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PEAPACK PRIVATE

Welcome to the November 2023 issue of the Peapack Private Planning Quarterly. As we enjoy the fall weather and head toward the holidays and year end, it is timely that we discuss college financing, holiday gifting and year end tax tips. With the current higher interest rates we can consider certain estate planning strategies that are now attractive. Also, there have been new changes to 529 plans that may be of interest to you. Please reach out to our authors – or any of our investment and planning professionals – with your questions and feedback.

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Paying for College

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Yes, the cost of a college education has soared! For the 2023-2024 academic year, the average private four-year college charged $57,570 for tuition, fees, room, board and other expenses for a single school year. The most selective private colleges are charging up to $80,000 a year. Public universities are a little more reasonable with the average four-year public institution having a cost of attendance of $45,240 per academic year for out-of-state students and $27,940 for in-state students, per College Board data. Although aware that these costs have increased, many families may not have a realistic grasp on the price tag they will face and how they will pay for four years of college for their student. For those families with college in the future, now is a good time to start researching college costs and working with tools such as college cost calculators to project the potential future bill.

Understanding the expense of a college education is key, but how do families actually pay for college? Typically, families rely on several resources to finance college:

- Past – Savings.
- Present – Current income and financial aid.
- Future – Loans repaid from future income.

Saving for College:

When saving for college, it is wise to start as early as possible, but it is never too late to start! There are several investment vehicles designed to help families save for college with 529 plans being the most well-known. 529 plans are investment accounts that have tax advantages much like Roth IRAs, but are strictly for educational expenses. Funds in the account are invested and grow tax-free and withdrawals are tax-free if used for qualified college expenses. All US states have 529 plans, and some states offer tax benefits for investing in the home state plan, but families are free to invest in any 529 plan and should do their homework. 529 plans are usually established by a parent or family member with a named individual as the beneficiary. Anyone can contribute up to $17,000 annually to a 529 plan. The owner of the account controls the account's investment decision.

There are other ways to save for college including **Coverdell Education Savings Accounts**. These accounts are similar to 529 plan accounts by providing tax-free investment growth and tax-free withdrawals when funds are used for qualified education expenses, but they have much lower maximum contribution limits per student and are only available to families below a specified income level.

UTMA/UGMA are custodial accounts held for the benefit of a minor. The adult named on the account has control of the account until the child reaches the age of majority. Unlike 529 plans and Coverdell accounts, there is no limit to the size of contributions and there are no restrictions on the use of the funds withdrawn from the account. Once the child reaches majority, they have control of the account and can take distributions for any purpose. These accounts do not have favored tax status and are taxed on investment income and capital gains. Because the account is considered owned by the child, it can impact financial aid eligibility.

Merit Aid versus Financial Aid:

A family should plan ahead when creating a list of target schools and include cost as part of the selection and application process. It is important to be aware of each college's cost profile. To lower total cost, the family should consider in-state public colleges. Colleges provide merit aid and financial aid as incentives to students they want to enroll. **Merit aid and financial aid are often confused**, but are markedly different. Scholarships are given to a student based on his or her academic merit or other merit standards and they do not need to be repaid. Grants are given to the student based on financial need and they also do not need to be repaid. Each college has its own scholarships and grants, and many nonprofit organizations offer scholarships and grants to qualifying students. The family should research the universe of grants and scholarships to learn if the student qualifies for any and take steps to apply. If interested in receiving merit aid, it is critical to understand how the student compares to the average applicant at a given college. Specifically, if the student has grades and scores toward the top of a college's pool of applicants, that student will be attractive to the college and is more likely to receive merit aid than a student with average grades and scores. By strategically selecting and applying to colleges where the student is an attractive applicant, the family increases the possibility of receiving merit aid.

What is Financial Aid?

At most, college financial aid is made up of a combination of **grants, loans and work study program** opportunities. Eligibility for financial aid is largely based on information provided by the family on the Free Application for Federal Student Aid (**FAFSA**) form. The US Department of Education develops and processes the FAFSA form used by nearly all US colleges. Some private colleges also require that applicants complete the CSS profile form and the college's financial aid form. The FAFSA form is used to determine the Expected Family Contribution (**EFC**), which is the amount the family will be expected to pay toward college expenses. It is also the key number that colleges will use to determine the student's financial aid package – the mix of scholarships, grants, loans and work study programs. Families submit the FAFSA form before the student starts college and in advance of each successive school year even if they received grants or loans in a prior year. If a family's circumstances change – a parent loses a job, family illness, divorce, or death – the family should appeal to the college for more financial aid.

Student Loans:

Student loans fall into two types – **federal loans and private loans**. Students should seek federal loans first because they carry a lower interest rates and better repayment terms than private loans and parent loans. **Federal subsidized student loans** are particularly advantageous because the federal government pays the interest while the student is in school and during the six-month grace period after the student graduates. Federal Parent Loan for Undergraduate Students (PLUS) are loans that parents commonly use to borrow for their student's college expenses. However, there are no explicit borrowing limits and no ability-to-repay standards for parent PLUS loans, so although it is easy for parents to finance college educations using PLUS loans, parents may find themselves in the dangerous position of facing large debt.

Private student loans are offered by various financial institutions. These loans typically carry a higher interest rate and interest payments are not deferred and will start accumulating immediately after the funds are released. They do not qualify for income driven repayment terms or for forgiveness. Borrowers should be aware of repayment terms and timing.

Parents - Have a Plan!

Parents should understand the all-in costs of four years at the student's target schools and design a plan for financing college, possibly using funds from savings, current income, and loans. Furthermore, parents should discuss the cost of college and financing college expenses with the student. Clear communication on the subject and realistic expectations will benefit the family. Many parents want their student to participate in financing college either through working during college or shouldering some of the loans. Lastly, parents need to prioritize their own financial future first by funding their retirement accounts and paying down debt, so they are not paying off student loans in their retirement.

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529 Plan-to-Roth IRA Conversion

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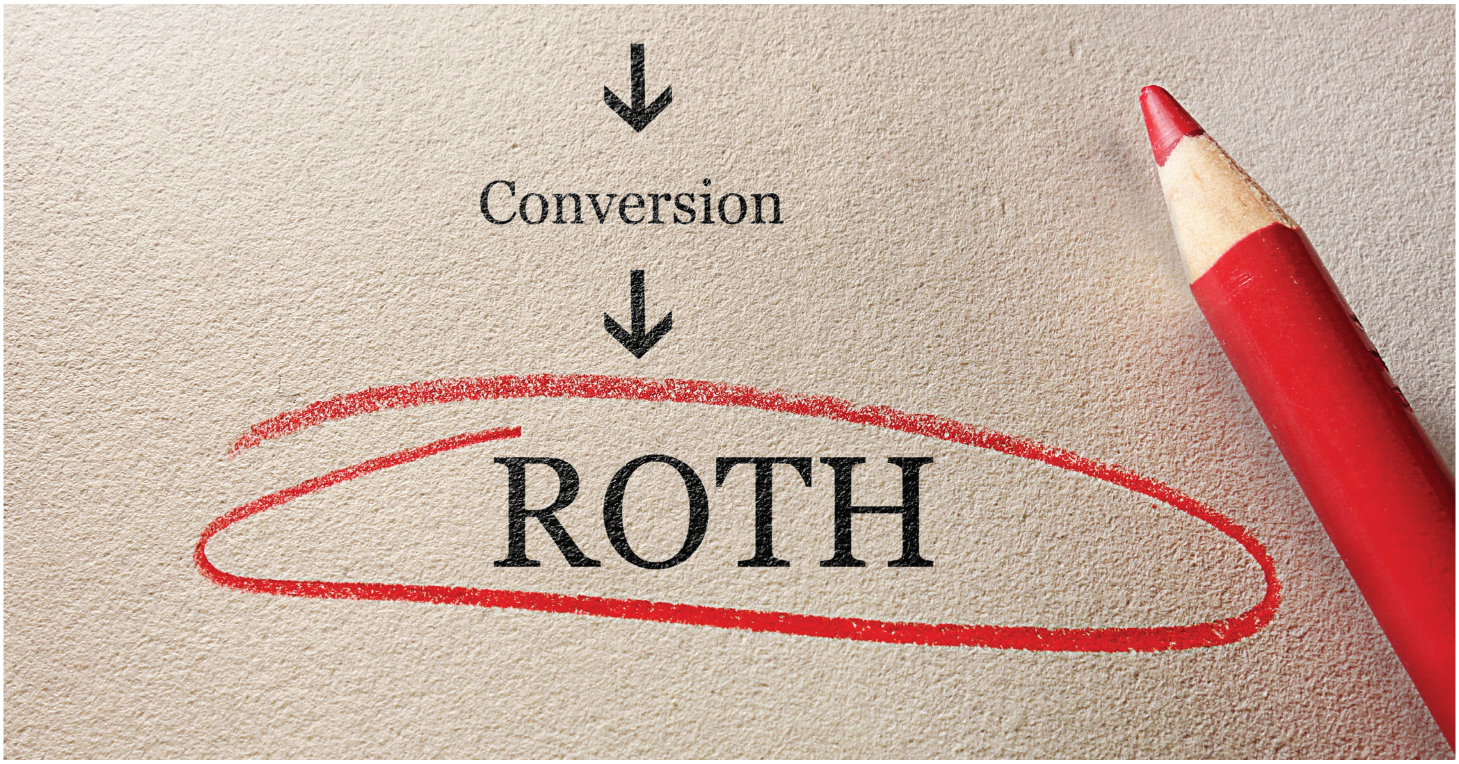
In December 2022, Congress passed the SECURE 2.0 Act, which made several changes to U.S. tax law that should strengthen Americans' ability to save more money for retirement. It also introduced two new rules relating to 529 plans and student debt that will take effect in 2024.

One of these was to create a new 529-to-Roth IRA transfer option that will start in 2024. It allows excess funds in the 529 to be rolled over into Roth IRAs tax-free, if the Roth belongs to the beneficiary of the 529. Previously, if leftover funds were withdrawn and not used for qualified educational expenses, the 529 owner would owe income tax on the earnings portion of the withdrawal and a 10% penalty would be imposed.

There are several reasons you may have excess funds; securing a scholarship, attending a military academy, or deciding not to pursue higher education. The risk of unused money in a 529 plan may cause some families to fund their plans conservatively or to not even open an account. Next year's rule change could ease the concern some 529 holders have about over-investing in those accounts.

There are a few 529 Plan-to-Roth IRA transfer rules to be aware of:

- **529 plans must be open for a minimum of 15 years.** 529 accounts must have been maintained for a minimum of 15 years to be eligible for transfer.
- **The beneficiary of the 529 plan must also be the owner of the Roth.** The funds from the 529 plan must be moved directly to a Roth IRA of the 529 plan beneficiary.
- **Lifetime maximum:** The 529 transfer is subject to a lifetime maximum of $35,000 from a 529 plan account to a Roth IRA.
- **Roth IRA contribution limits still apply.** For 2024, those limits are $7,000 per year if the beneficiary is under 50 and $8,000 per year for those over 50. These limits are subject to change every year. You also can't contribute more in any given year to a Roth IRA than you earned in that year. or example, a 529 plan beneficiary only earns $3,000 in a year, that's the most they could transfer to their Roth IRA that year.
- **Roth IRA income limits don't apply but earned income requirements do.** The Roth IRA income thresholds will not apply to these contributions; however, the beneficiary will need to have earned income equal to or more than the contribution in order to move 529 funds into the Roth.



Finally, it's worth noting that if you do a 529-to-Roth IRA transfer, you may not put additional money into your Roth IRA that year if doing so would cause you to exceed the annual contribution limit. For example, if IRA contribution limits remain the same in 2024 as they are in 2023, and you transfer $6,500 from your child's 529 plan to a Roth IRA in their name, they won't be able to make any additional IRA contributions in 2024 without incurring penalties. However, they could save for retirement in a 401(k) or some other tax-advantaged retirement plan.

There remain a few unresolved issues that need further clarification by the IRS. Both involve what happens when a 529's beneficiary is changed. The first uncertainty is whether a new 15-year waiting period is established when a 529 account holder changes the beneficiary of the plan. The alternative to resetting the clock would be that the waiting period of the previous beneficiary carries over. If you created a 529 account for a loved one and have excess funds in the account, you could technically change the beneficiary to yourself, but based on the language in SECURE Act 2.0, this may likely reset the 15-year clock. This means you would need to wait 15 years before you could transfer any 529 plan funds into your Roth IRA. Government agencies still need to confirm whether the clock will be restarted or not, so there may be unknown consequences of initiating a beneficiary change.

The other question is whether the $35,000 lifetime maximum is the total for all rollovers made from an owner's 529 account or the amount allowable for each beneficiary. Experts generally believe that the $35,000 limit is per beneficiary and that amount can be rolled over to the Roth IRA of more than one person.

Parents and grandparents can feel more confident about opening and funding a 529 account. Now, if a student decides to pursue a less expensive educational path or receives more merit scholarships, those 529 plan funds will still be earmarked for their future, but in a different way.

This change also presents a unique estate planning opportunity for individuals wanting to make an impact with their legacy. Parents and grandparents may want to consider increasing their 529 plan contributions, or opening an account for their loved ones, now that excess 529 plan funds can give beneficiaries a head start on retirement savings.

Paying Off Student Loans

An additional new rule under the SECURE Act, allows beneficiaries to use 529 dollars to pay off student loans. The federal government recognizes student loan repayment as a qualifying education expense. You can use up to $10,000 per beneficiary to repay student loans. This is a lifetime limit that applies to each beneficiary. For example, a family with two children can use $10,000 per child to repay their student loan debt. 529 funds can only be used for qualifying education loans—which are loans taken out on behalf of the individual, their spouse or a dependent to pay qualified higher education expenses. Both federal and private loans are eligible.

Using a 529 plan for student loan repayment can be a game changer for working graduates and parents.

Here are some of the key considerations:

- **You can reduce high-interest debt.** If you have high-interest private student loans, federal parent loans or graduate school loans, using 529 funds to repay your loans can save more money.
- **529 accounts are flexible.** If a 529 beneficiary gets a scholarship or decides against attending college, you can switch beneficiaries. The new beneficiary can use the money for their college expenses or to repay student loan debt.
- **No age limit.** Unlike some tax-advantaged accounts, there aren't any age restrictions on 529 plans. You can change the beneficiary so the account benefits a parent or grandparent who can use the funds for qualified education expenses or to repay student loans.
- **Not all states allow 529s to repay student loans:** New York and New Jersey do allow this; however some states prohibit it. If you live in another state, you will need to check if this is allowable.
- **There are lifetime withdrawal caps.** The $10,000 limit on 529 withdrawals for student loan repayment is a lifetime maximum. Considering that the average student loan balance is nearly $30,000, that amount may not cover all your debt.

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Estate Planning Strategies that Work More Effectively in a Higher Interest Rate Environment

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There is no question that we are in a much higher interest rate environment than compared to a few years ago. To illustrate, since March 2022 the Federal Open Markets Committee increased the Federal Funds Rate 11 times to combat inflation. As a result, the Federal Funds Rate is 5.33% as of October 26, 2023, which is the highest it has been in over 20 years.

The Federal Funds Rate is the interest rate that banks charge when lending surplus balances to other banks on an overnight basis. In the end, it has a huge influence on the interest rates that are charged on bank loans, credit cards and mortgages.

Another gauge to determine our current interest rate environment is the yield on the 10-year Treasury. On March 8, 2020, a 10-year Treasury yield plummeted to a record low of 0.318%. On October 27, 2023, it soared to 4.84%. This represents a 1422.01% increase in just over 3.5 years, and is the highest yield in 16 years.

This is important because the effectiveness of many estate planning strategies is measured by the current interest rate environment. In fact, there are two federally established interest rates that have a direct impact on certain estate planning strategies. They include the Section 7520 Rate and the Applicable Federal Rate (AFR).

The Section 7520 rate is established monthly and is equal to 120% of the Federal midterm rate (to be covered later). The Section 7520 rate is used to measure the gift and estate tax consequences of many estate planning strategies, but the two that work most effectively in a high interest rate environment is the Charitable Remainder Annuity Trust (CRAT) and the Qualified Personal Residence Trust (QPRT).

One potential use of the CRAT is for a charitably inclined individual to create an irrevocable trust, then retain an annuity for either a term of years or during the lifetime of one or two individuals. The retained annuity can be used to support the creator of the trust during his or her retirement years. When the trust terminates, the remaining proceeds will go to a designated charity.

For example, suppose the wife transfers $1 million into a CRAT in October 2020 when the Section 7520 rate was 0.4%. The trust provides that a $50,000 annual annuity will be paid for the joint lives of wife and husband (both age 80). When the last surviving spouse dies, the remaining proceeds shall go to their favorite charity. In this example, the wife will receive a charitable deduction for income tax purposes in the amount of $440,000. This is equal to the present value of the charity's remainder interest. The Section 7520 rate in the month of transfer is used to make this determination.

By comparison, if this same trust was created in November 2023 when the Section 7520 rate was 5.6%, the charitable deduction would be $583,535, which is $143,535 more than the previous example.

The QPRT is another estate planning strategy that works better in a high interest rate environment. A QPRT is a lifetime irrevocable trust that is funded with the creator's personal residence. The creator is allowed to live in the home for a term of years. When the term ends, the home is typically transferred outright to a designated beneficiary. The initial transfer to the QPRT is a gift measured by the present value of the remainder interest. The Section 7520 rate in the month of transfer is used to make this determination. Many times, the creator can continue living in the home after the trust term expires by paying rent to the remainder beneficiary.

To illustrate, suppose a mother (age 65) transfers a $1 million home into a QPRT in August 2020 when the Section 7520 rate was 0.4%. That mother will retain the right to live in the home for 10 years. Thereafter, the home goes outright to the daughter. Further, assume the house appreciates by 5% a year. By applying the Section 7520 rate to this transaction, it is determined that the present value of the daughter's remainder interest is $754,460. This would be the value of the taxable gift. In 10 years, the home would be worth $1,628,895.

If this same QPRT was created in November 2023 when the Section 7520 rate was 5.6%, the taxable gift would only be $476,310; a reduction of $278,150 compared to the result shown in the previous example.

The other federally established interest rate that is used to measure the tax consequences of certain estate planning strategies is the AFR. Most importantly, the AFR reflects the minimum interest rate that shall apply to an inter family loan. These rates are determined on a monthly basis and are broken into three categories; Short Term (a loan under 3 years); Mid Term (a loan between 3 and 9 years; and Long Term (a loan over 9 years).

Many times, parents can make an inter family loan to their adult children. At creation, the interest on the loan must be at least equal to the AFR rate to avoid any gift tax implications. These loans are typically structured so that only interest is paid for a term of years with a balloon payment due when the loan terminates. If the loan proceeds are used to invest in an asset that appreciates by more than the AFR rate, the excess passes to the borrower gift tax free. Unfortunately, the inter family loan is less effective in a high interest rate environment.

For instance, suppose a mom lends her daughter $1 Million in November 2023. The daughter agrees to pay interest for 9 years with a balloon payment when the loan terminates. This is a 9-year loan, so the interest must be at least equal to the federal midterm rate, which in November 2023 was 4.69%. If the daughter invests the $1 million in securities that generate and annual return of 8%, after 9 years, the daughter's remaining assets after the loan is paid back is $413,497.

Yet if this loan was made in September 2020, when the federal midterm rate was .35%, daughter's remaining proceeds would be $955,298; more than double the result shown in the previous example. This proves that inter family loans are more effective in a low interest rate environment.

Conclusion

In the end, few, if any, economists are certain whether future interest rates will continue to rise, fall, or remain about the same. If interest rates fall, certain estate planning strategies are more effective in a low interest rate environment including the inter family loans, the Grantor Retained Annuity Trust or the Charitable Lead Annuity Trust. If interest rates remain high, the QPRT and the CRAT remain viable estate planning options. Either way, it is important to consult with an experienced estate planning attorney before implementing any of these interest rate sensitive strategies.

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Navigating the Tax Implications of Holiday Gifting

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As the holiday season approaches, many individuals and families embrace the spirit of giving. While the act of gifting is a heartfelt tradition, it's essential to consider the tax implications that may accompany your generosity. In this article, we'll explore the intricacies of holiday gifting from a financial planning perspective, providing insights to help you make informed decisions.

Understanding the Gift Tax

The United States has a federal gift tax system in place, which is designed to prevent individuals from giving away their wealth to avoid estate taxes. The basic rule for 2023, is that you can gift up to $17,000 per person per year without incurring any gift tax. This means that you can give a gift valued at $17,000 to as many people as you'd like, and it won't trigger any tax liability. However, gifts exceeding this annual exclusion amount may be subject to gift tax. The gift tax rate for 2023 ranges from 18% to 40%, depending on your taxable income during the reporting year.

Lifetime Exemption

In addition to the annual exclusion, there's a lifetime exemption for gift and estate taxes. In 2023, this exemption was $12.92 million per individual. Any gifts you make beyond the annual exclusion count towards this lifetime exemption. Christopher Picciurro, a certified public accountant with Integrated Financial Group, encourages us to think of the annual exclusions as "buckets or cups. Any excess gifting spills over into the lifetime exclusion bucket." If you exceed this threshold, you may owe gift taxes. It's important to note that tax laws can change, so it's advisable to consult with a tax professional for the most up-to-date information.

Conclusion

- Gift Splitting: Married couples can combine their annual exclusions to gift up to $34,000 per person per year without triggering the gift tax.
- Educational and Medical Expenses: Gifts used to pay for someone's educational or medical expenses are generally exempt from the gift tax. These payments must be made directly to the institution or medical provider.
- 529 Plans: Contributing to a 529 college savings plan can be a tax-efficient way to help fund a loved one's education. Contributions may be subject to state tax deductions or credits.
- Charitable Giving: Donations to qualified charitable organizations can also be tax-deductible. This can be an excellent way to support causes you care about while reducing your taxable income.

Reporting Requirements

If you make gifts that exceed the annual exclusion, you will need to file a gift tax return (Form 709) with the IRS. While you may not owe gift tax immediately due to the lifetime exemption, reporting these gifts is essential to keep track of your lifetime exemption amount.

State Gift Taxes

In addition to federal gift taxes, some states have their own gift tax laws with varying rules and exemptions. It's crucial to be aware of your state's specific regulations to ensure compliance. The state of New Jersey does not impose a state gift tax.

Estate Planning Considerations

For individuals with substantial assets, thoughtful gifting can be a crucial component of estate planning. By strategically gifting assets over time, you can reduce the size of your taxable estate, potentially minimizing estate taxes for your heirs.

In conclusion, while holiday gifting is a cherished tradition, it's vital to be aware of the tax implications that may arise. Careful planning, including the use of annual exclusions, lifetime exemptions, and tax-efficient strategies, can help you navigate the complexities of gifting while minimizing your tax liability. Always consult with a qualified tax advisor or financial planner to develop a gifting strategy that aligns with your financial goals and current tax laws. Keep in mind that tax laws may change, so staying informed is essential for effective financial planning.

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Year End Tax Tips

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There is still time to take advantage of some tax strategies to save on your 2023 taxes and plan for future tax years. The fourth quarter is a good time to review your tax plan and take advantage of these potential strategies. Here are some year-end tax tips to keep in mind.

1. Maximize your Annual Retirement Contributions

In 2023, you can contribute up to $22,500 in your 401k or 403B. If you are 50 and over, you can contribute an additional $7,500 as a catch-up contribution for a total of $30,000. Many employers offer a Roth component of the 401k, which allows you to contribute towards a Roth 401k. These limits are accumulated across multiple 401k plans so if you switch jobs, your combined contributions between all your plans are limited to $22,500 or $30,000 if you are 50 and older. It is never too late to change your contributions to your 401k or 403B. Many employers even match your contributions.

2. Make Qualified Charitable Contributions from your IRA

If you are required to take minimum distributions from your taxable IRA, you can consider making a qualified charitable distribution (QCD) to a charity. This would reduce your taxable income for the year. You would need to direct your IRA custodian to make the direct transfer of up to $100,000 from your IRA to the charity or charities. However, you must be 701/2 or older to make a QCD. The $100,000 is per individual and can be done each year.

3. Contribute to your HSA in 2023

If you have a high deductible heath plan, you qualify to have a Health Savings Plan (HSA). You can contribute up to $3,850 to your HSA if you have coverage for yourself or $7,750 if you have coverage for your family. An HSA is an "above the line" deduction and would reduce your adjusted gross income. To qualify to have an HSA, you would need to have health insurance with a minimum deductible of $1,500 for an individual and $3,000 for a family. In addition, the maximum out-of-pocket expenses need to be $7,500 for an individual and $15,000 for a family. You do not need to spend the 2023 HSA contributions in 2023, you can reserve the account to use it for future medical expenses. If you are on Medicare Part A or B, you cannot contribute towards an HSA.

4. "Bunch" Your Charitable Contributions

For those who are inclined to give money to charity and may be on the brink of taking the standard deduction or itemizing deductions, a good strategy is to "bunch" your charitable contributions into one calendar year. You can then take the standard deduction the next year. You can also consider donating highly appreciated securities to a charity. You would get the charitable deduction for the full current market value of the security and not have to recognize any built-up gains.

Another way to accomplish this, is to open a Donor Advised Fund or a DAF. When you contribute to the donor advised fund, you get the full charitable deduction in the year that you make the contribution. You do not have to distribute all the funds to the charity in one year but can donate the funds to charity over several years. Many of the large brokerage firms administer DAF plans. You can also transfer highly appreciated securities to the DAF without having to recognize any realized gains.

5. Spend your Flexible Savings Accounts (FSA) before year-end

An FSA is a way to lower your taxable income by setting aside some of your paycheck for medical expenses. The limit for 2023 was $3,050 and will be increasing to $3,200 for 2024. Your flexible savings account or FSA funds needs to be spent before the end of the year. Many companies let you roll over a portion of your funds into the next year if not spent. However, check with your employer about the details of your plan. Consider making doctor's appointments, purchasing glasses, contact lens or approved FSA products that qualify for using your FSA dollars.

6. Tax Loss Harvesting

You may want to consider or ask your advisor about taking some realized losses to offset any capital gains that you may have on profitable investments. This strategy may reduce your taxable income. In years where your losses outweigh the gains, you can take up to $3,000 a year of losses against your other income.

7. Roth Conversions

To contribute to a Roth, you need to be below a certain income level. In 2023, your income to make a Roth contribution needs to be below $153,000 for a single tax filer and $228,000 for those married and filing jointly. However, there are no income limits to convert to your Roth from your traditional IRA or an employer plan such as a 401k.

A strategy called a "back door Roth conversion" is used by high earners that may not qualify to make a Roth contribution. However, they can contribute to a non-deductible IRA each year. If they have no other IRA, they can convert the after tax or non-deductible IRA to a Roth each year and since they have basis (non-deductible contributions) in their IRA, there would be minimum taxable income. Just the earnings would be taxable.

However, if you convert pretax qualified accounts from a plan such as an IRA or 401k they would be taxable in the year that you convert. All pre-tax contributions and any earnings would be added to the taxpayer's gross income.

The benefits of a Roth IRA are that you there are no required minimum distributions, and the distributions are not taxable. A Roth can give you much more flexibility in tax and cash flow planning in the future. A potential strategy in Roth conversions is to manage your conversions over several years. The years between retirement and before you are required to take your RMDs, currently age 73, may be a great time to consider making a Roth conversion. One thing to keep in mind is that your modified adjusted gross income can impact your Medicare premiums (IRMAA) in the future. The income in 2023 would have a direct impact on your 2025 Medicare premiums. You can ask your tax advisor to help with the planning and try to manage the tax impact of the Roth conversion.

These tax strategies can help you in your year-end tax planning. You should contact your tax advisor, ask for guidance, and learn how these strategies would impact your taxes in 2023 and in future years.

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