

TAX AND ESTATE PLANNING NEWSLETTER

NOVEMBER 2003

The following tax and estate planning news may be of interest to you in your business or personal pursuits. If you have questions about any of these items, please call or e-mail one of the Tax and Estate Planning Attorneys listed below by clicking on the attorney's e-mail address or calling the telephone number.

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§529 Education Plans

Much has been written about these tax-favored education plans which are now offered in all 50 states. An alternative savings vehicle is the minor's trust which has greater appeal than in the past due to the recent tax reductions and lowered tax rates for individuals and the 15% maximum tax rate on dividends and long-term capital gains. Section 529 accounts still appear to be more favored for college savings. The reasons are the tax-free build-up of interest, dividends and capital gains within the account. Withdrawals from the account are also tax free if used for tuition, room, board, books, etc. Also, the flexibility of §529 plans is very appealing. For example, an account beneficiary can be changed if funds remain because the original beneficiary doesn't go to college or use all the funds, and another family member can take advantage of those funds on a tax-free basis. The fees of §529 plans should be carefully examined as they can vary from plan to plan. Estate tax breaks for §529 accounts also make this program appealing; while no

federal income tax deduction is permitted for §529 contributions, about one-half of the states do provide for a tax deduction.

Although the contributor to the §529 account (usually parent or grandparent) retains control over the account by having the right to change the beneficiary, the account is nevertheless excluded from the contributor's estate in almost all cases. Even though the contributions to the §529 accounts are gifts, donors can use their \$11,000 annual gift tax exclusion (\$22,000 if spouse joins in) and even can use 5-year averaging, electing as much as \$55,000 (or \$110,000) to be spread over a 5-year period.

Discounts for Gifted Family Limited Partnership/Limited Liability Company Interests

In a recent Tax Court case involving the issue of appropriate minority interest and lack of marketability discounts for gifts of FLP interests by parents to their children, the Court made a favorable finding. The FLP owned marketable securities (mainly

municipal bonds) and parcels of real estate. Although the taxpayer was not allowed the discounts as reported on the gift tax return, the Tax Court did allow a 15% minority interest discount and a 24% lack of marketability discount.

Attractive New Benefit for Flexible Spending Accounts

Many employers have adopted Flexible Spending Accounts (FSAs) to allow employees to take advantage of paying for certain items with pre-tax dollars, in particular, medicines and drugs purchased by the employee. In a recent ruling, the IRS held that FSAs may now allow employees to pay for over-the-counter drugs (no prescription needed) with pre-tax dollars. Prior to this ruling, the IRS's position was that such items could not be paid for with FSA funds unless the purchases were tax deductible under the Internal Revenue Code, and over-the-counter drugs are not deductible under the Code. The IRS in this favorable ruling now says that expenses incurred by the taxpayer for medical care can be included and there is no requirement that the expenses be allowed as a deduction for medical care or that a physician's prescription is a prerequisite. Amounts paid by the employee for dietary supplements (like vitamins) that are merely beneficial to general health are not reimbursable or excludable under FSAs, however.

This new Ruling is not a new pronouncement with a prospective date. It is an interpretation of existing law and, therefore, it could apply to FSAs for the current year, which would allow employees who may be scrambling at year-end to find ways to use amounts remaining in their

FSAs to use these dollars so they won't be lost under the "use-it-or-lose-it" requirement that applies to all FSAs. Many plans may require that only prescription drugs be allowed for reimbursement purposes, however, and this may block employees from doing this unless companies amend these plans in time. Employees will need to have saved receipts for the purchase of these over-the-counter drugs and, as a practical matter, most people don't save these. By allowing this new benefit there will be increased administrative burdens on the plan.

Lower Tax Rates on Dividends Help Cash-Outs

The new tax rules providing a maximum tax rate of 15% on dividends may help more senior shareholders in family owned corporations cash-out by way of stock redemptions. When the dividend rates were much higher than the capital gain rates (the rates are now the same for each at 15%), the senior shareholder had to qualify for "exchange treatment" in order to receive capital gain treatment and in order to do so could not remain actively involved in the business as an officer, director or employee. With the rate change on dividends, qualifying for exchange treatment is not so important (unless the senior member stockholder has a high tax basis, which is usually not the case), and the senior member could remain actively involved and withstand dividend treatment at the 15% tax rate. This is an important item to consider in family business succession planning.