529 Plans: Estate Planning Magic

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1. Fundamentals of 529 plans
    a. In order for estate planners to help clients compare 529 plans to other wealth transfer vehicles, they need to be familiar not just with the estate, gift, and GST tax rules governing 529 plans, but also with the fundamentals of how 529 plans work. Clients don't ask: "Is a 529 plan includible in the gross estate of the owner?" They ask: "Should I put money in a 529 plan or give it to my kids directly"? Or, "How much money should I put in my 529 plan?"
    b. Prepaid tuition program (§ 529(b)(1)(A)) vs. § 529 savings accounts
        i. Section 529 of the Code provides for both prepaid tuition program and college savings plans.
        ii. Most planners agree that prepaid tuition programs are much less useful because they offer less flexibility. In addition, fewer and fewer states are offering prepaid tuition plans—as of 2020, only nine (Florida, Maryland, Massachusetts, Michigan, Mississippi, Nevada, Pennsylvania, Texas, and Washington) have active programs.[1]
        iii. For this reason, this presentation focuses on § 529 savings accounts and uses the term "529 plan" as shorthand for such accounts.
    c. Four important characters in a 529 plan:
            1. State
                a. Each 529 plan is administered by a specific state.
        ii. Contributor/donor
            1. "Contributor" and "donor" are used interchangeably. Notably, anyone can contribute to a 529 plan, even if he or she is not the account owner.
            2. The contributor/donor is the person who funds the 529 plan.
        iii. Account owner
            1. The "account owner" is the person who has control over the 529 plan, including the power to change beneficiaries, make investments, and make distributions.
            2. An account owner does not have to be an individual, and can be a trust or other entity.
            3. The account owner can designate a "successor account owner." Upon the death of the account owner, the successor account owner gets all powers originally held by the first account owner, including the power to designate a new successor account owner.
            4. Generally speaking, merely being an account owner does not imply fiduciary duties. However, if the 529 plan is owned by a trust, the trustee owner will have fiduciary duties to the beneficiary of the trust. For example, in *Alberhasky v.*

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[1] https://www.investopedia.com/financial-edge/0311/the-last-states-with-prepaid-tuition-plans.aspx

Alberhasky,[2] a father, as trustee of a trust of which his son was the beneficiary, owned a 529 plan of which his son was the beneficiary. The father changed the beneficiary of the 529 plan from the son to the son's brother. The Court of Appeals of Iowa ruled that the father could be subject to a suit for breach of fiduciary duty for doing so.

iv. Designated beneficiary
   1. The "designated beneficiary" is the person for whose benefit the 529 plan is held.
   2. The beneficiary must be an individual.
   3. Distributions to the designated beneficiary are in the discretion of the account owner. No rule appears to require the account owner to account to or even notify the beneficiary of the existence of the 529 plan. However, if the account is owned by a trust, the Uniform Trust Code would impose such duties on the trustee.
   4. The account owner may change the designated beneficiary. This power is subject to some tax-related limitations, which are discussed further below.

d. Contribution limits
   i. There is no limit to the value of assets that may be held in a 529 plan.
   ii. However, each state has a maximum lifetime limit for the amount that may be contributed to 529 plans held in that state for a given beneficiary.[3]
      1. Arizona: lifetime contribution limit of $501,000
      2. Illinois: lifetime contribution limit of $500,000
   iii. Contrary to popular opinion, there is no limit on how much can be contributed to a 529 plan in a given year (other than the lifetime limit discussed above). Many clients confuse the annual exclusion from gift tax (discussed below) with a yearly contribution limitation.

e. Investment options and fees for 529 plans in many states have improved significantly in recent years.

2. Income tax rules
   a. In general, ongoing interest and dividends earned in a 529 are exempt from federal income tax.[4]
   b. Contributions to a 529 plan are not deductible for federal income tax purposes but are sometimes deductible for state income tax purposes.
      i. Some states allow a deduction for a contribution to any state's 529 plan. For example, a married in couple in Arizona filing jointly can deduct up to $4,000 per beneficiary for contributions made to any state's 529 plan.[5]
      ii. Other states only allow a deduction if contributions are made to that state's 529 plan. For example, a married couple in Illinois filing jointly

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[2] 928 N.W.2d 867 (2019).
[3] https://www.savingforcollege.com/article/maximum-529-plan-contribution-limits-by-state
[4] IRC § 529(c)(1).
[5] https://az529.gov/what-is-a-529-plan/az-tax-incentives/

can deduct up to $20,000 per year, but only for contributions made to the Illinois Bright Start plan.

   c. The taxability of a distribution from a 529 plan depends on whether or not the distribution is a "qualified distribution."
      i. A "qualified distribution" is a distribution for "qualified higher education expenses" at an eligible educational institution.[6]
         1. "Qualified higher education expenses" include tuition, fees, books, supplies, and equipment that are required for enrollment or attendance, certain computer expenses, and room and board for students who are enrolled at least half-time.
         2. Tuition expenses for elementary or secondary schools (e.g., private or religious schools) qualify, but with a cap of $10,000 per year.
            a. However, some states do not allow withdrawals for elementary or secondary school expenses.
         3. Distributions must be made in the same year in which the expenses are paid.
         4. Distributions can be made to a person in reimbursement of expenses paid, but it is best to make distributions to the provider directly.
         5. Qualified distributions are free of income tax.
      ii. Distributions that are not qualified distributions are subject to income tax at ordinary rates on the earnings portion of the distribution, plus a 10% penalty on the entire distribution.
   d. Changing the beneficiary of a 529 plan does not have any income tax consequences as long as the new beneficiary is a "member of the family" of the original beneficiary.[7] "Member of the family" includes:
      i. Spouse
      ii. Descendant
      iii. Sibling or stepsibling
      iv. Ancestor
      v. Stepparent
      vi. Niece or nephew
      vii. Aunt or uncle
      viii. Son-, daughter-, father-, mother-, brother-, or sister-in-law
      ix. Spouse of any of the foregoing
      x. First cousin
3. FAFSA eligibility
   a. A 529 plan owned by a dependent student or a parent is counted as a "parent asset." Parent assets beyond the allowance reduce the student's aid package by up to 5.64% of the value of the account.[8]
   b. By contrast, a "student asset" such as an UGMA or UTMA account will reduce the student's aid package by up to 20% of the value of the account.
   c. Grandparent-owned 529 plans are not reported on the FAFSA. Previously, distributions from grandparent-owned 529 plans were manually reported by

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[6] IRC § 529(e)(3).
[7] IRC § 529(c)(3)(C)(i)(II).
[8] https://www.savingforcollege.com/article/yes-your-529-plan-will-affect-financial-aid

students as untaxed income. However, beginning this year, the FAFSA will instead pull student income directly from federal income tax returns—which will not include qualified distributions from grandparent-owned 529 plans.[9]

4. Gift tax rules
    a. A gift to a 529 plan is a "completed gift" for gift tax purposes.[10] This is remarkable given that the donor/owner retains the power to change the beneficiary and control distributions from the 529 plan.
    b. The gift is not treated as a transfer of a "future interest," meaning that the $16,000 per person/per year annual exclusion from gift tax applies.
    c. In addition, a donor may elect to "superfund" a 529 plan with five years' worth of annual exclusion gifts in a single year as long as a gift tax return is filed and the proper election is made.[11] Married donors may also elect to "split gifts," letting them use ten "annual exclusion gifts" in a single year for each beneficiary.
    d. Any gifts above the annual exclusion amount will use up a portion of the donor's $12.06 million estate/gift tax exemption.
    e. For example, a married couple with three children could, in a single year, contribute $480,000 ($16,000 (annual exclusion amount) x 5 (years' worth of annual exclusion gifts) x 2 (two spouses) x 3 (three children)) without using any estate/gift tax exemption.
    f. Changing the beneficiary of a 529 plan is a taxable gift unless the new beneficiary is (i) in the same generation as the original beneficiary or of a higher generation and (ii) a member of the family of the old beneficiary (using the same "member of the family" definition as outlined above for income tax purposes).
5. Estate tax rules
    a. "No amount shall be includible in the gross estate of any individual for purposes of [the estate tax] by reason of an interest in a qualified tuition program."[12]
    b. This clearly means that a 529 plan is not includible in the taxable estate of the account owner. This is unusual given the account owner's retained power to change beneficiaries and control distributions. For any other kind of gifting vehicle (e.g., trusts), such a retained power would cause the assets to be brought back into the donor's taxable estate under Section 2036.
    c. It is unclear whether a 529 plan is includible in the taxable estate of the beneficiary upon the beneficiary's death. If assets are distributed to the beneficiary's estate upon death, they would be so included, although it may be possible to avoid this result by changing the beneficiary.[13] However, in practice most 529 plan beneficiaries do not have taxable estates.
6. GST tax rules
    a. A contribution to a 529 plan of which a grandchild or more remote descendant is the beneficiary is likely considered a "direct skip" subject to GST tax, although the rules are somewhat unclear.[14]

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[9] https://www.savingforcollege.com/article/new-fafsa-removes-roadblocks-for-grandparent-529-plans
[10] Prop. Reg. § 1.529-5(b).
[11] IRC § 529(c)(2)(B).
[12] IRC § 529(c)(4).
[13] T.M. Portfolio 846-3rd: Gifts to Minors, § VII(B)(6)(f).
[14] T.M. Portfolio 846-3rd: Gifts to Minors, § VII(B)(6)(a)(3).

b. A contribution to a 529 plan of which a grandchild or more remote descendant is the beneficiary is eligible for the "annual exclusion" from GST tax.
c. Any gifts above the GST annual exclusion amount will use up a portion of the donor's $12.06 million GST tax exemption.
d. Changing the beneficiary of a 529 plan is a GST transfer if the new beneficiary is two or more generations younger than the old beneficiary.[15]

7. Planning implications
    a. 529 plans are underutilized by high-net-worth clients, who are often excessively concerned about "overfunding" 529 plans. Indeed, in some cases, "overfunding" can lead to a better result even if the 10% penalty is paid given the tax-free growth of the assets in the 529 plan.[16]
    b. Comparing and coordinating 529 plans with other transfer vehicles
        i. UTMA/UGMA accounts
            1. 529 plans are nearly always superior to UTMA/UGMA accounts. Although UTMA/UGMA accounts can be used for any purpose, many donors come to regret "overfunding" such accounts shortly before the beneficiary's 21st birthday.
        ii. Direct payment of tuition
            1. Tuition payments made directly to an educational institution are completely free of gift tax and GST tax, and do not use any exemption. As such, very high net worth clients should prioritize such payments over funding 529 plans.
            2. However, 529 plans may still provide a useful supplement to such a strategy even for very high net worth clients.
            3. Direct payment of tuition is limited to current tuition obligations and does not allow "prefunding" for future generations.
        iii. Intentionally defective grantor trusts
            1. With an IDGT, the donor pays the ongoing income tax liability, whereas with a 529 there is no ongoing income tax liability. Which strategy is superior will likely depend on whether or not the ultimate distributions from the 529 are "qualified distributions."
            2. IDGTs are often structured with "Crummey" withdrawal rights, which allow the donor to use the annual exclusion from gift tax for gifts to the trust, similar to 529 plans. However, 529 plans still have two major advantages in this regard:
                a. Five-year "frontloading," or "superfunding" is not available for IDGTs.
                b. The annual exclusion from GST tax is generally not available for gifts to Crummey trusts.
            3. IDGTs are more effective vehicles for generation-skipping planning if the intent is for children to be current beneficiaries.
            4. IDGTs offer more investment choices than 529 plans.
            5. To the extent clients expect to have qualified distributions from 529 plans, funding 529 plans should often be prioritized over

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[15] T.M. Portfolio 850-2nd: Generation-Skipping Transfer Tax, §IV(F)(4).
[16] See e.g. https://rpgplanner.com/529-plan-opportunity/.

funding IDGTs. However, these strategies can be used in conjunction with each other.

iv. Spousal lifetime access trusts
   1. SLATs offer some flexibility comparable to 529 plans if the spousal beneficiary has a limited power of appointment over the trust assets.
   2. SLATs offer more investment choices than IDGTs
   3. SLATs are a type of IDGT, so whether a SLAT is superior to a 529 plan may be depend on whether or not the ultimate distributions from the 529 are "qualified distributions."

c. The big question: how much money do you put in these things? There's no one right answer, but here are some factors:
   i. Number of children/grandchildren
   ii. Expected future educational expenses
   iii. Willing to benefit family members other than descendants
   iv. Expected estate tax rate (including state estate taxes in applicable states)
   v. Availability of state income tax deduction
   vi. Desire to retain control over assets

d. Clients do not necessarily need to limit gifts to 529 plans to the annual exclusion amount, or even to the five-year "superfunding" amount. It's okay to use estate/gift tax exemption (especially given the expected 50% reduction in the federal transfer tax exemption in 2026)!