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Trusts and Estates

Understanding How 529 Plans Fit Into the Estate Plan

Rebecca Rosenberger Smolen and Amy Neifeld Shkedy, The Legal Intelligencer

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As summer has been winding down, so many of our clients' children and grandchildren have headed off to college in the last few weeks and have begun (or resumed) tackling hefty tuition bills. Many families have set aside funds, in one form or another, in advance for these college costs. Setting aside funds for future college costs in advance not only can help provide peace of mind, but also may generate "subsidies" by the available gift, estate, and income tax benefits. One of the ways this can be accomplished is through investments in 529 plans.

Basics

A qualified tuition program (QTP), more commonly known as a "529 plan," is an education savings program which allows you to make contributions to an account set up to meet an individual's future higher education expenses or buy tuition credits for an individual. The name "529" refers to Section 529 of the Internal Revenue Code which was enacted by Congress in 1996 to create these types of savings plans which encourage saving for higher education by providing generous tax breaks.

Types of 529 Plans

There are two basic types of 529 plans: prepaid tuition plans and savings plans. Each state has its own plan, and each state may offer both types of plans. A qualified education institution, however, can only offer a prepaid tuition type 529 plan. Pennsylvania offers two types of plans: the PA 529 Guaranteed Savings Plan (GSP), which allows you to purchase tuition credits based on today's rates, and the PA 529 Investment Plan (IP) which allows you to choose from 15 investment options through Vanguard. An individual's state of residency will not restrict which 529 plan he can invest in, so it is important to research 529 plans offered in various states to determine which plan is the best fit. There are many publicly available websites which offer state by state comparisons, taking into account various

factors, such as enrollment fees and expense ratios, investment options, state residency requirements and minimum and maximum contributions. Some states provide incentives for residents who invest in their own state plan. It is advisable to weigh all of the factors in determining which plan to invest in since the market is competitive.

Income Tax Savings

The earnings on contributions to a qualified tuition program will accumulate tax-free until the college costs are paid from the funds, and distributions are tax-free to the extent the funds are used to pay qualified higher education expenses. While contributions to a 529 plan are not deductible for federal purposes, in Pennsylvania taxpayers may deduct their contributions from Pennsylvania taxable income up to $14,000 per beneficiary per year (married couples can deduct up to $28,000 per beneficiary per year, provided each spouse has taxable income of at least $14,000).

Gift & GST Tax Benefits

Contributions to 529 plans are eligible for the annual exclusion from the federal gift tax (currently $14,000 per donor or $28,000 for a married couple splitting the gift), and from the federal generation skipping transfer (GST) tax (only relevant if the beneficiary is a grandchild of the donor). Contributions can be front-loaded so that a donor who contributes more than the annual exclusion limit for the year can elect to treat the gifts as if they were spread out over a five-year period. This allows you to use as much as $70,000 (or $140,000 for a married couple splitting the gift) in annual exclusions to cover a larger contribution. It is important to understand that if this election is desired, it must be reported on a timely filed gift tax return, and each subsequent year (for a period of five years), the 1/5 portion must be taken into account when determining what, if any, annual exclusion remains available for each donee. Care should be taken when contributing to 529 accounts for those individuals who are already making other gifts to the beneficiary, to make sure that the annual exclusion limit is not exceeded in any calendar year with respect to the beneficiary of the 529 plan. These other gifts would include outright gifts and certain gifts to trusts benefitting the beneficiary for which the annual exclusion may be available. If trusts are involved, it is advisable to consult with your estate planning attorney or accountant to ensure that gifts to 529 plans do not cause you to exceed the annual exclusion limits for any particular year.

Donors who have already maximized their annual exclusion gifts might want to consider direct payments for a beneficiary's education expenses, rather than a 529 plan investment. Under Section 2503(e)(2) of the Internal Revenue Code, direct tuition payments to educational institutions (at all levels) are exempt from the federal gift tax without regard to the annual gift tax exclusion limitation. However, such donors also might conclude that gifts to a 529 plan are a worthy use of their gift and estate tax exemption because of the income tax savings opportunity.

Limitation to Education

Savings in 529 plan accounts can be used for tuition, books, and other education-related expenses (which now includes the cost of the purchase of any computer technology, related equipment and/or related services such as internet) at most accredited two- and four-year colleges and universities (including for post-graduate programs), U.S. vocational-technical schools, and eligible foreign institutions. A withdrawal that is made for anything other than education-related expenses will be subject to a 10 percent penalty on the earnings portion of the nonqualified withdrawal (distributions are allocated between principal/contribution and earnings on a pro-rata basis). Ordinary income taxes will also have to be paid on the earnings. However, a beneficiary receiving a scholarship may be eligible for an exception to the 10 percent penalty. In that case, money can be withdrawn from a 529 plan up to the amount of a tax-free scholarship without paying the 10 percent penalty, but the earnings portion of the withdrawal would still be subject to income tax.

Beneficiary Designation

The owner of a 529 plan (sometimes referred to as the participant) will need to name a beneficiary of the plan. An owner may name anyone as a beneficiary, although typically a child or grandchild is named. An owner may change the beneficiary for any reason. This may be desired, for example, if the original intended beneficiary chooses not to attend college or obtains a scholarship and does not need the funds. A change in the beneficiary will not trigger a tax issue if the new beneficiary is a member of the family of the old beneficiary and the new beneficiary is assigned to the same generation as the old beneficiary (for generation skipping transfer tax purposes). Family members include a beneficiary's spouse, siblings, descendants, parents, cousins and others, as defined in Section 529 of the Internal Revenue Code. Any change of the beneficiary to a person who is not an eligible member of the family of the current beneficiary is treated as a nonqualified withdrawal subject to income taxes as well as the 10 percent penalty.

Successor Owner Designation

Each 529 plan owner should be sure to designate a successor owner to the plan in case the owner dies while funds remain in the plan. Some states allow a trust to be named as the successor owner.

Financial Aid

The way in which a 529 plan affects eligibility for financial aid should be carefully evaluated, since the rules vary depending on a number of factors. Overall, for federal aid, 529 plan assets and withdrawals are treated favorably compared to many other assets. 529 plans owned by parents will not count as parental income for financial aid purposes under the Free Application for Federal Student Aid (FAFSA), whereas other non-529 parental income is counted at 22 percent to 47 percent. Instead, parent-owned 529 plans are counted as a parental asset, however, under the federal formula, only 5.64 percent of parental assets are considered (as opposed to student assets, such as UTMA/UGMA custodial accounts, which are counted at a rate of 20 percent).

The rules apply differently if a grandparent owns a 529 plan. In that case, the asset itself is not reportable for FAFSA, but withdrawals are considered student income.

It should be noted that in Pennsylvania, a PA Investment Plan 529 Account will not be included in determining eligibility for Pennsylvania state financial aid programs. Pennsylvania, however, will count 529 plans in other states.

Before the advent of 529 plans, it was much more common for clients, whether parents or grandparents, to create trusts or use UTMA accounts to both save for college and take advantage of the annual exclusions from the federal gift and GST tax each year. These days, it often makes much more sense for clients to use 529 plan accounts for this purpose, in order to also benefit from the available income tax "shelter" while avoiding the hassle and cost for maintain a trust structure for funds which will likely be used to pay for college. Of course, when the time comes to pay for tuition, clients with asset levels which will likely trigger federal estate tax at death, must also carefully weigh the benefits of paying the tuition directly to take advantage of the available gift and GST tax exclusion available for such payments, despite that they may have funded 529 accounts which could also be used for such costs. Not a bad dilemma to have to face! •

Rebecca Rosenberger Smolen and Amy Neifeld Shkedy are co-founders of the boutique firm Bala Law Group (www.balalaw.com) and concentrate their practices in trust and estate planning and administration. Shkedy Smolen

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