FEATURE | BY JOHN D. DADAKIS AND CHANIE S. FORTGANG

529 Plans: Sophisticated Planning with Simple Devices

We recently met with a client to wrap up his basic estate planning package. His children were all grown up, and his daughter was about to get married. As he reveled with us in the excitement of the upcoming occasion, he proclaimed that, as soon as he had a grandchild, he would set up a 529 plan for his or her benefit. Our response: Why wait?

In the estate planning world, attorneys pride themselves on devising ultra-sophisticated solutions to enable their clients to pass on wealth from generation to generation in a tax-efficient manner. But sometimes the simplest solutions are the most overlooked. 529 plans, as they have colloquially been termed, have traditionally functioned as a stand-alone solution for middle-income families to prepare for the educational well-being of their children. Upon the birth of a child or at some later point, parents invest money in these accounts in the hope of setting aside money for college. While 529 plans successfully serve this goal, if carefully structured, they can also enable ultra-high net worth clients to transfer significant wealth to successive generations and plan for the educational objectives of more remote progeny, even if they are unborn.

Planning for Future Generations

Section 529 of the Internal Revenue Code permits individuals to set up a 529 account, or an investment medium, whose proceeds may be used for tuition, fees, books, supplies, and equipment required for study at any accredited college, university, or vocational school in the United States and even at some foreign universities.[1] 529 plans may also be used toward a capped amount of room and board expenses for students enrolled in a qualified educational program at least half of the time.[2] Because distributions from 529 plans for qualified higher education expenses are exempt from federal income tax, and contributions to such plans may be deductible for state income tax purposes (depending on the state in which the plan is administered), these plans have become very popular investment vehicles.[3]

For individuals who have the funds to spare, as well as the desire to plan ahead for the education of their grandchildren and further descendants, investing in 529 plans can be an excellent vehicle to set aside funds for college tuition costs of future generations while removing assets from their taxable estate.[4] While the proceeds of a 529 plan are intended to be used for the qualified educational expenses of the original designated beneficiary of such plan, the Internal Revenue Service permits a "rollover." By this mechanism, the proceeds of one 529 plan may be paid over to another 529 plan for the benefit of a qualified family member of the beneficiary of the original plan.[5] A qualified family member includes, among others, children and their descendants, parents, siblings, nieces, nephews, first cousins, and spouses of any of the aforementioned. Alternatively, the beneficiary of the original plan may simply be changed to a qualified family member.[6] Neither scenario will incur income tax liability.[7]

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plans that are intended to benefit future grandchildren, but initially name each of his or her children as the beneficiaries of such plans. If the family structure and dynamic allows, the individual could also create plans for each of his or her children-in-law.

For instance, a married father with three daughters and two sons-in-law could create a total of five plans in a given year. If neither he nor his wife has used any of their annual exclusion allowance for that year, the two of them could make a sizeable initial contribution. Beginning in 2013, the couple could utilize their combined annual exclusion allowance to contribute a total of $28,000 to each of the plans, which would be a sum investment of $140,000 alone during the first year of funding (see chart 1). Assuming that the returns on each of these plans keep up with inflation, the individual will have already invested sufficient funds to cover a sizeable portion of a grandchild's costs of attending a four-year college program.[8] If the contributing individual continues the same contributions, he will have fully covered the costs of a four-year college program and begun covering the costs of graduate school. Of course, the greater the number of plans that an individual can create, the greater the costs he or she can cover in any year.

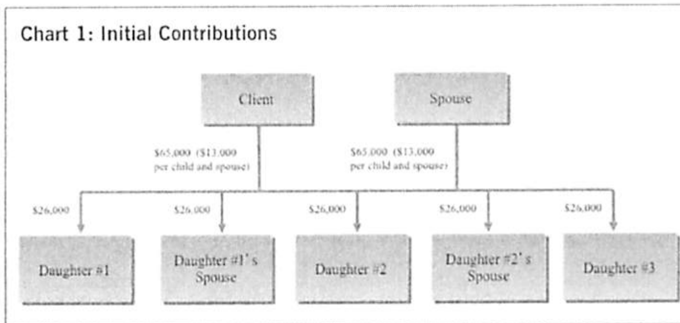

Chart 1: Initial Contributions

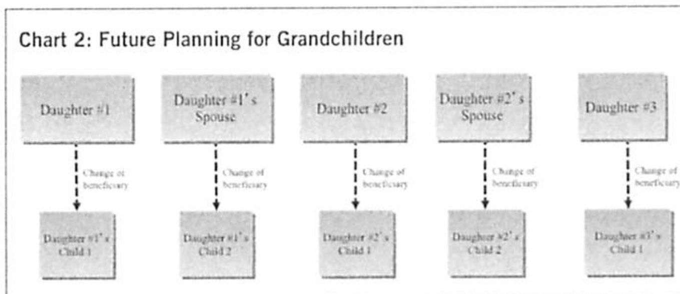

Chart 2: Future Planning for Grandchildren

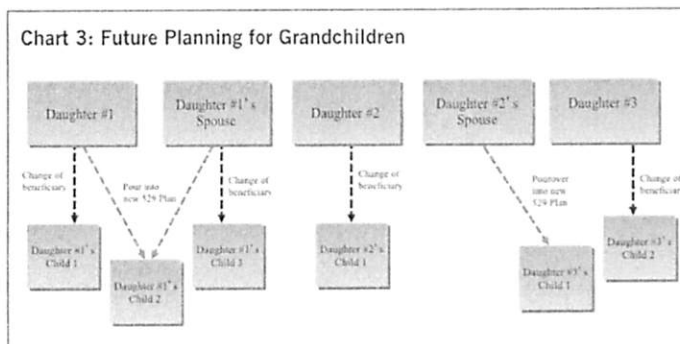

Chart 3: Future Planning for Grandchildren

When the time is appropriate, the father in question could change the beneficiary on the account that was set up for the benefit of one of his daughters or sons-in-law to one of the grandchildren (see chart 2). He could also establish a new plan for a grandchild and pour the proceeds of one of the original plans into the new one. In both situations, the father will continue to be the "custodian" of the resulting plan, and the assets contributed to the plan will remain outside of his estate. If the number of grandchildren exceeds the number of 529 plans that this father created and funded, he may also have the option, depending on the plan administrator, of creating several new 529 plans for the additional grandchildren. He could then split the proceeds from one of the original accounts among the new ones, allowing for great flexibility in future planning (see chart 3). In the event that one of his daughters does not have children, the 529 plan set up for the daughter's benefit may be paid over to the plans for her nieces and nephews, or if need be, to a plan for a cousin.

The primary caveat to this super funding technique is that the total contribution to any one 529 plan cannot exceed the amount necessary to provide for the qualified education expenses of the original designated beneficiary. While this amount varies

from state to state, many states are quite generous with this allowance, permitting total contributions of more than $300,000 to any one account.[9] California, for example, permits total contributions of $350,000, while New York permits contributions of $375,000. Additionally, since limitations are imposed individually by states and not by the federal government, a contributor could technically set up plans in numerous states to evade the state contribution limits.

Pitfalls of the 529

Excessive funding of a 529 plan could theoretically create exposure to unwanted tax treatment and penalties. Withdrawing funds from a 529 plan for reasons other than for qualified purposes will subject earnings to income tax plus an additional penalty of 10 percent.[10] To the extent that a state income tax deduction was claimed on the original contribution, reporting the state recapture income may also be required. For individuals undertaking creative planning with 529 accounts, however, the penalties associated with withdrawals of funds from 529 plans for unpermitted purposes are not always so meaningful.

The general rule does have limited exceptions, including instances in which the beneficiary dies (and the distribution goes to another beneficiary or to the estate of the designated beneficiary), becomes disabled, or receives a tax-exempt scholarship or tuition assistance.[11] In addition, given the relatively large number of options for transferring 529 plans among qualified beneficiaries, as well as the number of individuals in a taxpayer's life who may ultimately benefit from tuition funding, the chances of having to withdraw funds for a non-qualified purpose is minimal.

The ideal candidates for contemplating long-term 529 planning are not only financially capable of putting aside funds without affecting their retirement savings or standard of living, but also have part of their annual exclusion amount to spare on a regular basis. While the proceeds of 529 plans are not subject to income tax, contributions to such plans that exceed the annual exclusion amount in any given year will incur gift taxes unless any remaining lifetime exemption remains. As an exception to this rule, the IRS allows for a front-loaded contribution of five times the relevant annual exclusion limit to be treated as if it were made pro rata over five years if a proper tax election is made.[12] If this exception still does not offer reprieve, a financial planner or tax advisor should be consulted. While individuals can make taxable gifts to 529 plans, the gift tax costs may outweigh the income tax savings and an alternative investment strategy may be preferable.

Changing the beneficiary of a plan or pouring the proceeds of one plan to another plan may also have unintended gift tax consequences for the children who served as the initial beneficiaries of the 529 plans. To the extent that the plan proceeds are eventually used for one of their children or grandchildren (or any of their descendants) and are in excess of the annual gift tax exclusion, the children will be considered to have made taxable gifts to the ultimate beneficiary.[13] In essence, the children step into the shoes of their parents and will be held accountable for gift tax purposes even though they never actually gifted the asset. Careful planning, however, can prevent or at least reduce this risk.

Finding Solutions

Making the five-year election in connection with a rollover or splitting the assets of one plan among multiple plans for different beneficiaries can reduce risk. For instance, if in the first year of funding, parents have already contributed $140,000 to 529 plans in New York (which imposes a cap of $375,000 on contributions), they can contribute an additional $235,000 to each plan before they max out on the permitted contribution amount. Using their respective $14,000 annual exclusion exemptions, the couple can make the additional allowable contributions to each of the plans within nine years, without incurring the gift tax.

If inflation continues to drive the annual exclusion amount up, the couple might even be able to make these contributions within a shorter timeframe. Upon the birth of a grandchild in the tenth year, the daughter and son-in-law of the

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original couple (and parents of the grandchild) can roll over a total of $140,000 from their own respective 529 plans to a new plan for this child. In the process, they can treat the contributions as if they were made pro rata over five years.[14] In each of the next five-year cycles these new parents will take the same action until the plan for their child is fully funded. They will then follow the same pattern of action at the birth of each of their other children.[15] If there is insufficient money in the 529 plans of these second-generation parents to fund fully a 529 plan for a later born child, a rollover can be made from the plan of their older children to the younger child's plan. This will not result in any negative gift tax consequences since the transfer is being made between parties on the same generational level.

This creative solution to avoiding inadvertent gift tax liability further highlights the beauty of funding 529 plans for grandchildren ahead of their birth. The father in our example could have used his annual exclusion allowances elsewhere and waited until the birth of a grandchild to create 529 plans for the next generation. By taking action early, not only did he maximize his annual exclusion allowances by applying them toward a use with favorable income tax treatment, he overcame an inherent difficulty associated with estate and tax planning — the unknown of the future. This father may not have lived to see a grandchild or perhaps he would have died when the grandchild was very young, and the opportunity to fund the grandchild's college education fully would have been lost. By planning creatively, he was able to maximize the contributions he could make toward the education of his descendants and give his own children plenty of time to distribute the proceeds equitably without being exposed to unfavorable tax treatment. ■

Notes

[1] I.R.C. § 529.

[2] I.R.C. § 529(c)(3)(B).

[3] I.R.C. § 529(c)(3); for a complete listing of which states provide state tax deductions or credits, *see* http://www.savingforcollege.com/529_plan_details/.

[4] Even though the initial creator of a 529 plan does not part fully with control over the plan assets, the assets are not includable in his or her estate. *See* I.R.C. § 529(c)(4)(A). *But see infra* note xii and accompanying text.

[5] I.R.C. § 529(c)(3)(C)(i).

[6] I.R.C. § 529(c)(3)(C) (ii).

[7] I.R.C. §§ 529(c)(3)(C)(i)-(ii).

[8] This analysis is based on an informal review of tuition costs at various private universities throughout the United States. As an example, the total expected cost of attending Lehigh University for the 2012-2013 academic year is approximately $55,515. *(see http://www4.lehigh.edu/admissions/undergrad/tuition/costs.aspx).* The corresponding cost of attending Harvard University is $57,950 (*see http://www.admissions.college.harvard.edu/apply/transfer/cost.html).*

[9] Prop. Treas. Reg. § 1.529-2(i); for a complete list of state limitations on contributions to 529 plans *see* http://www.savingforcollege.com/529_plan_details/.

[10] Prop. Treas. Reg. § 1.529-2(e)(2)(ii); *see also* "Qualified Tuition Program (QTP)", Publication 970 (2005), *available at http://www.irs.gov/pub/irs-pdf/p970.pdf.*

[11] *See* "Qualified Tuition Program (QTP)", Publication 970 (2005), *available at http://www.irs.gov/pub/irs-pdf/p970.pdf.*

[12] I.R.C. § 529(c)(2)(B). As an exception to the general rule that amounts contributed to a 529 plan will not be includable in the donor's estate, if the donor dies within this five-year period, the gifts that the donor would not have lived long enough to make had he or she only made one annual exclusion gift each year will be included in the donor's estate. *See* Prop. Treas. Reg. § 1.529-5(d)(2).

[13] I.R.C. § 529(c)(5)(B); Prop. Treas. Reg. § 1.529-5(b)(2)(i).

[14] Prop. Treas. Reg. § 1.529-5(b)(3)(ii) allows for the application of the five-year averaging rule to be applied to a transfer by reason of a change of beneficiary or rollover in determining the portion of a transfer deemed a taxable gift.

[15] If either of the parents dies during this five-year period, the pro rata portion of the rollover attributable to calendar years subsequent to the relevant parent's year of death will be included in such parent's estate. *See* Prop. Treas. Reg. § 1.529-5(d)(2). At worst, this will leave the parent in the same position as if he or she did not make the transfer, because had the assets remained in the original account named for his or her benefit, they would have been included in his or her estate. *See* I.R.C. § 529(c)(4)(B). Arguably, however, even if a portion of the frontloaded rollover is brought back into the parent's estate, the appreciation on that portion would still remain outside of his or her estate, leaving all parties better off.

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