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REPORT FROM COUNSEL

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THE ESTATE PLANNING BENEFITS OF SECTION 529 EDUCATIONAL SAVINGS ACCOUNTS

By James J. Anfang, Jr., Esquire

In view of the recent announcements made by many colleges and universities that tuition will be increased substantially for the next school year, it may make sense for parents and grandparents to consider the possibility of establishing qualified tuition programs under Section 529 of the Internal Revenue Code in order to subsidize their children's or grandchildren's future educational expenses. In addition to providing funds for educational expenses, the establishment of one or more such programs may also have the added advantage of being a useful estate planning tool for the parents and grandparents.

Section 529 of the Code authorizes the establishment of two types of qualified tuition programs: the prepaid educational arrangement and the educational savings account.

Under the prepaid educational arrangement, an individual would purchase tuition credits or certificates for a designated beneficiary's future use. In effect, tomorrow's college tuition costs would be locked in at today's prices.

Under the educational savings account program, an individual would make contributions to an account that is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account, which expenses would include

tuition, room and board, books and the like. The educational savings account is the more flexible of the two qualified tuition programs and is also of more interest from an estate planning perspective.

Every state in the Union has either established or is in the process of establishing a Section 529 Plan. The Pennsylvania Legislature has enacted the law which provides the framework for the Pennsylvania Section 529 Plan, and the Pennsylvania version of the educational savings account program is in the process of being implemented by the Treasurer's Office. Pennsylvania residents may either wait until the Pennsylvania version has been made available, which may be in the very near future, or they may choose at any time to establish an educational savings account under the Section 529 Plan of another state. The various state plans differ considerably from state to state, and some may even contain restrictions not required by Section 529. It is important, therefore, that the particular state's Section 529 Plan be reviewed carefully in regard to its contribution limitations, investment options, costs, and state income tax consequences.

Anyone may establish an educational savings account for a beneficiary. Although parents and grandparents are the more likely donors, other relatives and friends of the family may also make contributions to an account for a beneficiary. Instead of making annual exclusion gifts of \$11,000 per beneficiary (the annual exclusion amount was increased from \$10,000 to \$11,000 effective as of January 1, 2002), the donor may make such gifts in the form of contributions to an educational savings account for the beneficiary.

In fact, Section 529 provides that the donor may, in effect, combine five years' worth of annual exclusion gifts and make all of such gifts at one time. Thus, an individual may contribute up to \$55,000 to an educational savings account on behalf of a beneficiary (\$110,000 for a married couple) in one year. If the donor does not make any additional gifts to the beneficiary during those five years, there would be no federal gift tax liability on the part of the donor. However, if the donor dies during the five-year period, the portion of the contribution allocable to calendar years beginning after the donor's death would be includable in the donor's gross estate. Although the "front loading" of annual exclusion gifts does not result in an increase in the total of the annual exclusion gifts which may be made to a beneficiary, the donor is able to remove from his or her estate a greater amount of appreciation than would otherwise be possible.

Section 529 provides that the earnings generated by the educational savings account are not currently taxable. Because of this advantageous tax treatment, certain restrictions are imposed to make sure that the individual who has established the account does not use it primarily as a tax-deferred investment vehicle. First, Section 529 provides that all contributions to the account must be in cash, thereby eliminating the possibility of appreciated assets being contributed to the account.

Second, neither the donor nor the designated beneficiary may direct the investment of the assets in the account. Typically, the state agency would select a family of mutual funds to provide the donor with a variety of investment strategies from which to choose. The ability of the donor to alter the initial investment decision is limited, however. At present,

the donor is permitted to transfer the assets from one educational savings account for the benefit of a designated beneficiary to another such account for the benefit of the same beneficiary without the transfer being considered a distribution, so long as there is no more than one such transfer during any 12-month period. It is anticipated, however, that the final regulations to be issued by the IRS in connection with Section 529 will ease this restriction by allowing the donor to change the investment strategy selected for the account once per calendar year without the change being considered as a distribution.

Third, there is also an overall limitation on the amount which may be contributed to any one educational savings account. Section 529 provides that only the amount which would be necessary to meet the beneficiary's qualified educational expenses may be contributed to the account. Each state provides its own formulation in this regard; however, the amount which may be contributed to an account may be well in excess of \$100,000 depending upon the provisions of the particular state's Section 529 Plan.

Despite these restrictions, the advantages of establishing an educational savings account are considerable. As noted above, the earnings of the account are tax-deferred, and no amount will be included in the gross income of the donor or the beneficiary so long as such earnings are expended for the educational needs of the beneficiary. Thus, under such circumstances, distributions from the account would be exempt from income tax.

In addition to the income tax advantages of the educational savings account, the most remarkable aspect of this type of account from an estate planning point of view is the extent to which the donor is able to retain control of the account even though the contributions made to the account are considered to be completed gifts for federal gift and estate tax purposes. The designated beneficiary of the account does not have a vested right to receive distributions from the account. The donor decides when distributions are to be made, and the donor may change the beneficiary designation on the account at any time to name another family member as the new beneficiary.

Indeed, the donor is even able to reclaim the funds contributed to the account. Although the donor would be subject to the payment of a 10% additional tax penalty if the donor reclaims the assets, this could be a relatively small price to pay if the donor had a compelling need for the funds. The ability of the donor to retain a measure of control over the account is an exception to the general rule that assets, which are the subject of a lifetime gift, are considered to have been removed from the estate of the donor for federal estate and gift tax purposes only if all control over such assets had been relinquished by the donor.

Thus, by utilizing this exception to the general rule, the donor is able to make gifts to an educational savings account thereby reducing the size of his or her estate. The assets will earn income on a tax-deferred basis until distributed; and, if the funds distributed are used to defray qualified educational expenses, the distribution would be exempt from income tax. In addition, the donor is able to change the beneficiary designation at any time and to reclaim the assets if the need for them should arise in the future. From an estate planning point of view, this is a very favorable development in the law.

The foregoing is, of course, only a summary of some of the more significant aspects of the Section 529 educational savings account program and is not meant to be exhaustive. In addition, depending on the prospective donor's particular circumstances, such as the tax cost of converting assets to cash to fund the gifts to the educational savings account or the existence of possible better uses for the donor's annual exclusion gifts, the establishment of such accounts may not necessarily be indicated. We would be pleased to discuss with you the use of such accounts in connection with your estate plan.

About the Author

Mr. Anfang is a shareholder and director of the firm and practices primarily in the areas of estate and trust administration and estate planning. He received his undergraduate degree from Georgetown University's School of Arts and Sciences in 1972 and his law degree from Georgetown University Law Center in 1976.

COMPUTERS IN THE WORKPLACE

By Lesley C. Gannon, Esquire

Computers are power tools for today's businesses. They increase efficiency and make critical information available at an unprecedented speed and at almost no cost. Unfortunately, computers, like most power tools, pose a danger.

Computers open new vistas of liability for your business. The same Internet access used by employees to pull crucial information may be used to download pornography or engage in criminal activity. The e-mail system your employees use to communicate with each other and with customers may also be transmitting trade secrets or circulating inappropriate jokes, images or comments.

Employee use of e-mail and the Internet can result in:

- * disclosure of trade secrets and other confidential information,
- * liability for harassment and hostile environment claims,
- * penalties for infringement of copyrights (up to \$100,000 in damages),
- * criminal penalties, including the seizure of computers used in criminal activity, and
- * damage to the business' position in litigation.

Employers must balance protecting against these liabilities with the actual or perceived rights of employees to privacy in their e-mails and Internet use. Employees have a right to privacy in the workplace, although with strict limitations. The employee must have a

reasonable expectation of privacy (such as an employee locker secured by the employee's own lock). Also, the invasion must be such that a reasonable person would be offended.

Although this area of law is still developing, courts have found no expectation of privacy in e-mail voluntarily sent by an employee over the employer's e-mail system and, even if such an expectation did exist, at least one court has found that the employer's interception is not a violation by which a reasonable person would be offended.

There is no way to limit liability entirely; however, the following steps could help minimize the potential liability to your business:

Buy Monitoring Software

Eighty percent of employers undertake some monitoring of employees' computer use. Thirty percent monitor e-mail. Software programs can monitor keystrokes, block certain web sites, or scan downloaded images for flesh-toned color. They can be visible or invisible to the employee. The costs for these software programs are negligible next to the potential liability that the programs can help reduce.

Inform Employees

An employee's claim of expectation of privacy would be difficult to support when company policies, procedures, or computer warnings inform all employees that e-mails and Internet use will be monitored.

Establish Formal Policies

Policies could limit employee computer use to business purposes only or give clear guidance as to what may be downloaded, viewed, or transmitted via e-mail. These policies should be strictly enforced.

As with all power tools, computers must be used with care. Employees using your computers may expose your company to substantial liability. While no power tool will ever be entirely safe, effective computer monitoring, employee communication, and policies and procedures can help to limit the potential damages.

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Ms. Gannon is an associate attorney with the firm and is a member of the firm's Corporate and Financial Services Groups. Ms. Gannon is a 1993 graduate of Carlow College and a 2001 graduate of Duquesne University School of Law.

CLICKWRAP AGREEMENTS

In the age of online commerce, "signing on the dotted line" has for many transactions evolved into "clicking on the 'I agree' box." But the resulting "clickwrap" agreement may be just as enforceable in court as if the parties had solemnly written their signatures at the end of a paper contract. As with so many twists on conventional legal concepts that have been ushered in with the Internet, courts are having to adapt time-tested principles on formation of a contract to the computer age.

In one case, a company paid thousands of dollars for sophisticated software. The company claimed that it was entitled not only to use the software but also to receive perpetual upgrades and support. As evidence of such a bargain, the company pointed to the purchase order for the transaction. The seller of the software countered by relying on a later clickwrap license agreement in the software itself that limited its liability to the price paid for the software.

The court ruled that the language in the clickwrap agreement that limited the seller's liability was binding. The buyer clearly had given its assent by clicking "I agree," just as if its representative had signed a standard contract. The only issue, according to the court, was whether clickwrap license agreements are an appropriate way to form contracts, and the court held that they are.

The court was aware of and sympathetic to the context in which most clickwrap agreements are created. The typical consumer, having paid a substantial sum for software, rushes it into the computer, clicks on "install" and scrolls past the fine print in the license agreement. Arriving at the "I agree" box, the customer clicks on it with hardly a thought. The lesson from this case is that the click of a mouse is the equivalent of the stroke of a pen.

Clickwrap agreements are no less enforceable than conventional contracts, but neither will they be recognized by courts if the basic elements of offer and acceptance are absent. From the early common law of England to American law today, promises become binding only when there is a meeting of the minds. As another court faced with a disputed clickwrap agreement put it, "[a]ssent may be registered by a signature, a handshake, or a click of a computer mouse transmitted across the invisible ether of the Internet."

That court had to resolve a dispute between visitors to a website who obtained a free software program that makes it easier to download files from the Internet. Someone wishing to download the free program would see at first only a "download" box but no reference to a license agreement. Only on the second screen was there an invitation to review and agree to a license agreement. A click on that invitation led to an unequivocal statement that the user must agree to the terms in the agreement before installing the software, and another click revealed the agreement in full. In short, visitors to the website were not required to indicate affirmatively their assent to the license agreement, or even to view the agreement, before downloading the software.

Individuals who had downloaded the software sued the provider because they believed that using the software caused private information about their Internet activity to be transmitted to the software provider, which was a violation of federal law. The court ruled that they were not bound by a clause tucked away in the license agreement that required arbitration of disputes in a specific location. From the user's vantage point, the software was like a free neighborhood newspaper at a supermarket counter, there simply for the taking. The provider of the "newspaper" could not impose contract terms on its taking without clearly requiring assent to the terms before a customer could take the paper.