited to the plan's investment options and timing restrictions.

Accelerated Gifting

The donor may elect to accelerate up to five times the annual gift exclusion into a single year's contribution to the plan. So, in 2014, a single person can contribute $70,000 and a married couple can contribute $140,000 without using any of their lifetime gift exemptions. However, doing so uses up those years' annual exclusions. Any additional gifts to that beneficiary during that time will be taxable (if not offset by the donor's lifetime gift exemption). If the donor dies before the five years have elapsed, a pro-rata portion of the accelerated contribution is recaptured by including it in the donor's taxable estate.

Trusts and UGMAs

Irrevocable trusts often are used to remove assets from a donor's estate and, in some cases, to provide funds for the educational expenses of future generations. A trust may be able to invest in a 529 plan if its document permits. The key benefit of a trust investing in a 529 plan is avoiding the high trust income tax rates, which now include the new Medicare 3.8% surcharge on a trust's investment income above a very low threshold.

Uniform gift/transfer to minor act accounts can fund education expenses, but their earnings are subject to the "kiddie tax," which causes their earnings to be taxed at the parent's marginal tax rate, which may be very high. Importantly, the donor loses control of the account when the beneficiary reaches adulthood. At that time, the beneficiary can use the assets for anything, not just college education. Unlike 529 plans, UGMA/UTMA account assets are included in the donor's estate for purposes of federal estate tax if the donor is the custodian.

Should You Use 529 Plans?

The prime candidate to make contributions to 529 savings plans is someone who wishes to save for family members' college expenses, doesn't currently make annual exclusion gifts to those family

members, and would like to retain control over the assets. The primary benefit is tax-free earnings within the plan.

However, very affluent families should consider foregoing the income tax benefit of 529 plans in order to minimize estate taxes. The reason is that they can make annual exclusion gifts (either in cash or in more sophisticated ways) and pay family members' college tuition using the tuition gift exclusion. The 529 plan "wastes" the annual gift exclusion's wealth-transfer benefit. This combination of annual exclusion gifts and the tuition exclusion typically will result in greater estate tax savings than the income tax benefit of a 529 plan.

The next time you discuss your estate plan with your trusted advisors, consider whether funding a 529 college savings plan is right for you.

There certainly are advantages, but you may find that better alternatives exist for maximizing multi-generational family wealth. Of course, if an affluent giver for whatever reason is not utilizing their annual exclusion amounts, using a 529 plan may offer an easy and flexible way to capture some of the unused tax advantages.

Determine your heirs' hopes, dreams and aspirations. If theirs differ from yours, you may or may not choose to alter your plans, but you should at least be leery of attempting to force them to do something that they do not want to or cannot do.

Family Wealth
TRANSITION PLAN

It just makes sense to have a plan to transition the family's wealth, whether it is an operating business or an investment portfolio, to the next generation. My experience is that the senior generation often doesn't have a carefully thought out plan. If it does, the plan typically is not well communicated to or accepted by the younger generation.

How do you develop a plan? Each family is different. The objectives and needs of family members vary. So, while one size cannot fit all, I'd like to quote my former mentor, Dr. Léon A. Danco, on the eight keys to successfully transition a family business from one generation to the next. While the keys are stated in the context of an operating business, there are analogous requirements for investment wealth.

1. Accommodating heirs who can cooperate and work together or agree to separate themselves from the enterprise.
2. Motivated successors who possess knowledge and experience beyond that of the founder and are capable of steering the business in the uncharted waters ahead.
3. An uncomplicated and rational ownership structure which does not confuse inheritance with management.
4. An organized team of key managers who approach their responsibilities professionally and agree to support the new leadership enthusiastically.
5. A group of competent advisors, who understand the business, know and respect the successors, and are capable of providing direction to the business and family through current and future uncertainties.
6. The presence and influence of a working board of outside directors who are respected by the family and provide objective insights and opinions.
7. A plan for meaningful contribution by the outgoing owner/manager after retirement that does not interfere with the long-term strategy of the company.
8. Estate planning that effectively recognizes the future realities of both family and business needs.

Your succession plan must address each of these keys; failure to do so imperils future family harmony and business success. Perhaps an appropriate starting point is to determine your heirs' hopes, dreams and aspirations. If theirs differ from yours, you may or may not choose to alter your plans, but you should at least be leery of attempting to force them to do something that they do not want to or cannot do. For example, if they do not want to be business partners or cannot get along with each other, it probably does not make sense to make them co-owners of the business.

Perhaps the toughest question is whether it is feasible to make meaningful progress toward accomplishing the keys to success. You may need help from your advisors in assessing your heirs' abilities, helping them build new skills, working through difficult relationships and much more.

Honest Talk

If you talk with your kids honestly (and with love) about your concerns, perhaps their realization that you might not do what they expect will cause them to reassess their own situations and make necessary adjustments to help alleviate your concerns. Help them (and yourself) to identify paths that may lead toward achieving the keys.

But, at some point, you have to be realistic. I remember a business owner telling me that his son just wasn't quite ready to take over the helm of the family's business. Dad's greatest hope was for the business to remain in the family. In response to my question, he told me his son was 56. Is he being realistic in thinking that a 56-year old who is not quite ready ever will be? Then, I spoke with the son, who told me he didn't want to run the business. The thought scared him to death. Hope springs eternal, but at some point you have to play with the cards you are dealt. There are options for this family, but the passage of time, with no affirmative action, is unlikely to fulfill the father's dreams.

Developing a transition plan requires you to determine your objectives, discuss them with those who are crucial to accomplishing those objectives, and assess the realistic chances of achieving success. Where there are deficiencies, you and those affected need to work together to develop approaches to overcome the deficiencies. Then, you need to make transition a priority and take action. After doing so, you can assess progress and make any necessary changes to the plan.

ROSS W. NAGER, CPA
Of Counsel

CONTRIBUTING
Instead of Selling Property

One of my clients sold a large ranch in the Southwest several years ago. The buyers bought the ranch, all of its contents and the 500 head of cattle.

They did not, however, want the five quarter horses and soon, my client - sans ranch - would have nowhere to stable them. "What should I do with the horses?" she asked me over a crackling cell phone connection, anxious to close the deal. It was during the post-Lehman crash and horses, which are expensive to keep, were being turned out into the wild in droves. Horse rescue organizations were already at capacity.

"We'll donate them," I suggested. "The charity can be responsible for selling them and you can take the charitable deduction on your tax returns." Thus began my foray into helping clients rid themselves of a variety of items, including boats, jewelry, art, livestock and personal real estate, without going through the machinations of selling them. They got the emotional upside of benefitting a favorite charity while clearing out a proverbial closet or two. The process of donating property to charity is not without its drawbacks, however. So, before you give your pearl choker to your favorite pug protection program, there are a few things you should know.

Deduction Amount

An outright gift of real or personal property to a public charity generally allows you to deduct the property's fair market value (FMV) while avoiding capital gains taxes. However, if you donate such property to a private foundation, your deduction is limited to your cost basis.

When making such a donation, it is very important to obtain and substantiate an accurate valuation of the property. Failure to do so can result in loss of the deduction as well as penalties for overvaluation. For any item or group of similar items worth more than $5,000, you usually need to get an appraisal by a qualified appraiser, file Form 8283 with your federal tax return, and have your appraiser sign the form. If you're claiming a charitable deduction of more than $500,000, you must attach the appraisal to your return.

If the charity disposes of the property within three years, the IRS requires the charity to report the sales price on Form 8282. If the price is significantly less than the value you reported on your income tax return, the IRS may challenge a portion of your deduction.

Avoiding Capital Gains Tax

One of the benefits of donating appreciated real or personal property is that you avoid capital gains tax. To preserve this benefit, don't donate property to charity after you've entered into a binding agreement to sell it. This sometimes happens when a property owner with philanthropic intentions gets close to consummating a sale and then realizes a better tax result could be achieved by donating the property. The IRS may view this as a pre-arranged sale and require the donor to pay capital gains taxes anyway.

If you donate property to a charity that you established, watch out for self-dealing rules. These rules impose harsh excise taxes on certain arrangements and transactions between a private foundation and a disqualified person (generally meaning the donor and family members).

Also, ensure that you have enough income to take advantage of the sizeable charitable deduction you may get from donating a valuable property. While it is true that excess charitable deductions can be carried forward for five years, some of my clients have struggled to use them, making the timing of the donation important.

Always talk with your tax advisor before making the contribution. The rules governing substantiation of the contribution, the value of the property and the amount deductible on your return are complex. Failure to comply with the rules can limit or eliminate your deduction and result in penalties.

In the end, these kinds of transactions seem to work best when a client has a history of charitable intent and assets they, quite frankly, don't want to deal with selling. Usually you get a better financial return from an outright sale than a donation, but life gets busy and the emotional return from making a large charitable gift allows you to accomplish multiple goals simultaneously.

LISSA GANGJEE, J.D., CFP®
Senior Managing Director
Head of Client Service

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Founded in 1997 as the successor to two 40-year old, investment-focused family offices, today Sentinel offers the stability of an institutional firm, the entrepreneurial spirit of a young firm, the personal feel of a family office and the in-house technical skills of independent planning and investment management firms.

Contributing to this issue:

Anthony J. DeToto
D. Fort Flowers, Jr., CFA
Lissa Gangjee, J.D., CFP®
Ross W. Nager, CPA
Andrew B. Smith, J.D.
Bruce L. Swanson, Ph.D.

For additional information about the topics presented in this newsletter, or to be placed on our mailing list for future editions, please contact Anthony DeToto at adetoto@sentineltrust.com or call 713.559.9578. You can find electronic copies of our past quarterly newsletters at www.sentineltrust.com/publications/on-watch/.

2001 Kirby Drive, Suite 1200

Houston, Texas 77019-6081

713.529.3729

www.sentineltrust.com

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