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REPORTER P&F

RETIREMENT PLANS AND LIFE INSURANCE:

Do You Know Who Your Beneficiaries Are?

Marcia C. Fidis, Esq.

For many clients, retirement assets such as 401 (k) plans, pension plans, annuity contracts or other types of "deferred compensation" plans and/or life insurance constitute a significant part of their wealth. Most clients expect that these assets will pass to their chosen beneficiaries upon their death. However, to avoid undesirable results, it is necessary to carefully plan for the disposition of retirement and life insurance assets. The problems commonly occur under three scenarios.

POST-DIVORCE

In the event of divorce, it is essential to check the beneficiary designations on all retirement accounts and life insurance policies to see that they are changed in accordance with the separation agreement or divorce decree. Just because the separation agreement provides that a former spouse waives his or her rights in "all retirement accounts" or in "all other property" of the other spouse, the former spouse may still have rights in the retirement asset or life insurance policy until the beneficiary designation is changed. In the 2001 case of *PaineWebber Incorporated, et al. v. East*, Maryland's highest court held that the decedent Dewey's ex-wife, Carol, had not waived her interest as a beneficiary of Dewey's IRA account even though their separation agreement included a broad waiver of the other's estate, retirement assets and rights in other property. The court found that none of the waiver provisions terminated Carol's rights in Dewey's IRA. Therefore, since Dewey had not changed the beneficiary designation of his IRA after execution of the separation agreement, his ex-wife was entitled to receive his IRA account upon his death.

The moral of this case is clear. As soon as the separation agreement is signed, or if there is no separation agreement, as soon as the divorce decree is entered, check each beneficiary on any retirement asset, annuity contract or life insurance to be sure your former spouse is not named and that the beneficiary of your choice is specifically named.

PRENUPTIAL AGREEMENT

These agreements are becoming more common among engaged couples in order to protect some assets from claims of the spouse in the event of death or divorce. Again, the complex rules governing retirement plans can cause unintended results. In a recent case, *Hagwood v. Newton*, the Fourth Circuit Court of Appeals held that even though a husband waived his rights to his wife's retirement benefits in the parties' prenuptial agreement, he was nevertheless entitled to collect those benefits upon her death. Here the trap was a particular rule under ERISA (the Employee Retirement Income Security Act) which protects a surviving spouse's rights to certain pension and profit sharing plan benefits. One of the requirements under ERISA is that in order for a spouse's waiver of survivor benefits to be effective, it must be signed by a spouse, i.e. after the parties' marriage. A prenuptial agreement signed when the parties are unmarried does not meet this requirement.

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The Pasternak & Fidis Reporter

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Gifting to Provide for Education

Nancy G. Fax, Esq.

We are often asked by parents, grandparents and others the best way to set aside funds for the education of family members. This article will summarize five basic options you may wish to consider.

DIRECT PAYMENT OF TUITION

The payment of tuition directly to an educational institution does not constitute a gift for gift tax purposes. This provides a simple and effective way for one person to pay for the education of another person without concern about gift tax consequences. There are no limitations on the amount of payments and such payments may be made to any qualified educational institution, including primary and secondary schools, colleges, universities and vocational schools. It should be noted, however, that the non-gift treatment applies only to tuition, and not to other education expenses, such as room and board, books, fees and supplies.

EDUCATION SAVINGS ACCOUNTS (ESA'S)

Formally called Education IRAs, ESA's have undergone some changes. Beginning in 2002, you can establish and contribute up to $2,000 per year to an ESA on behalf of any beneficiary under age 18. There can be only one account per child and the contribution must be made in cash (not in securities or other assets). The funds can be withdrawn tax-free to pay for qualified educational expenses at primary and secondary schools, colleges, universities and vocational schools. If used for any other purpose, taxes and penalties will be due on the withdrawals. You can control where and how you invest the funds in the account. If the beneficiary has not used the funds by age 30, he or she can withdraw the money, minus taxes and penalties, unless the assets are rolled over to an account in the name of another eligible family member. ESA's cannot be set up by single filers earning more than $110,000 or married couples filing jointly earning more that $220,000.

SECTION 529 PLANS

Many states and educational institutions have established these plans, under Section 529 of the Internal Revenue Code, to provide for higher education expenses. Higher education expenses include tuition, fees, and the costs of books, supplies and equipment at a college, university and certain vocational schools.

The account owner retains control over the account funds irrespective of the age of the account beneficiary. You can select among investment strategies offered by the plan sponsor, but you cannot direct specific investments.

One unique feature of Section 529 plans is that you, as the account owner, can take the funds back if you need them. You would pay ordinary income tax on the withdrawal as well as a 10% withdrawal penalty. You can change the designated beneficiary at any time. However, there will be adverse tax consequences if the new beneficiary is not a member of the family of the original beneficiary or is of a different generation than the original beneficiary.

There are income tax advantages to Section 529 plans. Funds invested in state sponsored plans are not subject to federal income tax if the funds are used for the qualified higher education expenses of the beneficiary. In addition to federal tax advantages, certain states (including Maryland and Virginia) and the District of Columbia allow an income tax deduction for contributions to 529 savings plans and/or state income tax exemption for earnings distributed from a plan.

Another advantage of 529 savings plans is that the contributions are treated as gifts to the beneficiary and will qualify for the $11,000 per person annual gift tax exclusion. Even though you can get the funds back, they will not be treated as a part of your taxable estate at your death if the funds remain in the account.

Further, there is a front-end loading feature that is unique to the 529 savings plans. You may contribute up to five years worth of annual gift tax exclusions to the account all in one year. That is, you may contribute up to $55,000 to one beneficiary's account in one year and elect to treat the gift as made over the next five years for gift tax purposes. You would need to file a gift tax return for the year of the gift to

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make this election and you would not be able to make any other annual exclusion gifts to that beneficiary during the five-year period. It is important to note, however, that only cash (not securities or other assets) may be contributed to 529 savings plans.

In addition to the savings plans, Section 529 provides for prepaid tuition plans which allow benefits for prepaying college tuition. However, the plans are tied to a particular college and, therefore, for young beneficiaries generally the savings plan option under Section 529 is preferable because of its flexibility.

Because there are so many different versions of these plans, it is essential to shop around for the best plan for you. One website that has a great deal of useful information about Section 529 plans is *www.savingforcollege.com*.

CUSTODIAL ACCOUNTS (UNIFORM TRANSFERS TO MINORS ACT ACCOUNTS)

Custodial accounts can be set up at almost any financial institution for a single beneficiary and the donor can name the custodian as well as the beneficiary. A major advantage of a UTMA account is that it is not limited solely to expenditures for education. The account funds can be used for any purpose for the child, including education. You can be the custodian of the account but if you are the custodian at the time of your death, the value of the account will be included in your taxable estate. Accordingly, if estate taxation is a concern, generally you will want to choose someone else to act as the custodian of the account. You can contribute any amount to the account but if you contribute more than $11,000 per child per year, you will have to file a gift tax return allocating some of your gift tax exemption.

Education Funds for Children

	529 PLAN	EDUCATION SAVINGS ACCOUNT	CUSTODIAL ACCOUNT (UTMA)	DIRECT PAYMENT OF TUITION	TRUST
Donor Income Limits	N/A	Phase-out begins $95,000 – Single $190,000 - Joint	N/A	N/A	N/A
Contribution Limits (per donee)	$55,000 gift tax free every 5 years Total $175,000 (MD) $250,000 (VA)	$2,000 per year	No Limit ($11,000 per year gift tax free)	May qualify as non-taxable gift to tax-exempt educational organization	No Limit ($11,000 per year gift tax free)
Federal Income Tax	Tax-free for higher education	Tax-free for education	Taxed at child's tax rate at age 14	N/A	Taxed to trust or beneficiary
Change of Beneficiaries	To family member	To family member	No	N/A	May permit changes
Withdrawals	By account owner if permitted by plan	By beneficiary at age 30	By beneficiary, generally at age 21	N/A	May permit withdrawals
Investments	By plan	By contributor	By custodian	N/A	By trustee
State Tax Deductions	Yes – by state	No	No	No	No
Purpose	Higher education	Elementary through higher education	Any purpose	Elementary through higher education	May specify any purpose
Penalties or Withdrawals	10% if not higher education	10% if not education	N/A	N/A	N/A
Age Limits	N/A	18	Generally 21	N/A	N/A
Creditor Protection	Some state laws protect plans from creditors of account owner and beneficiary	Uncertain	Assets belong to child and are available to child's creditors generally at age 21	N/A	Trust provisions can protect assets from creditors

The disadvantage of the UTMA account as compared to 529 plans and the education savings accounts is that the funds in the custodial account do not grow tax-free or tax-deferred. The income on the account is taxed to the beneficiary of the account. If the beneficiary of the account is under age 14, the income on the account will be taxed to the child at the parents' income tax rate. Once the child reaches age 14, the income on the account will be taxed at the child's rate, which is generally lower than the parents' rate. Another drawback is that to the extent the funds remain in the account when the child reaches age 21, the child has legal control over the funds and can withdraw the funds and spend them as he/she chooses.

TRUSTS

The trust alternative is comparable to the UTMA custodial account in that there is no tax-deferred or tax-free growth and the assets can be used for any of the beneficiary's needs, not just for education. The advantages as compared to a custodial account are that 1) the trust can be designed so that the assets are held in trust beyond age 21, even to the child's death which could protect the assets from the child's creditors, unwise marriages or inability to manage assets; 2) the donor can specify in detail the purposes for which the trust assets will be used; and 3) the donor can determine who receives the trust assets in the event of the death of the beneficiary during the term of the trust.

The disadvantage of a trust as compared with the custodial account is the cost of establishing and maintaining the trust, such as legal fees and accounting fees. Notwithstanding the additional costs, generally a trust is preferable over the other options if you wish to gift large amounts and control the beneficiary's access to the funds. ●

D.C. Estate Tax Law Change

The Council of the District of Columbia recently passed legislation setting the D.C. estate tax exemption amount at $675,000 for decedents dying on or after January 1, 2002, even though the federal estate tax exemption amount has been increased to $1 million this year and is scheduled to increase incrementally to $3.5 million by 2009. This means that a D.C. estate worth between $675,000 and the federal estate tax exemption amount (currently $1 million) will be required to file a D.C. estate tax return (and possibly pay D.C. estate tax) even though no federal estate tax return will be due.

Several other jurisdictions have capped their estate tax exemptions at $675,000 or $1 million irrespective of any increase in the federal estate tax exemption. Under current law, the estate tax exemptions in Maryland and Virginia, however, will float with the federal exemption as it increases.

This action by the District of Columbia and the other jurisdictions is an attempt to avoid the projected revenue losses that would ensue if their estate tax exemptions kept pace with the increasing federal exemption. ●

PASTERNAK & FIDIS, P.C.

NEWS

Recent Publications

P & F attorneys Geoffrey M. Christian, Kathleen A. Marthaler, and Eric A. San Juan have authored an article in the Winter, 2002 issue of the *Estate Planning Newsletter*, published by the Washington, D.C. Estate Planning Council. The article, "Estate Planning in Maryland, the District of Columbia, and Virginia: Distinctions with a Difference" points out the importance of using estate planners familiar with the applicable laws in all three local jurisdictions.

Nancy Fax, contributing editor of the *Estate Planning Newsletter*, published an article in the Summer, 2002 issue entitled "Recent Developments in District of Columbia Law" highlighting changes in D.C. estate and trust law.

P & F Attorneys Featured in Family Law Programs

In October, 2001 Marcia Fidis was Program Chair and Anne (Jan) White was on the faculty for the Divorce Tax Workshop for the Maryland Institute for Continuing Professional Education of Lawyers. This workshop is designed to teach family law attorneys basic to advanced tax law necessary to represent the economic interests of divorcing spouses.

In June, 2001 Anne (Jan) White was the Chair and on the faculty of the District of Columbia Bar Association program, Family Law Around the Beltway. At this program experienced family law attorneys from the three local jurisdictions explained how the choice of location of a divorce can make a major difference in the results and compared the divorce law, court procedures, and strategies for a successful resolution in each of these jurisdictions. Jan White practices in all three jurisdictions.

SAVE THE DATE!

Interested in further information on Section 529 plans?

Pasternak & Fidis has arranged for a special presentation by

Joan Marshall

Executive Director
College Savings Plans of Maryland

Wednesday, September 25, 2002
4 - 6 pm
Hyatt Regency Hotel • Bethesda Metro Center
Bethesda, MD

Space is limited! Please call Mary Jane at (301) 656-8850 to reserve a space.

PASTERNAK & FIDIS, P.C.

NEWS

Marcia Fidis Wins Leadership in Law Award

We are pleased to announce that Marcia C. Fidis has been honored with 23 other Marylanders with The Daily Record's first Leadership in Law Award. The award recognizes successful members of the legal community throughout Maryland who have devoted their time and energy to bettering the profession, have committed themselves to improving the community in which they live and work, and have played the important role of mentoring future professional and community leaders.

Linda Ravdin Joins P & F

On August 1, Linda J. Ravdin, a principal in Ravdin & Wofford, P.C., will be joining us as a principal in the firm's divorce and family law practice. Linda brings a wealth of knowledge and experience to the firm.

Linda has been in private practice since shortly after her graduation from George Washington University School of Law in 1974. She began her career as a criminal defense lawyer, handling everything from disorderly conduct to first degree murder cases. For more than 20 years, she has concentrated in divorce and family law. In 1995 and 2000, *Washingtonian Magazine* named her one of the metro area's best divorce lawyers. She is the author of a forthcoming book, *TM 849, Marital Agreements*, a guide for attorneys to drafting and negotiating premarital and domestic partnership agreements. She is a member of the District of Columbia, Maryland and Virginia bars and has been elected a Fellow of the American Academy of Matrimonial Lawyers (AAML).

—continued from front cover

To avoid this result, it is necessary for the waiving party under the prenuptial agreement to sign the plan's waiver forms after the parties are married. A carefully drafted prenuptial agreement should require the spouse to sign any necessary forms after marriage upon request of the other spouse.

ESTATE PLANNING

The key here is understanding that the language of your will or revocable trust by itself does not control the disposition of your retirement assets or life insurance upon your death. When your new will or trust is signed, it is important to check the beneficiary designations on all your retirement accounts and life insurance policies to be certain that these designations are consistent with the provisions of your will or trust and do not thwart your estate plan. For example, assume you set up a trust for your minor children to hold all your assets, including retirement assets and life insurance. Unless you execute new beneficiary designations naming as beneficiary the "trustee of the trust for the benefit of my children under my will," these assets will not pass into the trust upon your death. If your beneficiary designation names "my children Susan and William" as the beneficiaries rather than the trust, the assets will pass outright to the children. Worse still, if Susan and William are minors at your death, a guardianship proceeding may have to be initiated to hold distributions from retirement plans or proceeds from life insurance policies.

To avoid this trap, you should work with your estate planning attorney to review your beneficiary designations and have them completed properly to coordinate with the planning in your will or trust. ●

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NEWS

Updates on Nancy Fax

On May 22, 2002, P & F partner Nancy Fax received an award from the Estates, Trusts and Probate Law Section of the District of Columbia Bar acknowledging her extraordinary contributions to the practice of law in the areas of estates, trusts and probate in the District of Columbia.

In June, 2002, Nancy presented a program for the D.C. Bar Taxation Section, Estate Planning Committee on recent legislative developments in the District of Columbia.

Nancy has been elected to the Maryland State Bar Association's Estates and Trusts Section Council, and has been elected to the Board of Directors of the Montgomery County Community Foundation, an affiliate of the Community Foundation for the National Capital Region.

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