Section 529:
A Primer on Qualified Tuition Programs

1.0 INTRODUCTION

The idea of paying for a child's college education can be intimidating for all but the wealthy. How can a family amass the tens of thousands of dollars required to pay tuition, book, and room and board? These costs are currently rising at four percent a year, but were rising at seven to nine percent a year throughout most of the 1990's.[1] Yet in 1999, 95% of American families (approximately 68.43 million) earned less than $155,000 annually.[2] Professional financial planners have a tremendous opportunity to help these families plan for these high college costs.

Section 529 of the Internal Revenue Code was passed in 1996 in order to help American families save for college expenses. An amendment to Section 529 as part of the Taxpayers Relief Act of 1997 allowed states to offer more Qualified Tuition Programs. The 2001 and 2002 Acts made additional changes to Section 529.

Proposed regulations on Section 529 Plans were issued in August 1998. The preamble to the proposed regulations states that taxpayers may rely on these proposed regulations for tax years ending after August 20, 1996.

These savings programs are now one of the very best ways to save and pay for college expenses. But many people are unaware of them and their benefits: "529 plans are the best kept secret in college investing," observed a vice president of Fidelity Investments in Boston.[3] Financial planners and families alike need to know about Qualified Tuition Programs. They need to know what they are, how they work, and the benefits they offer.

Not only do these plans allow for taxpayers to set aside significant amount of money in tax-deferred accounts, but also the distributions after 2001 may be structured to be free from federal income tax. Prior to 2002, the income earned on the accounts was income tax deferred and taxable at the time of withdrawal. Under the current sunset provision of the 2001 Act, the changes made by the 2001 Act will no long apply starting in 2011. However, it is possible that future congressional action will extend the 2001 Act's education provisions beyond 2011.

2.0 BASIC ELEMENTS OF QUALIFIED TUITION PROGRAMS

2.1 Prepaid Tuition Plans vs. College Savings Plans

Qualified Tuition Programs, as defined under Section 529, consist of two types of plans:

1. Prepaid tuition plans are types of Section 529 Plans that allow the owner to purchase a prepaid tuition contract today that will pay for future college tuition. These plans involve paying now for future tuition and typically require that participating beneficiaries reside in and attend a college/university in the state managing the plan. For example, parents living in Virginia may choose the prepaid plan for their young child. They pay $5,000 to purchase N tuition credits. Years later, when the child is ready to attend a public college in Virginia, the credits may be redeemed each semester until the credits are used up or the child graduates.

2. In contrast, College Savings Plans allow for private as well as public college/university education, and usually offer more flexibility regarding residency and college location. For example, parents in Virginia may open a $5,000 account with the state of Utah. They may make regular deposits over the years. If their child decides to go to college in Massachusetts, the parents can make distributions from the account to pay for their child's college expenses.

Taxpayers can expect to see variations on these terms. College savings plans might also be called savings plan trusts or investment plans; prepaid tuition plans may also be referred to as prepaid educational arrangement or contracts. Although every state has developed a Section 529 Plan, some have prepaid tuition plans, some have savings plans, some have both, and some have hybrids of the two. Various states with various plans that are subject to ongoing revisions made the mastery of evaluating the best Section 529 Plans an ongoing task.

A prepaid tuition plan locks in qualified college costs at today's dollars, protecting against the inflationary cost of college. A college savings plan is a tax-advantaged way to build up a college fund. There is no "inflationary protection." However, the prepaid tuition plan is limited to the amount of future tuition while the college savings plan includes books, supplies, and room and board.

Most prepaid tuition plans are designed for undergraduate expenses. There is no similar limitation on college savings plans. Most savings plans have no limit on how long the account can stay open. Prepaid tuition plans often have ending dates, defined, for example, as the year the beneficiary is scheduled to begin college plus 10 years.

College savings plans often have no residency requirement, prepaid tuition plans often require that either the account owner or the beneficiary be a resident of the state in order to use that state's plan.

Section 529 Plans have fees that are charged to participants for items such as enrollment, annual maintenance, and change of beneficiary, to name a few. However, it appears that often the fees charged to participants of prepaid tuition plans are higher than the fees charged to participants of college savings plans.

College savings plans offer no guarantees. The account value simply is a matter of the investment performance of the mutual fund or allocation model offered by the plan and chosen by the participant. Guarantees on prepaid tuition plans run the gamut from a safety net offered by the full faith and credit of the state to no guarantee at all. Other prepaid tuition plans require that the state legislature consider an appropriation to the program if the program is failing financially.

The choice of schools is immaterial to the value of a college savings plan because the beneficiary receives the same amount of money regardless if the money is spent on in-state, out-of-state, public, or private institutions. This is not case with prepaid tuition plans. Before fund can be spent for schools other than in-state public institutions, a value must be placed on the units or contract. Most plans will use a weighted average of the credit hour at an in-state school to peg the value; some will just assign a low fixed rate of return to the contributions. A disadvantage can arise if a student chooses a less expensive school in another state. Most plans limit the benefits to private and out-of-state schools to the lesser of actual expenses or the value of the contract. Prepaid tuition plans are not required to offer a refund.

Each Section 529 Plan is able to impose its own restrictions on its plans and occasionally a plan goes beyond what is required by Section 529.

2.2 Terms and Definitions

Some key terms and definitions are helpful in understanding Section 529 Plans. These terms and definitions include:

- **Basis** is the sum of all contributions plus the carryover basis of rollover contributions, less any basis removed in previous distributions.[4] Tracking the basis in an account will be the responsibility of the taxpayer. It is essential to know the basis when making distributions for other than qualified higher education expenses.

- **Designated beneficiary** is the individual for whom the account is established and for whom college expenses will be paid.[5]

- **Earnings** is defined as the total account value less the basis. Every distribution will be made up of an earnings portion and a return of principal.[6]

- **Participant** is the account owner or person who purchased the contract ("account owner').[7]

- An account owner is the person who is entitled to select or change the designated beneficiary.[8]

- A **withdrawal** is an amount taken out of a Section 529 Plan.[9] The Code refers to this as a **distribution**.[10] If used to pay for qualified higher education expenses, it is a **qualified distribution**. A withdrawal for any other purpose will be deemed a **nonqualified distribution** unless it falls under an exception, such as the death or disability of a beneficiary.

2.2 Private Prepaid Tuition Plans

Initially, all Section 529 Plans had to be established and maintained by a state. Pursuant to the 2001 Act, private eligible educational institutions may maintain a Section 529 prepaid tuition plan but not a Section 529 College Savings Plan.[11] Unlike state-sponsored plans, private prepaid tuition plans must receive IRS approval in order to qualify as a Section 529 Plan. In addition, contributions to a private prepaid tuition plan must be held in a qualified trust that meets the requirements in Sec. 408(a)(2) and Sec. 408(a)(5), which generally apply to individual retirement accounts (IRAs).[12]

Plans may be established and funded prior to 2004, but the earnings portions of distributions will be taxed as income to the beneficiary if distributions are taken before 2004.[13]

2.3 Contributions

The IRS places certain limits on contributions to Qualified Tuition Programs. First, all contributions can only be cash or an acceptable form of cash such as a check, money order, credit card, etc.[14] Contributions cannot be made with investment securities or other types of property. In addition, the IRS limits how much can be contributed to Qualified College Savings Plans. According to Proposed Reg. 1.529-2(i), the contribution limit is the estimated future qualified higher education expenses for five years of "undergraduate enrollment at the highest

cost institution allowed by the program." While states may have even more stringent limitations, current state limits on total contributions to college savings plan accounts range from $100,000 to in excess of $250,000.[15]

College savings plans typically allow contributions to be made at any time. Prepaid tuition plans have specified times or enrollment periods during the year and contributions have to be made during those times.

Contributions to a Section 529 Plan are not deductible for federal income tax purposes. Some states offer their residents a deduction for contributions.

Section 529 Plans must provide a separate accounting for each designated beneficiary.[16] This does not mean that they must maintain separate accounts. Programs must ensure that accounts are not overfunded beyond amounts needed for the beneficiary's expected educational expenses.[17] The total contributions may not exceed an amount, as determined by actuarial estimates, necessary to pay tuition, required fees, and room and board expenses for five years of undergraduate education at the highest priced school allowed by the program.[18] Most plans place a dollar limit on contributions. These limits are per beneficiary, regardless of the number of donors to the account.[19] The prohibition on excess contributions is based on all accounts established and maintained by a state for the benefit of the same designated beneficiary.[20]

Limits can be stretched, however, if a family can justify additional qualified expenses. According to CPA Joe Hurley, creator of SavingForCollege.com, a web site devoted to state 529 programs, it is not only possible to open accounts in more one than state, but it is also possible to contribute the maximum amount in more than one state. Expensive private college, plus graduate, medical, or business school can be used to justify multiple accounts.[21] However, Hurley adds a caveat that while there are no IRS or state " 'contribution police' " looking for people trying to use 529's as huge tax shelters, "if a state determines that you have made contributions without the intent to use the account for college, it will terminate your account and perhaps assess an extra penalty."[22]

Accounts may not be used by the owner or beneficiary as collateral for a loan.[23]

The entire amount of a rollover from a Coverdell Education Savings Account (Coverdell ESA) qualifying U.S. Savings Bond proceeds, or another Section 529 Plan will be treated as earnings until the recipient Section 529 Plan receives the necessary documentation of basis and earnings.[24]

For these purposes, "appropriate documentation" is as follows:[25]

1. For a rollover from Coverdell ESA: an account statement issued by the financial institution that was the trustee or custodian of the ESA showing the basis and earnings in the account.

2. For a rollover from the redemption of qualified U.S. Savings Bonds: an account statement or Form 1099-INT, Interest Income, by the financial institution that redeemed the bonds showing the interest amount; and

3. For a rollover from another Section 529 Plan: a statement by the distributing Section 529 Plan showing the earnings portion of the distribution.

For direct rollovers from one Section 529 Plan to another Section 529 Plan on or after January 1, 2002, the distributing plan must provide the recipient with a statement of the earnings portion of the rollover distribution with the earlier of:

1 30 days after the distribution; or

2. January 10th of the year following the calendar year in which the distribution was made.[26]

Tax Planning: A Coverdell ESA must generally be distributed when the beneficiary reaches age 30.[27] However, Section 529 Plans do not impose this limitation. There, if it is likely that a Coverdell ESA beneficiary will not attend college before age 30, the Coverdell ESA could be rolled over into a Section 529 Plan

2.4 Control of Account

One big advantage of 529 plans is that control rests with the owner of the account (usually a parent) for the life of the account. According to Prop. Reg. 1.529-1(c), the account owner has the power to close the account, change the beneficiary, direct distributions to "any person other than the designated beneficiary" including him or herself. In contrast, the commonly used Uniform Gift to Minors Custodial accounts require that once the child reaches majority, usually at 18 years of age, the funds in the account are under the child's control.[28] While there are many responsible college students, there are probably more parents who would worry that the funds saved for education could be squandered. Parental control alleviates those worries and helps ensure the funds will go toward education.

Control does not mean direction of investments, however. Section 529(b)(5) prohibits any direction, directly or indirectly of the investments by "any contributor to, or designated beneficiary" of the account. For those wanting to finesse a mix of equities and bonds unavailable through their chosen college savings plan, there are other options that will be discussed in the Investment Options section below.

2.5 Distributions

2.5.1 Nontaxable Distributions

In order to qualify for the many tax advantages that come with 529 plans, distributions must meet the requirements laid out in Section 529 and further clarified in Prop. Reg. 1.529. For example, to avoid penalties, distributions must be made for "qualified higher educational expenses." Under Section 529 (e)(3)(A), "qualified higher educational expenses" includes "tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution." For those students who are at least half time, room and board also qualifies.[29]

The new definition of room and board costs is the same definition of room and board costs used to calculate a student's cost of attendance for federal financial aid programs under 20 U.S. C. §108711:[30]

1) For students living at home with parents -- an amount determined by the institution;

2) For students residing in housing owned or operated by the school -- as a standard allowance based on the amount most of the school's residents are normally charged for room and board; and

3) For all other students -- as the amount of expenses reasonably incurred by the student for room and board.

4) For qualified tuition distributions to students residing in housing owed and operated by an eligible educational institution -- if the actual room and board expenses charged by an eligible institution exceed that allowed under 20 U.S.C §80711, the allowance is the actual amount charged to the student by the institution for room and board.

The definition of qualified higher education expenses is expanded to include expenses of a special needs beneficiary that are necessary in connection with the beneficiary's enrollment or attendance at an eligible institution.[31]

In addition, states operating a 529 programs must follow the distribution procedures set out in Prop. Reg. 1.529. When funds are needed to pay for qualified higher education expenses, the funds must be distributed directly to the educational institution, jointly to the institution and the student beneficiary, or to the beneficiary student upon substantiation that the funds have been spent or are required to pay qualified higher educational expenses.[32]

Example 1: In 1999, Bill Smelt invested $50,000 in a Section 529 Plan for the benefit of his daughter, Shannon. When she eventually enters college, he expects the account will have grown to $150,000. Assuming Shannon is in the 15% tax bracket, qualifying distributions of the entire amount will result in a tax savings of $15,000 ($100,000 earnings x 15% tax bracket). However, if no congressional action is taken and the 2001 Act's sunset provisions take effect, then Shannon will pay income tax on the earnings portion of qualified distributions after December 31, 2010.

2.5.2 Taxable Distributions

All distributions are considered to be made up of contributed funds and accumulated earnings in the same manner as Section 72 annuity distributions.[33] For tax purposes, all distributions made in a taxable year are "treated as one distribution."[34] Proposed Reg. 1.529-1(c) clarifies that the earnings portion is determined by applying an "earnings ratio" computed by dividing the "earnings allocable to the account as of the close of the calendar year . . . by the total account balance at the close of the calendar year." Both the earnings allocable and the total account balance "include all distributions made during the calendar year."[35] However, the IRS has stated that the earnings portion of a distribution is to be determined as of the date of the distribution.[36] Once computed, the earnings portion of the distribution is then taxable as gross income to the beneficiary, who is usually in the 15% tax bracket.[37]

For purposes of computing the earnings portion, accounts maintained by a Section 529 program and having the same account owner and the same beneficiary are aggregated and treated as one account. A state with both a prepaid tuition plan and a savings plan should consider each plan separately.

Example 2: Parents and grandparents set up a $50,000 college savings plan on 1/1/01 for Jane Smith when she is four years old. No additional contributions are made and the account earns an average 10% annual return. In August 2015, $20,000 is distributed to pay for non qualified

expenses. On 12/31/15, the CSP account balance including the $20,000 distribution is $189,874. The earnings portion of the account is $139,874, or 73.7% ($139,874 |$189,874). Thus, 73.7% of any distribution for that taxable year (2015) is deemed earnings. Of the $20,000 distribution, 73.7% or $14,740 is deemed earnings and taxable to Jane as gross income. If Jane is in the 15% tax bracket, her tax on the distribution will be $2,211 ($14,740 x 15%).[38]

Note that the value of the account contributions and earnings must be recalculated at the end of each calendar year in order to calculate the earnings ratio for the corresponding tax year.

Example 3: Parents and grandparents open an account with $20,000 on 1/1/01 for David Jones when he is four and contribute $5,000 for each of the next 14 years. Assuming an average annual return of 10%, the account will have grown to $215,825 by 12/31/15 when David is 18. Of that total, $90,000 was contributed and $125,825 was earned. The earnings ratio for distributions that taxable year will be $125,825 |$215,825, or 58.3%. Thus, if a total of $35,000 is withdrawn to pay for nonqualified expenses, $20,405 is considered earnings and $14,595 contribution. The account total the next calendar year ending 12/31/16 will be $198,908 (assuming 10% average annual return). Of this amount, $75,405 is contribution ($90,000 in original contributions – $14,595 from first year distribution) and $123,503 is earnings. The new earnings ratio for this taxable year will be 62.1%.

Any funds distributed for other than qualified higher education expenses are subject to a penalty unless (1) the beneficiary has died or become disabled; (2) the beneficiary has received a scholarship (the distribution cannot exceed the amount of the scholarship); or (3) the funds are being rolled over into a new 529 account.[39] According to Section 529(b)(3), the penalty for non-qualified distributions must be more than a "de minimus" penalty. Proposed Regulation 1.529-2 (e)(2)(ii) establishes that "de minimus" shall mean "equal to or greater than 10% of earnings." While most states have adopted 10% as the penalty, the penalty in some states is as high as 15%.[40] The state managing the program may collect the penalty from the distribution, the account balance or on the state tax return.[41]

Example 4: Using the same facts as in Example 2 above, George Smith, a taxpayer in the 30% tax bracket, withdraws $12,000 to buy a used Volvo in 2015. If the earnings ratio for that year is 73.7%, then he will pay a 10% penalty on the $8,844 earnings, or $884, plus $3,600 in additional income taxes ($12,000 x 30%). Total cost for use of the funds = $4,488. Had the money been distributed for Jane's educational expenses, there would have been no tax and no penalty

The earnings portion of distributions in tax years before January 1, 2004, from prepaid tuition plans maintained by private educational institutions is included in the beneficiary's gross income.[42] However, the 10% penalty will not apply so long as the distribution is used for qualified higher education expenses.[43]

2.6 Management of College Savings Plans

While each state administers its program, not every state manages the assets in the program. Many states have contracted with well-known companies such as TIAA-CREF (nine states),[44] Vanguard (Utah), Fidelity (New Hampshire), Merrill Lynch (Maine) and others to manage the assets.[45] Some states offer multiple options: Utah, which has one of the top-ranked college savings plan programs[46] offers an option for a "state-managed fixed income fund," and three other options that are managed by Vanguard.[47]

2.7 Investment Options

Sec. 529 prohibits the contributor or beneficiary from directing investments either directly or indirectly.[48]

The IRS has issued proposed regulations that list the following permissible activities:[49]

1. At the time of the initial contribution establishing the account, the account owner may select among different investment strategies offered by the program.

2. The account owner who establishes the account may choose between a prepaid tuition program or a savings account plan.

3. Board members or employees of a Section 529 Plan may participate in the plan.

The IRS has issued Notice 2001-55 that expands the list of permissible activities. This Notice allows a change in investment strategies offered by the program no more than once per calendar year and upon a change in the designated beneficiary.[50]

While the owners and contributors of college savings plans are prohibited from directing the investments in an account, there are many alternatives. The Utah program mentioned above provides a good example of the range of choices that may be available:[51]

Utah Option Management Investment Mix

1. State 100% Fixed income
2. Vanguard Mix of Vanguard equity index funds and state's fixed income fund; mix adjusted for beneficiary's age
3. Vanguard Mix of Vanguard equity and bond funds; mix adjusted for beneficiary's age
4. Vanguard 100% Vanguard Institutional Index Fund

Many other college savings plans offer "age-banded" investment options that link the mix of stocks and bonds to the beneficiary's age, thus allowing a higher proportion of stocks when the child is young and a high proportion of bonds as the child nears college.[52] For example, all of the college savings plans that TIAA-CREF operates are age-banded.[53]

For those who are dissatisfied with an asset allocation of a college savings plan, there are additional alternatives. One straightforward option is to open another account in another state and by combining the two plans, get the asset allocation desired. Another possibility suggested in *Kiplinger's Magazine* is more complicated: name a new beneficiary for the current college savings plan, rollover the account to a new college savings plan in another state, "then change back to the original beneficiary."[54] Such a strategy runs counter to IRS intent and may be prohibited in the final version of Prop. Reg. 1.529.[55] In addition, the family and generation relationships between the original and transition beneficiaries may trigger gift or generation-skipping taxes as discussed below in Section 4.2 Rollover Distributions.

2.8 Fees and Penalties

A penalty is imposed on distributions of earnings from Section 529 Plans that are not used to pay for qualified higher education expenses. The 2001 Act adopted the 10% penalty that Code Sec. 530(d)(4) imposes on nonqualifed distributions of earnings from Coverdell Education

Savings Accounts. The penalty applies to all Section 529 Plans. This requirement is designed to discourage people from using the plans merely for the tax deferral aspect. Exceptions to the penalty include:

• Distributions due to the death or disability of the designated beneficiary.[56]

• Distributions up to the amount of scholarship received by the beneficiary.[57]

• Rollovers from one Section 529 Plan to another.[58]

In addition to the 10% to 15% penalty for non-education distributions, state college savings plans have other fees and penalties. Many college savings plans have management fees that run from 0.31% to 1.86% of assets per year.[59] In addition, there may be enrollment fees[60] or "multiple layers of fees" that depend on the investment option chosen.[61] States may have fees in addition to those of the managing company. For example, the Arkansas and Wyoming plans list "direct expenses" of 0.6% of assets, but also list additional fees in an addendum "ranging from 0.67% . . . to 1.62% of assets" depending on the mutual fund.[62] Utah is another example: while Vanguard charges only 0.06% of assets for its Institutional Index Fund, Utah adds more fees, bringing the total to 0.31% of assets per year.[63]

States may also add additional penalties. For example, some states charge penalties if withdrawals are made too soon. Arizona and Montana charge a "10% of principle penalty if [one withdraws funds] within three years of opening the account."[64] In addition, states may charge penalties if accounts are closed within a few years of opening the account. In Utah, earnings are "forfeited on a refund requested within two years of opening an account."[65]

The Job Creation and Worker Assistance Act of 2002 clarifies that clients who use a Section 529 Plan distribution to pay qualified expenses but then claim the Hope Scholarship Credit or Lifetime Learning Credit in the same year for those expenses will not be subject to the 10% penalty merely because the education used up the available qualifying expenses. However, the Section 529 Plan distribution will still be subject to income tax.

3.0 TAX BENEFITS

3.1 Income Taxes

3.1.1 Federal Income Taxes

Under current law, college savings plan account earnings are taxed only on nonqualified distributions. This tax deferral allows the growth to compound without the IRS taking 28% or more of the earnings each year. The following example from *Kiplinger's Magazine* illustrates the substantial long-term effect.

Example 4:[66] One thousand dollars is put into a taxable account for 18 years with an average annual return of 10%. If "the IRS [claims] 28% of the earnings each year, the account would grow to $3,495. In a college savings plan, it would grow to $5,560, and after paying tax on the earnings in the 15% bracket," $4,876 would remain. The tax deferral results in having "40% more money to pay nonqualified expenses simply by keeping the IRS away from the annual earnings."

Starting in 2002, distributions are reported by the 529 plan on Form 1099-Q, Qualified Tuition Program Payments (Under Section 529)[67].

3.1.2 State Income Taxes

Some states also offer state tax savings for 529 plans. Residents are able to deduct on their state tax form at least a portion of their contribution to their home state's 529 plan. A sampling of some of the state tax deductions is as follows:[68]

STATE DEDUCTION ALLOWED

Colorado Unlimited deduction

Mississippi Up to $20,000/year

Missouri Up to $16,000/year for couples

New York Up to $10,000/year for couples

Ohio Write off $2,000/year per child

Virginia Under age 70: write off $2,000/year per child, per account (up to 7 accounts per child) Age 70 and above: write off all at once

States can impose large penalties on those who misuse this tax benefit. Residents who take the deductions and then use the funds for non-education purposes, or who move their 529 account to another state may be required to pay back the tax benefit they received from the deductions.[69]

3.2 Gift Taxes

Contributions to a Section 529 Plan do not qualify as gifts for educational expenses under Section 2503(e).[70] However, contributions to Section 529 Plan are treated as completed present-interest gifts for gift tax purposes, qualifying for the annual exclusion against taxable gifts.[71] Contributions that qualify for the gift tax annual exclusion are also excludable from GST tax.[72] Distributions from a Section 529 Plan are not taxable gifts.[73]

Section 529 provides substantial gift tax benefits. Section 529(c)(2)(B) allows donors to 529 accounts to average their donations over five years. Given the annual exclusion per donee for gift taxes provided in Section 2503(b), which is $11,000 in 2002, individual donors are thus allowed to exclude $55,000 per donee from gift taxes. The election to average the gift is made on the Form 709, for the calendar yer in which the election was made.[74] Married couples using gift splitting and gift averaging can contribute up to $110,000 free of gift taxes.[75]

The tremendous advantage of this "front-loading" is that larger sums can be put to work immediately, thus maximizing the compounding of earnings.[76]

Tax Planning: In the case of a couple making contributions for a student, the account owner should be the spouse with the longest life expectancy for control purposes.

Example 5: Greta Anderson contributes $55,000 to her daughter's college savings plan on 1/1/02 and elects to average the gift over five years to obtain the $11,000 gift tax exclusion for each year. Assuming a 10% average annual return over the next 10 years, the balance in the account 12/31/11 will be $142,655. If, instead, Greta gives $11,000 for the five years 2002-2006, the balance in 2011 will be $118,970 (assuming same 10% average annual return). Front-loading the contribution results in $23,685 more in earnings.

If the election is made to treat the transfer to a Section 529 Plan as being contributed over five years, and the donor dies within the five years, a prorated portion is brought back into the donor's estate.[77]

Note that not all donations to college savings plans escape gift taxes. If donors choose to give more than $55,000, the excess will be taxable in the calendar year the contribution is made.[78] Note, too, that this gift averaging uses up at least a portion of the annual exclusion for that donee for the five-year period. Whatever amount of annual exclusion remains each year will be applied to any additional gifts to that donee. Once the annual exclusion is used up, the excess will be "a taxable gift in the calendar year of the contribution."[79] But if the annual exclusion increases during the five-year period, the donor can make additional gifts up to the amount of the new exclusion.[80]

Example 6: Greta Anderson contributes $90,000 to her daughter's college savings plan account in 2002. By electing the five-year gift averaging, she can exclude $55,000. The excess $35,000 is subject to gift taxes for the 2002 tax year. If the annual exclusion increases to $12,000 in 2003, Greta can give an additional $1,000 to her daughter tax-free in 2003 since she has only used $11,000 of her annual exclusion due to the gift averaging. If she gives an additional $5,000 instead, $1,000 will tax-free and the excess $4,000 will be subject to gift taxes.

3.3 Estate Planning

College savings plans offer a tremendous opportunity for estate planning. This opportunity follows from two fundamental properties of 529 plans. First, any contribution to a 529 account is considered a completed gift of a present interest.[81] Second, the value of a 529 account is includible in the estate of the designated beneficiary, not the owner (unless also the beneficiary) and not any contributor to the account.[82] As a result, any contribution removes funds from a donor's estate. The ability to contribute up to $55,000 ($110,000 with gift splitting) per beneficiary free of gift taxes allows donors to remove funds from their estate tax-free without using any portion of their unified tax credit.[83] In addition, the amount of a contribution excludable from gift taxes is also "excludable for the purposes of the generation skipping transfer tax."[84] As a result, grandparents can contribute substantial amounts to their grandchildren's college education and reduce their gross estate.

Example 7: Fred and Jean Baker contribute $110,000 to each of their five grandchildren's college savings plans. With gift splitting and gift averaging, they are thus able to remove $550,000 from their gross estate tax-free.

Note that in order to ensure that no amount is pulled back into the estate, donors electing the five-year gift averaging need to live at least five years following their gift. The amount of contribution allocable to the remaining calendar years after the donor's death is included in the deceased donor's estate.[85]

Example 8: Lucy Calvert contributes $55,000 to her granddaughter's 529 account in 2002 and elects gift averaging. In 2004, Lucy dies. Since $11,000 was allocated to each year, the remaining $22,000 total for 2005 and 2006 are includible in Lucy's gross estate. However, Lucy is no worse off than if she contributed $11,000 each of the three years. The $22,000 not contributed would still be part of her estate.

4.0 POTENTIAL PROBLEM AREAS

4.1 Financial Aid

Some families may be concerned about the impact that Qualified Tuition Programs may have on financial aid eligibility. They may be concerned that they will be unable to save enough to pay all of the college costs but may save their way out of financial aid eligibility. A college savings plan will be considered an asset of the parent (owner) for financial aid consideration. On the other hand, the formula will treat prepaid tuition plans differently. The expenses paid by the prepaid tuition plan reduce the family need for aid on a dollar-for-dollar basis.

For federal financial aid, parents are expected to contribute "no more than 5.6% of their assets to college costs," and students are expected to contribute 35% of their assets.[86] In this case, because the student does not own the college savings plan, a parent-owned college savings plan is minimally considered in the aid computation. (A grandparent-owned college savings plan would not be considered at all.) As Business Week author Macnamee points out, "Private financial aid – student scholarships and grants offered by colleges themselves – is trickier. Some private colleges have decided that 529 plans are student-owned assets."[87] Yet, parents should not let eligibility fears stop them from saving in college savings plans. As their child nears scholarship application time, they will want to research the treatment of 529 plans, but in no way should they bypass this excellent opportunity to save for those future expenses.

4.2 Rollover Distributions

Funds in a 529 account can be transferred through a rollover to any member of the designated beneficiary's family.[88] An account owner can make a rollover from one Section 529 Plan to another Section 529 Plan with the same beneficiary as often as once over 12 months.[89] The 12-month period runs from the date of any previous transfer to any Section 529 Plan for the benefit of the beneficiary.[90]

Example: Jon and Celia Rodgers invested in a Section 529 Plan for their son, William, but lately they are unhappy with the investment performance in the account. After conducting some research, they find a plan in a different state than has investment allocation models much more to their liking. They may roll the money from the current plan into the more desirable plan, keeping themselves as owners and William as the beneficiary.

While such transfers may be penalty-free, they may not be tax-free depending on the relationship between the original designated beneficiary and the new one. According to Section 529 (c)(3)(C)(i), rollover distributions to a new designated beneficiary who is a "member of the family" of the original one is not considered taxable income. However, the definition of "member of the family" is involved. Prop. Reg. 1.529-1(c) provides a list of those considered "members of the family" of the beneficiary: (1) children; (2) stepchildren; (3) siblings and stepsiblings; (4) parents, grandparents or other ancestor of parents; (5) step-parents; (6) nieces and nephews; (7) aunts and uncles, (8) in-laws, (9) spouse or spouse of any of the above.[91] Pusuant to the 2001 Act the definition of "member of family" now includes first cousins.[92]

Adhering to such a list may avoid taxable income on a rollover, but still may trigger gift and generation-skipping taxes. Rollover transfers to a "member of the family" who is in the same generation as that of the original beneficiary, as defined in Section 2651, is not a taxable gift according to Prop. Reg. 1.529-5(b)(3). (If the new account is in another state, state tax penalties may result. See Section 3.1.2 above) If, however, the new beneficiary is in a lower generation that the old beneficiary, the transfer is subject to gift taxes.[93] Moreover, if the new beneficiary is "assigned to a generation which is two or more levels lower than [that] of the old beneficiary," a generation skipping transfer tax results.[94]

Note that any rollover to someone not a member of the beneficiary's family is a taxable gift and the generation-skipping provisions of Section 2651 apply.[95]

5.0 CHOOSING A PLAN

5.0.1 Selecting from Among the State Programs

The benefits of a college savings plan are clear. Which plan to choose is more complicated. As of March 2001, all states and the District of Columbia either have or are implementing college savings plans.[96] By the end of 2002, pending legislation being considered in several states, no state will be without a college savings plan. [97]

In order to choose a program, investors need to consider some important criteria:[98]

1. Residency Requirements – Open to non-residents?
2. Asset Allocation – Options available? Age-based allocation available?
3. Performance – Fees and penalties? Special deductions or credits available to residents? Investment returns?
4. Limitations – Yearly minimums? Maximum contribution? Age requirements for beginning or completing distributions? Limitations on transfers or changes of beneficiary? Limitations on distributions for non-education purposes?

Some programs will require that a beneficiary be under a certain age when the account is opened. This can be troublesome if the primary goal is to save for graduate education expenses. Other requirements may include U.S. citizenship, proof of birth date, or a Social Security Number.

If a client is planning to transfer UGMA money or a Coverdell ESA into a Section 529 Plan, the client must choose a plan that allows the beneficiary to be the owner because the child is already the owner of the money in the UGMA or Coverdell ESA account. Clients saving for their own education will also want to be both owner and beneficiary.

An advisor should consider the minimum and maximum contribution rules of each plan. Much like mutual funds, some plans will allow smaller minimum contributions if the donor enrolls in an automatic transfer or payroll deduction system.

The procedure for paying qualified expenses to eligible institutions should be scrutinized. An advisor should know how much advance notice is required for distributions, which payments

may be paid to the beneficiary, and which must be paid to the institution. Also, an advisor should find out what kind of documentation will be required to validate a distribution as a qualified distribution.

Some programs will limit ownership to U.S. citizen adults. If a minor can be an owner, an advisor should know who can or must sign the documents on behalf of the minor. If the plan accepts as an account owner the custodian under a UGMA or UTMA account, an advisor should find out if the plan imposes any special prohibitions on the custodian and if ownership changes automatically to the child at the age established for control of the UGMA or UTMA. It is also prudent for an advisor to review what happens to ownership of the account in the event of death, disability, or divorce of the owner.

Participants will want to know when a refund can be requested and to whom it will be paid. Some plans may require that the beneficiary has attained a certain age before refunds are possible.

Determine whether a plan accepts direct transfers into its program and under what circumstances it will make a transfer directly to another program. If the plan allows the account owner to make rollover distributions that are intended to be rolled into another plan within 60 days, an advisor should ask about the documentation that may be required.

Each state is free to define its plan's minimum and maximum time frames that accounts may be open. An advisor should know whether accounts have to be open for a minimum length of time before a distribution may be taken. Also, an advisor should determine whether an account is required to be closed after a number of years or as the beneficiary reaches a certain age. In states that offer state income tax benefits, an advisor should make particular not whether or nor a distribution will trigger a recapture of the deduction claimed.

5.0.2 Coordinating Section 529 Plans with Other Incentives

It is important to understand where coordination of benefits and strategies is required. Most of these rules seem to be designed to keep the taxpayer from using the same higher education expense to claim more than one tax benefit.

For qualifying taxpayers, the Hope Scholarship Credit and Lifetime Learning Credit may be used to reduce income tax liability even during a year when distributions from a Section 529 Plan have been used to pay for qualified higher education expenses. However, the 2001 Act's coordination provisions require that qualified higher education expenses under Sec. 529 first be reduced by expenses used to compute the Hope Scholarship Credit or Lifetime Learning Credit.[99] Consequently, some taxpayers will find that the maximum tax benefits are obtained when college expenses are paid for with a combination of Section 529 Plan distributions and other resources.

Example: Marilyn Smart establishes a 529 plan for her daughter, Susan. When the account has $30,000 ($12,000 of contributions; $18,000 of earnings, a $20,000 distribution is made from the account in 2002. Qualified education expenses for the year are $20,000, $2,000 of which are used to claim the Hope credit. Qualified education expenses of $20,000 are reduced by $2,000. Thus, aggregate distributions of $20,000 exceed qualified education expenses of $18,000 by $2,000. Although $2,000 of the distribution will be included in income, the 10-percent additional tax will not be imposed.

Earnings ratio of Section 529 Plan =40% ($12,000 / $30,000)

Earnings portion withdrawn = $8,000 (40% of $20,000)

Taxable portion of withdrawal = $800 [($2,000 / $20,000) x $8,000]

Marilyn could avoid any tax by paying the $2,000 of tuition from resources with withdraw only $18,000 from the Section 529 Plan.

Under Sec. 222 enacted by the 2001 Act, some taxpayers will be eligible to take an above-the-line deduction for the payment of tuition and related expenses. The maximum deduction in years 2002 and 2003 is $3,000 for single taxpayers with adjusted gross income below $65,000 and $130,000 for joint filers. The maximum deduction is scheduled to increase to $4,000 in years 2004 and 2005. Also in 2004 and 2005, for single taxpayers with AGI between $65,000 and $80,000 and joint filers with AGI between $130,000 and $160,000, the maximum deduction is $2,000. The deduction is not available in years when Hope Scholarship Credit or Lifetime Learning Credit is claimed.

The expenses eligible for the deduction are the same as those for the Hope Scholarship Credit and Lifetime Learning Credit. Eligible expenses include tuition and related fees only.[100] The tuition deduction expenses are reduced by expenses used for:[101]

1. Tax-free withdrawals from a Coverdell ESA,

2. Exclusion from income under Sec. 135 for U.S. Government Savings Bonds used to pay for higher education, and

3. Qualified Section 529 Plan withdrawals. However, the contribution portion of a Section 529 Plan distribution does not reduce the expenses that may be used to claim the tuition deduction.

5.0.3 Coordinating Section 529 Plan Distributions with Coverdell ESA Withdrawals

Withdrawals from Coverdell ESAs and Section 529 Plans have to be coordinated with one another if the withdrawals from a Section 529 Plan and a Coverdell ESA in the same year for the same beneficiary total more than the qualified higher education expenses.[102] Qualified higher education expenses will first be reduced by the amount of the Hope Scholarship Credit or Lifetime Learning Credit claimed. The manner in which the remaining qualified expenses are allocated between the Coverdell ESA and the Section 529 Plan is not clear because it is not specified in the Code.

6.0 CONCLUSION

Families have many ways to plan for college expenses. Custodial accounts, irrevocable trusts, U.S. Series EE Savings Bonds, and U.S. I-Bonds are all useful instruments to save funds.[103] Yet the tax deferral, and gift and estate planning benefits that college savings plans provide make them one of the best and most powerful ways to save. Families and professional Financial Planners need to research what college savings plans have to offer and make them an essential part of their college planning.

Endnotes

[1] Raasch, B.J. & Amitrano, A. p.1
[2] U.S. Census Bureau
[3] Brown, C.M. p. 1
[4] Prop. Reg. 1.529-1(c).
[5] Prop. Reg. 1.529-1(c).
[6] Prop. Reg. 1.529-1(c) and Prop. Reg. 1.529-3.
[7] Prop. Reg. 1.529-1(c).
[8] Prop. Reg. 1.529-1(c).
[9] Prop. Reg. 1.529-1(c).
[10] Sec. 529(c).
[11] Sec. 529(b)(1)(A).
[12] Sec. 529(b)(1).
[13] Sec. 529(c)(3)(B)(iii).
[14] Sec. 529(b)(2) and Prop. Reg. 1.529-2(d).
[15] Raasch, B. J. & Amitrano, A. p. 5.
[16] Sec. 529(b)(3); Prop. Reg. 1.529-2(f).
[17] Sec. 529(b)(6).
[18] Prop. Reg. 1.529-2(i)(2).
[19] See Notice 2001-81, IRB 2001-52.
[20] Notice 2001-81, IRB 2001-52.
[21] SavingForCollege.com. Frequently asked questions.
[22] SavingForCollege.com. Frequently asked questions.
[23] Sec. 529(b)(5); Prop. Reg. 1.529-2(h).
[24] Notice 2001-81, IRB 2001-52.
[25] Notice 2001-81, IRB 2001-52.
[26] Notice 2001-82, IRB 2001-52.
[27] Sec. 530(b)(1)(E).
[28] Kom, D.J. Tuition 101. P.2.
[29] Section 529(c)(3)(B)(i)
[30] Prop Reg. 1.529-1(c).
[31] Sec. 529(e)(3)(A)(ii).
[32] Prop. Reg. 1.529-2(e)(4)(ii)(A).
[33] Sec. 529(c)(3)(A).
[34] Sec. 529(c)(3)(D)(ii).
[35] Prop. Reg. 1.529-1(c).
[36] Notice 2001-18.
[37] Sec. 529(c)(3)(A).
[38] This example is patterned after “Example 1” in Wienreb, D. L. & Budin, B. R., p.4. Note that there seems to be some confusion concerning taxability of distributions. One journal article incorrectly stated that “plan withdrawals are considered to be . . . first-in, first-out” returns of contributed capital so that distributions were not taxable until a sum equal to the amount contributed had been distributed (Korn, D. J. Tax dismissed! p. 1).
[39] Sec. 529(b)(3).
[40] Weinreb, D. L. & Budin, B. R. p. 5; Raasch, B. J. & Amitrano, A. p. 5.
[41] Prop. Reg. 1.529-2(e)(4)(ii)(E).
[42] Sec. 529(c)(3)(B)(iii).
[43] Sec. 529(c)(6).
[44] Korn, D. J. Tax dismissed! p. 2.

[45] Davis, K. p. 1.
[46] Kiplinger's Magazine. The winners. p. 1. The other state programs in the Top Five included California, Iowa, Maine and New Hampshire.
[47] Savingforcollege.com. Utah educational savings plan trust.
[48] Sec. 529(b)(4).
[49] Prop. Reg. 1.529-2(g).
[50] Notice 2001-55, IRB 2001-39, 299.
[51] Savingforcollege.com, Utah educational savings plan trust; Utah investment. p. 1.
[52] Korn, D. J. Tax dismissed! p. 3.
[53] Korn, D. J. Tax dismissed! p. 2.
[54] Kiplinger's Magazine. Savings plans 101. p. 2.
[55] Weinreb, D. L. & Budin, B. R. p. 5.
[56] Sec. 529(c)(3)(C)(I).
[57] Sec. 529(c)(6) and Sec. 530(d)(4).
[58] Sec. 529(c)(3)(C)(I).
[59] Novack, J. p. 1.
[60] Raasch, B. J. & Amitrano, A. p. 5.
[61] Novack, J. p.3.
[62] Novack, J. p.3.
[63] Novack, J. p.3.
[64] Novack, J. p.3.
[65] SavingForCollege.com. Utah educational savings plan trust. p. 2.
[66] Kiplinger's Magazine. Savings plans 101. p. 1.
[67] Notice 2001-81, IRB 2001-52.
[68] Novack, J. p. 2.
[69] Novack, J. p. 2.
[70] Sec. 529(c)(2)(A)(ii).
[71] Sec. 529(c)(2)(A).
[72] Prop. Reg. 1.529-5(b).
[73] Sec. 529(c)(5)(A).
[74] Prop. Reg. 1.529-5(b)(2)(iii)
[75] Prop. Reg. 1.529-5(b)(2)(ii).
[76] Weinreb, D. L. & Budin, B. R. p. 6.
[77] Sec. 529(c)(4)(C).
[78] Weinreb, D. L. & Budin, B. R. p. 6.
[79] Prop Reg. 1.529-5(b)(2)(i).
[80] Prop. Reg. 1.529-5(b)(2)(iv).
[81] Sec. 529(c)(2)(A)(i); Prop. Reg.1.529-5(b)(1).
[82] Prop. Reg. 1.529-5(b)(3)(d).
[83] Weinreb, D. L. & Budin, B. R. p. 6.
[84] Prop. Reg. 1.529-5(b)(1).
[85] Sec. 529(c)(4)(C).
[86] Mcnamee, M. p. 2.
[87] Mcnamee, M. p. 2.
[88] Sec. 529(c)(3)(C)(i).
[89] Sec. 529(c)(3)(C)(i).
[90] Sec. 529(c)(3(C)(iii).
[91] The list in Prop. Reg 1.529-1(c) is as follows: "1) a son or daughter or descendent of either; 2) a stepson or stepdaughter; 3) a brother, sister, stepbrother or stepsister; 4) a father or mother, or an ancestor of either; 5) a stepfather or stepmother; 6) a son or daughter of a brother or

sister; 7) a brother or sister of the father or mother; 8) a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-inlaw, or sister-in-law; or 9) the spouse of the designated beneficiary or the spouse of any individual described in paragraphs (1) through (8) above."

[92] Sec. 529(e)(2)(D).

[93] Prop. Reg. 1.529-5(b)(3)(ii).

[94] Prop. Reg. 1.529-5(b)(3)(ii).

[95] Prop. Reg. 1.529-5(b)(3)(ii).

[96] Business Week's Guide to College Savings Plans.

[97] Business Week's Guide to College Savings Plans.

[98] Novack, J. p. 2-4; Raasch B. J. & Amitrano, A. p. 7-8.

[99] Sec. 529(c)(3)(B)(v).

[100] Sec. 25A(f) and Sec. 222(d)(1).

[101] Sec. 222(c)(2)(B).

[102] Sec. 529(c)(3)(B)(vi).

[103] Raasch, B. J. & Amitrano, A. p. 8.