



# FINANCIAL *Planning Strategies*

A Financial Planning Update

**WestPoint** *Private client*  
G R O U P



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## 529 Plans: A College Savings Alternative

As higher education costs continue to soar, many parents find themselves faced with the nagging question, "Will I have enough money to pay for my child's college education?" Although most people today are likely to agree that an investment in higher education usually reaps its rewards in higher long-term earnings—and, hopefully, greater job satisfaction—one key concern is how to choose a smart savings alternative. **529 plans** are flexible investment options with tax benefits.

These state-sponsored plans offer attractive tax benefits and allow you to contribute substantially higher sums

than other savings vehicles, such as the **Coverdell Education Savings Account (ESA)** and custodial accounts. The funds may generally be used for any "qualified" higher education expense, including tuition, room, board, fees, books, supplies, and equipment. You don't necessarily need to be a resident of a state to participate in its 529 plan. In some states, you may even name *yourself* as the beneficiary, if you are planning to further your education in the future. However, participation does not guarantee admission to college—the prospective student will still have to meet the school's entrance requirements.

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## Assessing Portfolio Risk

Most investors know that they should evaluate their **risk tolerance** when considering an investment. Oftentimes, investors think of risk only in terms of possibly losing money. However, in the investment world, risk is broadly defined as the probability that the *actual* return from an investment will be different from its *expected* return. Actual returns (making or losing money) can be affected by a number of factors, and total risk is a measure of variation in return due to *all* sources.

### General Risk

*General* risk refers to factors that lie *outside* individual companies but affect an entire class of investments or the market as a whole (although individual companies may be affected to varying degrees). One type of general risk, known as **market risk**, may be a function of political, economic, and sociological events or changes in investor preferences. For example, market risk occurs when the overall

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Although many details of these plans vary by state, they generally come in two forms—**prepaid tuition plans** and **college savings plans**. Prepaid tuition plans allow participants to “lock in” tuition rates at eligible state colleges or universities with a lump-sum investment or monthly installment payment. The funds are pooled and invested over the long term, so the earnings should meet or exceed expected future tuition increases. The contract value may also be applied to private or out-of-state schools (although possibly not at full value, depending on the state). College savings plans allow contributions to vary, and the full value of the account can be applied at any accredited institution of higher education nationwide.

### Major Advantages

**Substantial Contributions Allowed.** Contribution limits are significantly higher than with other college savings alternatives. Some states allow you to set aside more than \$100,000 per beneficiary, and they generally have no age or income restrictions.

**Tax Free Distributions.** Earnings grow tax deferred, and distributions are tax free if used for qualified education expenses. In addition, some states offer their own tax breaks, although you may need to be a resident of that state.

**Gift Tax Benefits.** 529 plans allow you to transfer

up to five years' worth of annual gift tax exclusions in *one* calendar year, as long as no additional gifts are given to that individual during the five-year period. Individuals may gift up to \$60,000 in one year, and married couples may give up to \$120,000.

**Switching Funds Tax Free.** You are able to switch funds from one 529 plan to another 529 plan free of any taxes. This allows you to make such a switch as frequently as once a year without changing beneficiaries, and it also allows interstate plan transfers.

**Expanded Beneficiary List.** Thanks to 2001 tax reform, the list of possible beneficiaries has been expanded to include cousins. For example, grandparents with multiple grandchildren can set up a 529 plan for their first grandchild. Should that first grandchild choose to delay pursuing an education, the grandparents may transfer the plan to another grandchild.

### Other Considerations

**Professional Asset Management.** 529 plans offer a “hands-off” savings approach. Funds invested in the plan are professionally managed through the appropriate state treasurer's office or by an outside investment firm hired by the plan.

**Penalty for Refunds.** A federal 10% penalty may be imposed on the *earnings* portion of a nonqualified withdrawal in addition to

ordinary income tax. However, you may be able to roll over the account to a new beneficiary to avoid a nonqualified withdrawal.

**Effect on Financial Aid.** Any investment may affect a student's eligibility for financial aid. Interested organizations are attempting to clarify exactly how 529 plans will affect federal financial aid. For many families who earn less than \$50,000 and file 1040EZ or 1040A tax forms, a 529 account may not be counted at all. Others, in higher income brackets, may want to open the account in the parents' names, since financial aid offices typically count around 6% of parental assets compared to 35% of the student's assets. For more specific information, refer to the particular state plan that interests you, and consult a knowledgeable professional.

The Pension Protection Act of 2006 gave a boost to 529 plans by making tax-free distributions a permanent benefit. Since 529 plans also operate under individual state laws, costs and details vary by state. For more information and to compare state plans, do a little “homework” and visit these websites: [Savingforcollege.com](http://Savingforcollege.com) and [Collegesavings.org](http://Collegesavings.org). \$

*Note: 529 Plans are state-sponsored investment programs. There is no guarantee by the issuing municipality or any government agency. You should consider the potential benefits (if any) that your own state's plan*

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(if available) offers to residents prior to considering another state's plan. There may be tax benefits to plans offered by your resident state. As with all tax-related decisions, consult with your tax professional.

Annual asset charges for a 529 plan may be higher than corresponding share classes

of underlying mutual funds. Municipal fund securities (529 plans) are sold by offering statements, which are available from your registered representative. Please carefully consider investment objectives, risks, charges, and expenses before investing. For this and other information about municipal fund securities,

please obtain an offering statement and read it carefully before you invest. Investment return and principal value will fluctuate with changes in market conditions such that shares may be worth more or less than original cost when redeemed. Diversification cannot eliminate the risk of investment losses.



## Assessing Portfolio Risk

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business climate changes, bringing expectations of lower corporate profits in general and causing the larger body of common stock prices to fall.

A second general factor that may broadly affect all companies is **interest rate risk**—the fluctuations in the general level of interest rates. The bond market is particularly sensitive to interest rate risk in that bond prices tend to move in the opposite direction of interest rates. Although fixed-income securities (such as bonds) are generally the securities most affected by interest rate risk, other investment vehicles may be affected as well. Companies that borrow heavily for plants and equipment (e.g., utilities) may see their common stock prices affected by changes in the cost of borrowing.

A third general risk factor is **purchasing power risk**—the impact of **inflation** (a general rise in prices) or **deflation** (a general fall in price levels) on an investment. Purchasing power risk is a reflection of the

uncertainty of price levels during the time an investment is held, particularly the inability of a particular investment to keep pace with inflation. For example, if an investment returns 3% annually but inflation averages 4% annually during the holding period, the investor will be losing purchasing power by holding the investment. Purchasing power risk is generally highest in investments paying relatively low fixed-interest rates, such as savings accounts.

### Specific Risk

In contrast to general risk, *specific risk* is that portion of total risk that is *unique* to a firm, industry, or property (in the case of a real estate investment). Specific risk is typically subdivided into business risk and financial risk.

**Business risk** is the risk associated with the nature of the enterprise itself (or the industry in which the enterprise resides) and measures the company's ability to meet its obligations, remain a profitable

entity, and provide acceptable returns to investors. It is generally believed that like kinds of firms or properties have similar business risk. However, among similar businesses, differences in management, operating costs, and market opportunities can create different levels of business risk.

**Financial risk** measures a company's mix of debt and equity used to finance its operations. Debt creates legal obligations (i.e., principal and interest payments) that must be met before earnings are distributed to owners (e.g., dividends to stockholders). The larger the proportion of debt, the greater the financial risk.

Risk can be affected by political, social, and economic influences. Consequently, fitting individual risk tolerance to specific investments is an ongoing process that examines the interplay between the individual investor's objectives and the constantly changing sources of risk that can impact investment returns. \$



## Your Legacy and Generation-Skipping Taxes

Many high net worth individuals concentrate their personal planning efforts on *minimizing* estate and gift taxation while *maximizing* the passing of assets to heirs. However, as many estate planning practitioners can attest, the **generation-skipping transfer (GST) tax** is an equally important, yet often overlooked, estate planning issue.

### Taking a Closer Look

The GST tax is an additional tax imposed on certain transfers (during your lifetime or at death), which can be either *outright* or *in trust*, to a person at least *two generations* removed from you (the **transferor**). For example, suppose a grandparent wishes to transfer assets to a grandchild. In this case, the grandparent would be considered the transferor, and the grandchild, a **skip person**, because the transfer "skips" a generation (the grandparent's own children).

Fortunately, every citizen or resident of the U.S. has a \$2 million (for 2007) **generation-skipping exemption** that may be allocated during one's lifetime or upon death. As a result of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the GST tax is scheduled for repeal in 2010 but reap-

plies in its entirety as of 2011. Prior to repeal, rates will be pegged to the top estate tax rate. Being subject to the GST tax (45% in 2007) can potentially undermine an otherwise well-planned estate.

One estate planning tool designed to take advantage of the GST tax exemption is a **generation-skipping trust**. Such a trust can be established as follows:

- **During the grantor's lifetime.** All, or part, of the GST tax exemption will be allocated to the trust on the grantor's *gift tax return*.
- **Upon the grantor's death.** The executor or personal representative of the estate would allocate the exemption on the decedent's *estate tax return*.

Whether you establish a generation-skipping trust during your lifetime or at death, assets will also be subject to gift or estate taxes. Therefore, the tax consequences of *when* the trust is established must be compared. If the trust is established with a *lifetime gift*, the total transfer tax cost to you is the gift tax and the GST tax. If the transfer takes place *at death*, the total transfer tax is the estimated estate tax on your estate (assuming no lifetime gift) plus the GST tax. If the trust takes

advantage of the GST exemption, then there would not be any GST due as the amount in the trust would be covered by the exemption.



Since the goal is to *maximize* the amount of wealth passing to future generations while *minimizing* total transfer taxes, it may make sense to place assets with *growth potential* into a generation-skipping trust during one's lifetime. In this respect, **life insurance** can also be an attractive asset to place in a generation-skipping trust because the GST tax exclusion is applied to the premium, *not* to the policy's death benefit proceeds. This potentially creates the opportunity to significantly leverage the use of the GST exemption.

With proper planning, substantially more than the amount of the GST tax exemption might ultimately pass to future skip generations free from the GST tax transfer. For specific guidance, consult your tax and legal professionals. 💰

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