Section 529 Plans

(Tax-Free College Savings Plans)

by Kevin C. Curry
Board Certified Tax Law Specialist
Board Certified Estate Planning and Administration Specialist

Kean Miller Hawthorne D'Armond McCowan & Jarman, L.L.P.
P. O. Box 3513
Baton Rouge, LA 70821
(225) 387-0999

QUALIFIED TUITION PROGRAMS - SECTION 529 PLANS

Background

Section 529 plans were originally created by the Small Business Job Protection Act of 1996. Although 529 plans were attractive savings vehicles when originally created, they are now even more attractive as a result of changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Act"). The materials discussed below describe the 529 plans as they exist after the 2001 Act, but the 2001 Act does contain a sunset provision which will nullify all of the changes made by the 2001 Act for all tax years beginning after December 31, 2010. Therefore, this sunset provision should be taken into consideration when evaluating 529 plans and their related benefits.

Two Types of Qualified Tuition Programs

Section 529(b)(1) of the Code defines a 529 plan as a program established and maintained by a state or agency or instrumentality thereof or by one or more eligible educational institutions under which a person can do one of the following:

1. Purchase tuition credits or certificates on behalf of a designated beneficiary which entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a "prepaid tuition plan"), or

2. In the case of a program established and maintained by a state or agency or instrumentality thereof, may make contributions to an account which is established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account (the "savings account plan").

The savings account plan tends to be the more popular of the two types of 529 plans because of the flexibility inherent in such plans. The savings account plans operate like investment accounts and allow the owner to contribute funds to the plan to be invested for the future educational expenses of the beneficiary.

Plan Requirements

A 529 plan must meet the following general requirements:

1. The plan must provide that all purchases or contributions may only be made in cash.

2. The plan must provide separate accounting for each designated beneficiary.

3. The plan must provide that any contributor to, or designated beneficiary under, the plan may not directly or indirectly direct the investment of any contributions to the program (or any earnings thereon).

4. The plan must prohibit the use of any interest in the plan or portion thereof to be used as security for a loan.

5. The plan must provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of the amounts necessary to provide for the qualified higher education expenses of the beneficiary.

6. With respect to plans maintained by one or more eligible educational institutions, the plan must provide that the amounts are held in a qualified trust and such plan must have received a ruling or determination that the plan meets the applicable requirements for a qualified tuition program. For purposes of this requirement, the term "qualified trust" means a trust which is created or organized in the United States for the exclusive benefit of designated beneficiaries and with respect to which the requirements of paragraphs (2) and (5) of I.R.C. Section 408(a) are met. Section 408(a)(2) generally requires a bank or other corporate trustee for the trust. Section 408(a)(5) prohibits commingling of the trust assets with other property except in a common trust fund or common investment fund.

Investment of Plan Assets

One of the crucial factors in selecting a 529 plan relates to the permissible investments of the plan. As pointed out in requirement no. 3 above, the plan cannot allow the contributor or beneficiary to direct investments in the plan. However, proposed regulations which were issued in 1998 provide that this prohibition is not violated if participants are allowed to select among a variety of different investment strategies at the time the initial contribution establishing the account is made. Furthermore, Notice 2001-55 has indicated that the I.R.S. is considering allowing changes in investments or more frequently, possibly once per year or upon a change of a beneficiary.

© 2002 Kean Miller Hawthorne D'Armond McCowan & Jarman, L.L.P.

Contribution Limits

With respect to the limitation on excess contributions described in requirement no. 5 above, the limitation is generally based upon the actuarial value of tuition, fees, and room and board for five years at the most expensive undergraduate program allowed by the plan. This determination is generally made by looking at the most expensive school in the state adopting the plan (with respect to state plans) and using the tuition at that school to compute the limitation. Therefore, plans located in states with relatively expensive colleges may have higher caps on the amounts of contributions allowed.

Tax Benefits of 529 Plans

Section 529 plans provide a variety of income, gift and estate tax benefits for the contributors and the beneficiaries.

Income Tax Benefits

Although there is no federal income tax deduction for a contribution to a 529 plan, the earnings under a 529 plan are exempt from income tax and grow tax-deferred within the plan.

With respect to state income taxes, some states do not impose taxes on their earnings of 529 plans, either. For instance, Louisiana would not impose an income tax upon such plans due to the "piggybacking" nature of our income tax. Furthermore, some states provide deductions for contributions to their own 529 plan.

As originally enacted, the earnings and income of 529 plans would have been taxed to the beneficiaries at the beneficiaries' rate when the funds were withdrawn from the plan for educational purposes. However, as a result of the 2001 Act, distributions from state-sponsored plans are income tax-free beginning in 2002, provided that the distribution is used for "qualified higher education expenses." With respect to private institution 529 plans, the earnings will be tax-free beginning in 2004.

Gift Tax Benefits

Any contribution to a 529 plan on behalf of any designated beneficiary is treated as a completed gift to such beneficiary and it is treated as a gift of a present

© 2002 Kean Miller Hawthorne D'Armond McCowan & Jarman, L.L.P.

interest (*i.e.*, it qualifies for the annual gift tax exclusion). This provision is unusual because the contributor retains the right to decide when and by whom the funds are received because the contributor can ultimately change the beneficiaries of the 529 plan and furthermore, the contributor could reacquire the funds from the 529 plan (subject to a penalty).

The contributor can elect to treat a contribution to a 529 plan as having been made ratably over the five year period beginning with the calendar year of the contribution in order to take advantage of five annual exclusions for gift tax purposes. This proration is only available for the portion of the contribution equal to five times the amount of the annual exclusion. Any contribution in excess of that amount will be a taxable gift in the year of the contribution (as opposed to over a five-year period). For example, if a contributor makes a contribution of $100,000 in 2002 when the annual exclusion is $11,000, $55,000 of the contribution will be spread over five years ($11,000 in 2002, $11,000 in 2003, etc.). The balance of $45,000 will be a taxable gift in 2002. If the contributor dies during this five year period, then a portion of the contribution allocable to the future calendar years after the year of the contributor's death would be included in the contributor's estate.

Estate Tax Benefits

No portion of a 529 plan is included in the gross estate of the contributor, notwithstanding the fact that the contributor maintains control over the plan.

Distributions

A mentioned above, as a result of the 2001 Act, distributions from state 529 plans (and the distributions from private 529 plans beginning in 2004) will be exempt from income taxation to the extent used to pay "qualified higher education expenses," the definition of which is provided below. However, if a distribution is not used for the payment of such expenses, then the distribution will be included in the gross income of the distributee and taxed under the annuity taxation rules of Section 72 of the Code.

The 2001 Act clarified the provision with respect to the penalty imposed for distributions which are not used for qualified higher education expenses. In particular, Section 529(c)(6) adopts the penalty imposed by Section 530(d)(4) of the Code with respect to Education IRAs (now called Coverdell Education Savings Accounts) which provides a 10% penalty for the taxable portion of any distribution. However, this penalty will not

© 2002 Kean Miller Hawthorne D'Armond McCowan & Jarman, L.L.P.

apply to any payment or distribution from a private 529 plan before 2004 if such distribution is used for qualified higher education expenses.

The proposed regulations impose substantiation requirements upon 529 plans to insure that the penalty is collected on any distribution not used for qualified higher education expenses. In particular, Prop. Reg. 1.529-2(e)(4) provides a safe harbor for 529 plans to use for substantiation purposes. A 529 plan can treat a distribution as being made for qualified higher education expenses if one of the following applies:

1. The distribution is made directly to an eligible educational institution;

2. The distribution is made in the form of a check payable to both the designated beneficiary and the eligible educational institution;

3. The distribution is made after the designated beneficiary submits substantiation to show that the distribution is a reimbursement for qualified higher education expenses that the designated beneficiary has already paid and the program has a process for reviewing the validity of the substantiation prior to the distribution; or

4. The designated beneficiary certifies prior to the distribution that the distribution will be expended for his or her qualified higher education expenses within a reasonable time after the distribution; the program requires the designated beneficiary to provide substantiation of payment of qualified higher education expenses within 30 days after making the distribution and has a process for reviewing the substantiation; and the program retains an account balance that is large enough to collect any penalty owed on the distribution if valid substantiation is not produced.

If a distribution does not fall within one of the above provisions, then the plan is required to withhold the penalty (except in cases of death or disability), but the penalty can be refunded if substantiation is provided at a later date.

A 529 plan must provide the distributee with Form 1099-Q (after 2001) showing the amount of earnings distributed to the distributee during the year.

Qualified Higher Education Expenses

The term “qualified higher education expenses” includes the following:

© 2002 Kean Miller Hawthorne D’Armond McCowan & Jarman, L.L.P.

1. Tuition, fees, books, supplies and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution; and

2. Expenses for special needs services in the case of a special needs beneficiary which are incurred in connection with such enrollment and attendance; and

3. Room and board expenses for students who are enrolled at least half-time.

The proposed regulations (which were drafted prior to the 2001 Act) provide the following with respect to room and board costs under Prop. Reg. 1.529-1(c):

> (2) The costs of room and board (as limited by paragraph (2)(i) of this definition) of a designated beneficiary (who meets requirements of paragraph (2)(ii) of this definition) incurred while attending an eligible educational institution:
>
> (i) The amount of room and board treated as qualified higher education expenses shall not exceed the minimum room and board allowance determined in calculating costs of attendance for Federal financial aid programs under Section 472 of the Higher Education Act of 1965 (20 U.S.C. 108711) as in effect on August 5, 1997. (Presumably, this provision would now be modified to reflect that the date of the 2001 Act would be the controlling date). For purposes of these regulations, room and board costs shall not exceed $1,500.00 per academic year for a designated beneficiary residing at home with parents or guardians. For a designated beneficiary residing in institutionally owned or operated housing, room and board costs shall not exceed the amount normally assessed most residents for room and board at the institution. For all other designated beneficiaries, the amount shall not exceed $2,500.00 per academic year. For this purpose, the term "academic year" has the same meaning as that term is given in 20 U.S.C. 1088(d) as in effect on August 5, 1997. (Presumably, this provision would look to the term as in effect on the effective date of the 2001 Act).

© 2002 Kean Miller Hawthorne D'Armond McCowan & Jarman, L.L.P.

(ii) Room and board shall be treated as qualified higher education expenses for a designated beneficiary if they are incurred during any academic period during which the designated beneficiary is enrolled or accepted for enrollment in a degree, certificate, or other program (including a program of study abroad approved for credit by the eligible educational institution) that leads to a recognized educational credential awarded by an eligible educational institution. In addition, the designated beneficiary must be enrolled at least half-time. A student will be considered to be enrolled at least half-time if the student is enrolled for at least half the full-time academic workload for the course of study the student is pursuing as determined under the standards of the institution where the student is enrolled. The institution's standard for a full-time workload must equal or exceed the standard established by the Department of Education under the Higher Education Act and set forth in 34 CFR 674.2(b).

<u>Change of Beneficiaries or Programs</u>

No income tax will be imposed on a distribution which, within sixty days of such distribution, is transferred to another 529 plan for the benefit of the designated beneficiary or is transferred to the credit of another designated beneficiary under a 529 plan provided that such beneficiary is a member of the family of the designated beneficiary with respect to which the distribution was made.

Any change in the designated beneficiary of an interest in a 529 plan shall not be treated as a distribution from the plan if the new beneficiary is a member of the family of the old beneficiary.

Rollovers from one 529 plan to another 529 plan for the same beneficiary are only permitted once every twelve months.

For purposes of the above rules, the term "member of the family" means, with respect to any designated beneficiary, the following:

1. The spouse of such beneficiary;

2. A son or daughter of the beneficiary, or a descendant of either;

© 2002 Kean Miller Hawthorne D'Armond McCowan & Jarman, L.L.P.

3. A stepson or stepdaughter of the beneficiary;

4. A brother, sister, stepbrother, or stepsister of the beneficiary;

5. The father or mother, or an ancestor of either, of the beneficiary;

6. A stepfather or stepmother of the beneficiary;

7. A son or daughter of a brother or sister of the beneficiary;

8. A brother or sister of the father or mother of the beneficiary;

9. A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the beneficiary;

10. The spouse of any individual described above; and

11. Any first cousin of the beneficiary.

Comparison with Other Education Financing Options

UGMA/UTMA Accounts. Uniform Gifts to Minors Act/Uniform Transfers to Minors Act. A popular investment option. Easy to establish and inexpensive to administer. The major drawback is that the control of the account falls into the hands of the student at age 18 and they do not have to use it to further their education. The earnings on the account are taxable to the minor and could be subject to taxation at the parent's rate under the "kiddie tax" rules.

Savings Bonds. Subject to certain limitations, the interest on Series EE United States Savings Bonds are completely or partially excluded from federal income tax when used for qualified higher education expenses paid in the same calendar year the bonds are redeemed. Proceeds must be used to pay educational expenses for the taxpayer, the taxpayer's spouse or a dependent of the taxpayer.

Hope Scholarship and Lifetime Learning Credit. Allow parents to claim a tax credit when their child attends college and incurs qualified educational expenses. Specified age and income limits are enforced, and qualified expenses are limited to tuition and fees.

© 2002 Kean Miller Hawthorne D'Armond McCowan & Jarman, L.L.P.

Financial Aid. Financial aid is the second most popular tuition funding option. Some students may be eligible only for loans because of the high net worth of their parents. Paying back these loans can be a burden on parents who are planning for retirement as well as graduates who are starting out.

Coverdell Education Savings Account (Education IRA). A trust or custodial account created exclusively for the purpose of paying qualified education expenses of a designated beneficiary. Trust can be created by anyone and must be designated as a Coverdell education savings account at the time it is created or organized. Married couples earning as much as $220,000 a year are now able to open accounts. Contributions must be in cash and are limited to $2,000 per beneficiary. Although contributions are not tax deductible, the funds grow tax-free and are not taxable when withdrawn, as long as the funds are used to pay qualified higher education expenses (as defined under Section 529) or qualified elementary and secondary education expenses (added by the 2001 Act). The account must be fully withdrawn by the time the beneficiary reaches age 30, or else it will be subject to tax and penalties. If the beneficiary should not need the funds, or if an excess of funds remains after paying for college, the account may be transferred to certain relatives of the original beneficiary.

© 2002 Kean Miller Hawthorne D'Armond McCowan & Jarman, L.L.P.