BY MARK E. HOUSE

big savings on campus

529 PLANS OPEN COLLEGE GATES

Despite Congress' shortcomings, our elected officials occasionally hit the nail right on the head. Such is the case with the new legislation regarding qualified tuition plans, or 529 plans, as they are commonly called. And now they have been modified by the Economic Growth and Tax Relief Reconciliation Act of 2001 (the Act).

529 Plans provide a great way for attorneys to assist clients in helping their children or grandchildren pay for college. As the cost of a college degree becomes increasingly expensive, attorneys can now arm clients with a way to alleviate some of that burden through good planning.

The 529 plan is a very simple way to save money for a child's college education. In fact, its use could be called "thought-free" giving, because most 529s allow the donor to contribute money automatically from a checking or savings account.

Plan Types

529 plans come in two flavors—prepaid tuition plans and savings plans. This article focuses on the college savings plan alternative under Internal Revenue Code (the Code) § 529.[1]

A savings plan involves the deposit of funds into an investment account managed by a professional investment adviser. If we use a pension plan analogy, a savings plan is analogous to a defined contribution pension plan. Some of the more recent programs, such as Arizona's, offer the donor a choice among various investment strategies.

Although savings plans are structured to defray the cost of tuition, the investor is relying on the assumption that the market will outpace inflation generally and increases in college costs specifically. Although this is historically true, there is an element of risk to investing in a savings plan that is not present in prepaid tuition plans.

Income Tax Treatment

Income tax issues are raised during three phases of 529 plans—contributions, earnings, and distributions. The first two are simple:

- Currently, contributions to a 529 plan receive no favored treatment for federal income tax purposes; contributions are made entirely with after-tax dollars. Arizona does not provide a state income tax deduction for contributions.
- At any time before distribution, dividends, interest and gains on sales in a 529 plan are not taxed for federal income tax purposes.

When it is time for the assets to be distributed, issues can become more complex. Under the old rules, qualifying distributions[2] were includible in the gross income of the beneficiary—and therefore taxed at the beneficiary's tax rate.[3] Non-qualifying distributions were taxed at the recipient's (or sometimes the owner's, regardless of who received the money) rate, plus a penalty.

But qualifying distributions are no longer taxed at all under the new rules.[4] Think Roth IRA. The assets are placed into the account on an after-tax basis. All earnings, regardless of whether the earnings are income or capital gain, are distributed to the beneficiary tax-free. This single change makes the returns available on 529 plans nearly impossible to beat by any other method of saving for college.

With regard to state income taxes, there is no uniformity. Arizona does not tax qualifying distributions from 529 plans. Because the federal government will no longer be taxing distributions, the states are likely to follow suit.

Gift and Estate Tax Treatment

A transfer to a 529 plan is a completed gift for transfer tax purposes and is considered a present, not a future, interest.[5] This means that the transfer qualifies for the gift tax annual exclusion under Code § 2503(b).[6] The transfer also qualifies for the generation-skipping transfer (GST) tax annual exclusion.

The other substantial gift tax benefit is that any contributions in excess of the annual exclusion amount can be prorated over the 5-year period beginning with the year of contribution.[7] Any excess over the aggregate 5-year amount will be taxed in the year of contribution as a gift.[8] Gift-splitting is available for a transfer to a 529 plan as for any other gift.[9] Unfortunately, a contribution to a 529 plan is not treated as a qualified ed–med transfer pursuant to Code § 2503(e). Transfers under that section are not considered taxable gifts.

Prior to the Taxpayer Relief Act of 1997, payments made directly from a 529 plan to an educational institution were treated as qualified transfers under Code § 2503(e)—the contribution would not be treated as a taxable gift for either gift or GST tax purposes. Rather, the contribution would be treated as if it were a payment from the donor directly to the educational institution. This would be the preferred treatment, but Congress is not likely to return to this treatment any time soon.

Any gift tax and GST tax burden is placed on the original beneficiary when a change in beneficiaries occurs. No tax liability is placed on the donor. The only difference regarding rollovers between income tax treatment and gift tax treatment is that in order to avoid gift and GST taxes, the successor beneficiary must be in the same generation as (or a generation above) the original beneficiary.[10] If the successor beneficiary is one generation lower than the original beneficiary, then gift tax is imposed, and if the successor beneficiary is two or more generations lower, then GST tax is also imposed. The rules set forth in Code § 2651 are used to determine generation assignment.

If the transfer is subject to gift or GST taxes, the 5-year rule for gifts can be used to alleviate some of the burden.[11] Thus, the original beneficiary may elect to apply the 5-year averaging rule to reduce or eliminate the adverse tax consequences imposed on the original beneficiary.

The general rule is that no portion of any 529 plan funded by the owner is includible in his or her estate for federal estate tax purposes. The only exception to this rule is if the owner dies during a 5-year period for prorating a gift made in a prior year, in which case the amount prorated to years after the owner's death (but not including the year of death) is includible in the owner's estate.[12]

The amount of the account is includible in the beneficiary's gross estate for federal estate tax purposes.[13] It is difficult to believe that this is the result Congress intended. The language of Code § 529(c)(4)(B) indi-

cates that only in certain cases will the account be included in the beneficiary's estate. Prop. Reg. § 1.529-5(d)(3), however, states simply that the account will be included in the gross estate of the beneficiary.

The lack of parity between the gift tax treatment and the estate tax treatment is not consistent with general tax policy. When a beneficiary is treated as making a gift, no transfer tax consequences arise if the successor beneficiary is in the same generation. When a beneficiary dies, the account is included in his or her estate, regardless of the identity, if any, of a successor beneficiary.

A more thoughtful approach would be to allow qualified rollovers from an estate similar to qualified rollovers for gift tax purposes. The Act did nothing to resolve the disparity—but perhaps the final regulations will.

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Changing Beneficiaries

A change in beneficiaries is not a taxable event for federal income tax purposes if the new beneficiary is a "member of the family" of the original beneficiary.[14] "Member of the family" under the old rules was defined broadly and even reached in-laws, but it did not include cousins; the new rules have changed that.[15] This is a significant improvement. The issue arises when a grandparent establishes an account for a beneficiary and wants to change beneficiaries from one grandchild to another. Before, this could be done in steps, with potential gift tax consequences. Now, the transfer can be accomplished without any problems.

Changing the beneficiary is accomplished through a qualified rollover. Qualified rollovers must occur within 60 days of the withdrawal.[16] The requirement that a change in beneficiary also occur has been removed. When the 10 percent was treated as a penalty rather than as a tax, there were issues regarding who (the state, the taxpayer, etc.) was responsible for ensuring the rollover actually occurred. This problem should be resolved with the new tax.

If the successor beneficiary is not a member of the original beneficiary's family,[17] the distribution is treated as a non-qualified distribution to the account owner[18]: The account owner is taxed, regardless of who actually receives the money. This result can be avoided by transferring ownership of the account to the new beneficiary. That way, when the new beneficiary is named as the beneficiary of the account, he or she will be responsible for paying the tax due as a result of the non-qualified rollover.

General Rules for 529 Plans

To spot a 529 plan when you see it, here are some general requirements for them that are imposed on the states, not on the contributors or bene-

ficiaries.

(1) *It may be established by the state or eligible educational institutions.* The new rules provide that an eligible educational institution—not just a state—may establish a 529 plan,[19] but the institution's plan can only be a prepaid tuition plan, not a savings plan.[20]

(2) *Only cash contributions are permitted.* Prop. Reg. § 1.529-2(d) expands this definition to include checks, money orders, credit cards, and similar methods, but not all programs accept credit cards.

(3) *There is a penalty on non-qualified withdrawals.* Under the Act, the government imposes a 10 percent tax on non-qualified withdrawals, in addition to the taxability of the withdrawal.[21] The question that remains is whether 529 plan administrators will continue to exact a penalty for non-qualified withdrawals. The Code does not prevent that, but that result is unlikely, given the number of 529 plans currently available and the competition for investment dollars.

(4) *The plan must provide separate accounting for each beneficiary.*[22]

(5) *There can be no investment direction.* No owner of, contributor to or beneficiary of a 529 plan may direct, either directly or indirectly, the investment of the contributions.[23] This does not prevent the contributor from selecting among various investment plans.

That prohibition goes hand-in-hand with the requirement under the old rules that the rollover of an account required a change in beneficiary. Under the new rules,

accounts can be rolled over into a new 529 plan without changing the designated beneficiary, although this cannot happen more than once in every 12-month period.[24] This enables the owner of the account to reevaluate annually how the account is performing.

In Notice 2001-55,[25] the Internal Revenue Service indicated that account owners would be allowed to change the investment strategy in the 529 plan account once per year without rolling the account over or changing the beneficiary.

Investment direction also comes in the form of allocating future contributions. If the account owner wants to change how investments are being allocated, all he or she must do is reallocate the future contributions to the account. Between the future allocations concept and the rollover opportunities, the prohibition on investment direction can be skirted if that is the desire of the account owner.

(6) *A 529 plan account cannot be used to secure a loan.*[26]

(7) *There is a prohibition on excess contributions.* 529s must have adequate safeguards to prevent contributions in excess of the amount necessary to pay for college.[27] The current limitation is the actuarial value of tuition, fees and room and board for the most expensive undergraduate program allowed by the program. It is not clear what responsibilities, if any, an individual plan has to ensure that a beneficiary does not have multiple 529 plans in multiple states.

Community Property Issues

One of the issues facing Arizona practitioners regarding 529 plans is how community property rules will be applied. The general rule, of course, is that income earned during a marriage is community property. Therefore, contributions to a 529 plan would retain their community property nature.

Recommendations

How could Congress best improve tax treatment of 529 plans? By making contributions to them be tax-deductible.

That is unlikely. A more realistic possibility is for Congress to allow repayment of student loans as a qualified distribution. This would enable the account to grow tax-deferred for an even longer period of time.

These plans vary from state to state, and certain plans are definitely better suited for certain clients. By examining fee structures, investment advisers and investment options (just to name a few considerations), clients can be well informed prior to making any investment decisions. Furthermore, certain states allow contributions from trusts and Uniform Gift to Minors custodianships.

There is still uncertainty over the wisdom of using a 529 plan as a primary vehicle for estate or income tax planning. But these plans have now become almost impossible to match in terms of saving money for education. Attorneys should not be intimidated when suggesting them to their clients for their intended purpose—college savings.

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endnotes

1. Conceptually, a prepaid tuition plan is analogous to a defined benefit pension plan. Many prepaid tuition plans are limited to state residents or are restricted to other special groups of people. Arizona does not maintain a prepaid tuition program.
2. Qualifying distributions are those (1) used exclusively for qualified higher education expenses, (2) made on account of the death or disability of a beneficiary, (3) made on account of the beneficiary receiving a scholarship, and (4) that are rolled over into another account. Code § 529(b)(1), Prop. Reg. § 1.529–2(e)(1)(i)-(iv).
3. Code § 529(c)(3).
4. Act § 402(b).
5. Code § 529(c)(2)(A)(i).
6. Prop. Reg. § 1.529-5(b)(1).
7. Code § 529(c)(2)(B).
8. Prop. Reg. § 1.529-5(b)(2)(i).
9. *Id.* § 1.529-5(b)(2)(ii).
10. *Id.* § 1.529-5(b)(3)(i).
11. *Id.* § 1.529-5(b)(3)(ii).
12. Code § 529(c)(4)(C); Prop. Reg. § 1.529-5(d)(2).
13. *Id.* § 529(c)(4)(B).
14. *Id.* § 529(c)(3)(C).
15. Act § 402(d).
16. Prop. Reg. § 1.529-1(c).
17. If the successor beneficiary is a scholarship program sponsored by a state or local government or a charity, the successor beneficiary does not have to be a member of the original beneficiary's family. *Id.* § 1.529-3(c)(2).
18. *Id.* § 1.529-3(c)(1).
19. Act § 402(a), amending Code § 529(b)(1).
20. Act § 402(a)(2).
21. *Id.* § 402(a)(3).
22. Prop. Reg. § 1.529-2(f).
23. *Id.* § 1.529-2(g).
24. Act § 402(c).
25. 2001-39 I.R.B. 1
26. Prop. Reg. § 1.529-2(h).
27. Code § 529(b)(7); Prop. Reg. § 1.529-2(i).

endnotes (death tax eulogy)

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1. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, H.R. 1836, § 901(a) (2001) (the Act).
2. Paul Krugman, *Bad Heir Day,* N.Y. TIMES, May 30, 2001, at 1. Available at http://www.nytimes.com/2001/05/30/opinion/30KRUG.html?searchpv=day01.
3. Internal Revenue Code of 1986, as amended, 26 U.S.C. § 1014(a).
4. The information to be reported to the IRS will include: (1) the name and tax identification number of the recipient of the property, (2) a description of the property transferred, (3) the adjusted basis of the property in the hands of the decedent, (4) the fair market value of the property on the date of death, (5) the decedent's holding period, (6) sufficient information to determine if gain from the sale of the property would be treated as ordinary income, and (7) the amount of basis increase allocated to the property. The Act, § 542(a).
5. A conservation easement is a voluntary restriction placed on the use of real property for a conservation-related purpose. The donor is generally entitled to reserve certain specific rights to use the property. However, the restrictions imposed and the rights reserved by the donor will affect the value of the property. I.R.C. § 2031(c).
6. *President Expected To Soon Sign Bill To Provide $1.35 Trillion in Tax Cuts,* DAILY TAX REPORT, May 30, 2001, at GG-1.
7. Dana Milbank & Glenn Kessler, *Charities Decry Tax Bill Setback,* WASH. POST, May 30, 2001, at A1.
8. David E. Rosenbaum, *News Analysis: Tax Cut Becomes Law, for Now,* N.Y. TIMES, June 8, 2001, at 3. Available at http://www.nytimes.com/2001/06/08/politics/08TAXE.html.