529 ACCOUNTS:
NOT JUST FOR COLLEGE ANY MORE

Estate Planner's Day 2026
Southern Arizona Estate Planning Council

January 23, 2026

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Susan Bart, Saving for Education Creating Educational Dynasty Trusts Using 529 Plans, 40 ACTEC Law Journal 197 (Fall/Winter 2014)

David Pfefferkorn, The Investment of Custodial Funds in Section 529 Qualified Tuition Programs: Tax Advantages and Fiduciary Concerns, 30 Est. Pl. 571 (November 2003)

Abbreviations

2001 Act: Economic Growth and Tax Relief Reconciliation Act of 2001

2007 Act: The College Cost Reduction and Access Act of 2007

2009 Act: American Recovery and Reinvestment Act of 2009

2005 Legislation: Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

2015 Act: Protecting Americans From Tax Hikes Act of 2015

2017 Act: Tax Cuts and Jobs Act

2020 Act: Further Consolidated Appropriations Act of 2021

2025 Act: One Big Beautiful Bill Act of 2025

Advance Notice: Advance Notice of Proposed Rulemaking on Section 529 (published in the *Federal Register*, January 18, 2008)

COA: cost of attendance

Code: Internal Revenue Code

Coverdell ESA: Coverdell Education Savings Account

DNI: distributable net income

EFA: estimated financial assistance

FAFSA: Free Application for Federal Student Aid

GST: generation-skipping transfer

IRS: Internal Revenue Service

MAGI: modified adjusted gross income

QHEEs: Qualified higher education expenses

QSTP: Qualified state tuition program

QTP: Qualified tuition program

SAI: Student Aid Index

TA: Trump Account

UGMA: Uniform Gifts to Minors Act

UTMA: Uniform Transfers to Minors Act

References to the “Code” mean the Internal Revenue Code.

I. **529 Savings Accounts in General**. A donor can establish a section 529 savings account under the qualified tuition program ("QTP") of a particular state for a particular beneficiary and make contributions to the section 529 account. **[In this outline, "section 529 account" refers only to 529 savings accounts; prepaid 529 accounts are not covered.]** Depending upon the QTP, this may be done directly or through a broker or financial advisor. In most states the donor may select among different investment options. In some states the donor may receive a state income tax deduction. The section 529 account is invested by the state or an investment manager selected by the state, generally in a portfolio of mutual fund investments. The earnings on the section 529 account are not subject to income tax while held in the section 529 account. The account owner of the section 529 account, usually the donor, can generally:

- approve or disapprove distributions to the beneficiary;
- change investment options to the extent permitted;
- rollover the account to another QTP;
- change the beneficiary; or
- withdraw the funds and get them back.

The earnings on the account are not subject to federal income tax when qualified distributions are made from the section 529 account. The earnings portion of a qualified distribution is subject to state income tax in some states and exempt from state income tax in other states. A ten percent federal penalty is imposed on the earnings portion of a distribution not used for qualified higher education expenses ("QHEEs"). Code § 529(c)(6); Code § 530(d)(4).

A. Advantages of Section 529 Savings Accounts

1. **No Income Limits**. There are no income limitations on who can contribute to a section 529 account.

2. **Income Tax Exemption**. Earnings are federally income tax exempt and either state income tax exempt or deferred.

3. **Front-Loaded Annual Exclusions**. Up to five times the annual exclusion amount can be deposited in a section 529 account in one year without incurring gift tax.

4. **GST Annual Exclusion Available**. Contributions to a section 529 account that qualify for the gift tax annual exclusion will also qualify for the GST tax annual exclusion, so grandparents can make a large contribution to a section 529 account for a grandchild without having to allocate any GST tax exemption.

5. **Beneficiary Has No Control**. Generally, the beneficiary has no direct access to, or control over, the section 529 account funds. The account owner typically directs the distribution of funds from the account, can change the beneficiary or take back the funds.

6. **Beneficiary Can Be Changed**. The account owner can change the beneficiary.

7. **Account Owner Can Reacquire Funds**. The account owner can withdraw the funds from the account. Thus a donor can set aside funds for a beneficiary's education, but get the funds back if the beneficiary does not attend college or otherwise use the funds, the donor needs the funds, or any other reason.

8. **Funds Can Be Used for Education Costs Not Included Under Section 2503(e)**. Section 529 account funds can be used for room and board and other required expenses (such as books) in addition to tuition and fees. In addition, up to $20,000 (starting in 2026) per year can be used for elementary or secondary public, private or religious school. Funds may also be used for apprenticeship programs and credentialing and licensing expenses.

9. **Financial Aid**. A section 529 account does not count as an asset of the student if the student is a dependent.

10. **Available to Adult Beneficiaries**. Adults can open accounts for themselves in many states, so section 529 account programs can be used to save for a return to school, for credentialing expenses, or for taking classes.

11. **Education Credits Still Available**. The American Opportunity Credit and the Lifetime Learning Credit are still available.

12. **State Income Tax Deduction**. Some states offer state income tax deductions to residents who invest in their own state program.

13. **Creditor Protection**. Section 529 savings accounts have special protection in bankruptcy. In addition, some states protect section 529 accounts from other creditors.

B. Disadvantages of Section 529 Savings Accounts

1. **Distribution Limitations**. Qualified distributions may be made only for qualified higher education expenses (but the definition of qualified higher education expenses is considerably broader than it was initially).

2. **Excess Funds**. If the beneficiary does not use all of the section 529 account funds for qualified higher education expenses, undesirable tax consequences may result if the remaining funds are distributed.

3. **Account Owner Can Reacquire Funds**. It's an advantage that the original account owner's power to reacquire the funds does not cause inclusion in his or her estate, but it's not always an advantage that the successor account

owner can withdraw the funds rather than direct a distribution to the beneficiary.

4. **Limited Investment Options**. The investment options are defined by the state programs. However, because the various programs use a variety of investment managers and offer a variety of investment portfolios, most donors should be able to find a suitable investment option.

5. **Lack of Complete Investment Control**. The ability to change investment options is limited to two times per calendar year, or upon a rollover to another plan, or when the beneficiary is changed.

6. **Uncertainty How Programs Will Develop**. State laws are still developing and changing. Further, the investment managers for different state programs change frequently.

7. **Tax Traps**. Rollovers, investment changes and changes of beneficiary can result in some negative tax consequences if the account owner is not careful.

8. **Tax Uncertainty**. Some tax consequences are still uncertain. Final regulations to Code section 529 have not yet been issued. On January 18, 2008 an Advance Notice of Proposed Rulemaking on Section 529 ("Advance Notice") was published in the Federal Register. If these rules are adopted, some of the flexibility of section 529 savings accounts would be lost.

C. Statutory and Regulatory Background

1. **Original Statute**. Code section 529 was added to the Internal Revenue Code by the Small Business Job Protection Act of 1996, and has been amended numerous times.

2. **2001 Act**. The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Act") made significant changes including the following:

   a. the repeal of a pre-EGTRRA requirement that there be more than a *de minimis* state penalty imposed on amounts not used for educational purposes and the imposition of the ten-percent additional tax on distributions not used for qualified higher education expenses;

   b. a provision permitting certain private educational institutions to establish prepaid tuition programs that qualify under Code section 529 if they receive a ruling or determination to that effect from the Internal Revenue Service, and if the assets are held in a trust created or organized for the exclusive benefit of designated beneficiaries;

c. certain provisions permitting rollovers from one account to another account;

d. the provision that treats first cousins as members of the family for purposes of the rollover and change in beneficiary rules; and

e. certain provisions regarding the education expenses of special needs beneficiaries.

These changes were made permanent by the Pension Protection Act of 2006.

3. **2014 Tax Act**. The 2014 Tax Act, Achieving a Better Life Experience Act, permitted investment changes twice per year.

4. **2017 Tax Act**. "An Act to provide for reconciliation pursuant to Titles II and V of the concurrent resolution on the budget for fiscal year 2018" (the "2017 Tax Act") made two significant changes.

a. **ABLE Accounts**. The 2017 Tax Act permits a tax-free rollover to an ABLE account limited to the amount that, when added to all other contributions made to the ABLE account for the taxable year, does not exceed the contribution limit for the ABLE account under Code section 529A(b)(2)(B)(i) (i.e., the gift tax annual exclusion). This benefit was made permanent by the 2025 Act.

b. **K-12**. The 2017 Tax Act defines QHEEs to include up to $10,000 (from all QTPs for the beneficiary) of tuition in connection with the designated beneficiary's enrollment or attendance at an elementary or secondary public, private or religious school.

5. **2020 Tax Act**. The 2020 Act expanded the definition of QHEE in two ways:

a. **Apprenticeship**. The 2020 Act includes expenses for a registered apprenticeship program. Code § 529(c)(8).

b. **Repay Loans**. The 2020 Act includes repayment of qualified education loans if the beneficiary and the beneficiary's siblings, but only up to a lifetime total of $10,000 per individual.

6. **2025 Tax Act**. The 2025 Act:

   a. **Postsecondary Credentialing Expenses**. The 2025 Act now includes "qualified postsecondary credentialing expenses" in the definition of QHEEs.

   b. **Elementary and Secondary Expenses**. The 2025 Act, beginning in 2026, permits up to $20,000 to be used annually for elementary and secondary school expenses, and expanded the expenses that may be paid.

   c. **Rollovers to ABLE Accounts**. The 2025 Act makes the provision permitting rollovers to ABLE accounts permanent.

7. **Proposed Regulations**. The IRS issued proposed regulations for section 529 on August 24, 1998. Proposed regulations carry no legal weight as far as the courts are concerned, but the IRS takes the position that taxpayers may rely on proposed regulations. The Preamble to the proposed regulations states that the "regulations are proposed to be effective on the date they are published in the Federal Register as final regulations. Taxpayers may, however, rely on the proposed regulations for taxable years ending after August 20, 1996." With respect to taxpayer and preparer penalties, proposed regulations are relevant in determining whether there is a "reasonable basis" or "substantial authority" for a position. Treas. Regs. §§ 1.6664-4; 1.6662-1(a). Thus in general a taxpayer is protected in following a proposed regulation, but may disregard a proposed regulation in favor of an alternative construction of the statute.

8. **Additional Guidance**. The IRS has provided some additional guidance by Notices.

   a. Notice 2001-81 (2001-2 C.B. 617) provides guidance on recordkeeping, reporting and other requirements applicable to QTPs.

   b. Notice 2016-13 provides guidance about the repeal of Code section 529(c)(3)(D), which required aggregation of distributions from different 529 accounts for the same beneficiary.

   c. Notice 2018-58 provides guidance on (1) the special rules for recontributions of refunds from schools, (2) rollovers to ABLE accounts and (3) using section 529 accounts for elementary and secondary tuition.

9. **Abuse Concerns Articulated**. In addition, the Pension Protection Act of 2006 authorizes the Secretary to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section and to prevent abuse of such purposes, including regulations under chapters 11,

12, and 13 of this title." Section 1304(b) of such Act added a new Code section 529(f), which is currently found at Code section 529(g). The Technical Explanation of the Act as prepared by the Joint Committee on Taxation explains:

> Present law regarding the transfer tax treatment of qualified tuition program accounts is unclear and in some situations imposes tax in a manner inconsistent with generally applicable transfer tax provisions. In addition, present law creates opportunities for abuse of qualified tuition programs. For example, taxpayers may seek to avoid gift and generation skipping transfer taxes by establishing and contributing to multiple qualified tuition program accounts with different designated beneficiaries (using the provision of section 529 that permits a contributor to contribute up to five times the annual exclusion amount per donee in a single year and treat the contribution as having been made ratably over five years), with the intention of subsequently changing the designated beneficiaries of such accounts to a single, common beneficiary and distributing the entire amount to such beneficiary without further transfer tax consequences. Taxpayers also may seek to use qualified tuition program accounts as retirement accounts with all of the tax benefits but none of the restrictions and requirements of qualified retirement accounts. The provision grants the Secretary broad regulatory authority to clarify the tax treatment of certain transfers and to ensure that qualified tuition program accounts are used for the intended purpose of saving for higher education expenses of the designated beneficiary, including the authority to impose related recordkeeping and reporting requirements. The provision also authorizes the Secretary to limit the persons who may be contributors to a qualified tuition program and to determine any special rules for the operation and Federal tax consequences of such programs if such contributors are not individuals.

10. **Advance Notice of Proposed Rulemaking**. An Advance Notice of Proposed Rulemaking on Code section 529 was published in the Federal Register on January 18, 2008 ("Advance Notice"). The rules proposed in the Advance Notice include:

    (1) An anti-abuse rule;

    (2) Rules relating to liability for transfer taxes upon a taxable change of designated beneficiary;

    (3) Rules relating to the account owner's liability for tax on any withdrawal from a section 529 account;

    (4) A rule restricting account owners to individuals;

(5) Rules concerning the application of transfer tax when a person other than an individual contributes to a section 529 account;

(6) Rules that apply when an individual contributes to a section 529 account for his or her own benefit or when a Uniform Transfer to Minors Act account contributes to a section 529 account for the benefit of its minor beneficiary;

(7) Rules regarding the inclusion of a section 529 account in a deceased beneficiary's estate;

(8) Rules regarding the five-year election;

(9) Rules regarding the timing of section 529 account distributions and the payment of QHEEs.

The rules tentatively proposed in the Advance Notice would generally become effective only after the effective date of final regulations and would apply prospectively. However, the anti-abuse rules could be applied retroactively. Transition rules may also be provided. In the interim, as stated in the Advance Notice, "Taxpayers and QTPs may continue to rely on the information provided in existing published guidance, including any effective dates therein. *See* § 601.601(d)(2)(ii)(b) of the regulations."

11. **Prepaid vs. Savings Accounts**. Under Code section 529, states may establish two different types of programs, prepaid tuition programs and savings account programs. Code § 529(b).

a. **Prepaid Tuition Programs**. A prepaid tuition program permits a person to purchase credits or certificates on behalf of a designated beneficiary, entitling the beneficiary to a waiver or payment of higher education expenses. Prepaid tuition programs "lock in" tuition at today's rate and avoid the risk that tuition increases will exceed the rate of earnings on the funds invested. If the beneficiary does not attend a participating college, the credits may be redeemed for cash based on a formula and used to pay education expenses at a non-participating school. Under the 2001 Act, educational institutions may establish Prepaid Tuition Programs. The Private College 529 Plan, a program established by a consortium of private colleges, has received a ruling that it meets the requirements for a QTP. See CollegeWell.com.

b. **Savings Account Programs**. A savings account program permits a person to contribute to an account established for the purpose of meeting the designated beneficiary's QHEEs. These programs essentially function as tax-advantaged investment accounts.

c. **Plethora of State Programs**. There are well over fifty 529 savings programs in operation. Every state and the District of Columbia now has at least one a section 529 account program. Each program is required to meet certain requirements set by Code section 529, but there are substantial differences among the programs where variation is permitted. A state may operate multiple qualified tuition savings account programs, and many do. Many states have both a direct-sold plan and an advisor-sold plan. Some states add an additional plan or plans. This can allow different investment managers to operate separate programs within a given state. In some states a program may be open only to residents. However, generally the broker-sold programs and about three-quarters of the direct-sold plans are open to residents of any state.

D. Definitions

1. **Contributor or Donor**. A "contributor" is the person who contributes money to a section 529 account. The contributor may, but need not, be the account owner. In gift tax parlance, the "contributor" is a "donor," unless the contributor is also the beneficiary of the section 529 account, in which case there is no gift and therefore no donor. Code section 529 uses both terms.

2. **Account Owner**. "Account owner" is defined in the proposed regulations as the person who has certain rights over the section 529 account:

> *Account owner* means the person who, under the terms of the QSTP or any contract setting forth the terms under which contributions may be made to an account for the benefit of a designated beneficiary, is entitled to select or change the designated beneficiary of an account, to designate any person other than the designated beneficiary to whom funds may be paid from the account, or to receive distributions from the account if no such other person is designated.

Prop. Treas. Reg. § 1.529-1(c).

a. The account owner is also the person who would certify to the QTP that the beneficiary died, became disabled or received a scholarship. Prop. Treas. Reg. § 1.529-2(e)(4)(ii)(B)(2).

b. In some states, the account owner may also be the designated beneficiary.

c. In many states the account owner may designate a successor account owner to assume management of the section 529 account when the original account owner dies, and in some states, when the original account owner becomes incapacitated.

3. **Participant**. The program materials for the states often use the word "participant" to refer to the account owner. Unfortunately, the materials sometimes create confusion by also using "participant" to refer to the contributor, who may not always be the account owner. The term "participant" or "account owner" is not used in Code section 529.

4. **Designated Beneficiary**. The "designated beneficiary" is the person who can receive qualified distributions from the section 529 account. The designated beneficiary must be an individual. Code section 529(e)(1) defines "designated beneficiary" as follows:

> (1) DESIGNATED BENEFICIARY. – The term "designated beneficiary" means –
>
> (A) the individual designated at the commencement of participation in the qualified tuition program as the beneficiary of amounts paid (or to be paid) to the program,
>
> (B) in the case of a change in beneficiaries described in subsection (c)(3)(C), the individual who is the new beneficiary, and
>
> (C) in the case of an interest in a qualified tuition program purchased by a State or local government (or agency or instrumentality thereof) or an organization described in section 501(c)(3) and exempt from taxation under section 501(a) as part of a scholarship program operated by such government or organization, the individual receiving such interest as a scholarship.

5. **Eligible Educational Institution**. An "eligible educational institution" means "an institution which is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) as in effect on August 5, 1997, and which is eligible to participate in a program under title IV of such Act." Code § 529(e)(5). The defining feature of an "eligible educational institution" is that it must be eligible to participate in Department of Education student aid programs. *Id.* The proposed regulations add:

> Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible institutions.

Prop. Treas. Reg. § 1.529-1(c). Institutions abroad may be eligible educational institutions. To verify that a U.S. or foreign school is an "eligible educational institution," visit the U.S. Department of Education Federal School Code Search Page at: https://fsapartners.ed.gov.

6. **Qualified Higher Education Expenses**. Qualified higher education expenses include:

   a. **College and Trade School**. Tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution. Code § 529(e)(3)(A)(i).

   b. **Special Needs Services**. Expenses for special needs services in the case of a special needs beneficiary which are incurred in connection with such enrollment or attendance. Code § 529(e)(3)(A)(ii).

   c. **Computer**. Expenses for the purchase of computer or peripheral equipment (as defined in section 168(i)(2)(B)); computer software (as defined in section 197(e)(3)(B)), or Internet access and related services, if such equipment, software, or services are to be used primarily by the beneficiary during any of the years the beneficiary is enrolled at an eligible educational institution. This shall not include expenses for computer software designed for sports, games, or hobbies unless the software is predominantly educational in nature. Code § 529(e)(3)(A)(iii).

   d. **Elementary and Secondary School Expenses**. Up to $10,000 per beneficiary per year ($20,000 beginning in 2026) for expenses in connection with enrollment or attendance at, or for students enrolled at, an elementary or secondary public, private or religious school including tuition, curricular materials, books or other instructional materials, online educational materials, tutoring, fees for national standardized tests, and educational therapies for students with disabilities. Code § 529(c)(7).

   e. **Apprenticeship Programs**. Fees, books, supplies and equipment required for participation in certain apprenticeship programs. Code § 529(c)(8).

   f. **Student Loan Repayment**. Up to a lifetime cap of $10,000 to repay qualified education loans for the designated beneficiary or a sibling of the designated beneficiary. Code § 529(c)(9).

   g. **Postsecondary Credentialing Expenses**. Qualified postsecondary credentialing expenses, which includes tuition, fees, books, supplies and equipment required for the enrollment or attendance in a recognized postsecondary credential program, fees for mandatory testing and fees for mandatory continuing education. Code § 529(f).

   h. **QTP Contributions**. Contributions to a QTP.

i. **Coverdell ESA Contributions**. Contributions to a Coverdell ESA.

7. **Member of the Family**. The term "member of the family" means, with respect to any designated beneficiary—

   a. the spouse of such beneficiary;

   b. an individual who bears a relationship to such beneficiary which is described in subparagraphs (A) through (G) of section 152(d)(2);

   c. the spouse of any individual described in subparagraph (b) above; and

   d. any first cousin of such beneficiary.

   Section 152(d)(2)(A) through (G) includes: (A) a child or a descendant of a child; **(**B) a brother, sister, stepbrother, or stepsister; (C) the father or mother, or an ancestor of either; (D) a stepfather or stepmother; (E) a son or daughter of a brother or sister; (F) a brother or sister of the father or mother of the taxpayer; (G) a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

E. Statutory Requirements of Section 529 Savings Accounts

1. **Government Sponsored**. QTPs offering savings accounts must be established and maintained by a state or agency or instrumentality thereof. Code § 529(b)(1).

2. **Purpose**. The account must be "established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account." Code § 529(b)(1)(A)(ii).

3. **Cash Only**. Contributions may be made only in cash. If permitted under the QTP, the contribution may be made by cash, check, money order or credit card. Prop. Treas. Reg. § 1.529-2(d). Some states permit contributions to be made by payroll deductions or automatic withdrawal from a bank account. Appreciated assets cannot be used to fund an account. This means the donor generally must liquidate the investment and pay the capital gains tax.

4. **Limited Investment Direction**. The account owner may change the investments in the account only twice each calendar year. Code § 529(b)(4). Code section 529(b)(4) provides: "A program shall not be treated as a qualified tuition program unless it provides that any contributor to, or designated beneficiary under, such program may directly or indirectly direct the investment of any contributions to the program (or any earnings thereon) no more than 2 times in any calendar year." (Note that literally this

language applies to a contributor or beneficiary, but not an account owner who is not the contributor.)

5. **No Pledges**. The account owner may not pledge the account as collateral or use the account as security for a loan. Code § 529(b)(5).

6. **Contribution Limits**. The program must establish procedures to prevent contributions beyond those reasonably necessary to pay the beneficiary's QHEEs. Code § 529(b)(6).

   a. **Safe Harbor**. The proposed regulations establish a safe harbor for preventing excess contributions:

      > *Safe harbor*. – A program satisfies this requirement if it will bar any additional contributions to an account as soon as the account reaches a specified account balance limit applicable to all accounts of designated beneficiaries with the same expected year of enrollment. The total contributions may not exceed the amount determined by actuarial estimates that is necessary to pay tuition, required fees, and room and board expenses of the designated beneficiary for five years of undergraduate enrollment at the highest cost institution allowed by the program.

      Prop. Treas. Reg. § 1.529-2(i)(2). Note the ambiguity between the first sentence, which suggests the limit should be on the balance in the account (including earnings), and the second sentence, which suggests that the limit should be imposed on the amount of contributions to the account. Note the safe harbor does not take into account the potential use of the funds for elementary and secondary school expenses.

   b. **Program Limits**. Most states have established a limit based on four or five years of in-state tuition in order to comply with the safe harbor in the proposed regulations. Prop. Treas. Reg. § 1.529-2(i). State programs vary as to whether the limit is applied against contributions or the account balance, though most impose a limit on the balance. However, the IRS has given favorable rulings to programs that have limits based on the cost of seven years of education. Priv. Ltr. Rul. 200030030 (Apr. 28, 2000) (Arizona: limit of seven times average cost of undergraduate education, as measured by an index); Priv. Ltr. Rul. 200134032 (May 30, 2001) (New York: limit of four times undergraduate annual expenses plus three times graduate school expenses at most expensive eligible educational institution); Priv. Ltr. Rul. 200214032 (Dec. 19, 2001) (Connecticut).

c. **Aggregation**. In theory, section 529 accounts in all states for a particular beneficiary should be aggregated for purposes of applying these contribution limits, but the proposed regulations do not address the issue. In practice, at least currently, the IRS and the states appear to have no mechanism to enforce these restrictions in the aggregate. The IRS could, under Code section 529(d), require plan sponsors to report account balances for each beneficiary to the IRS or a central federal authority, but this would be burdensome. It would be more workable to require account owners to report to the IRS all section 529 accounts held for a beneficiary. Further, although the IRS could require aggregation of all section 529 accounts for a beneficiary even if there are different account owners, aggregation of accounts with different account owners (at least other than spouses) may not be practical because any given account owner for a beneficiary may not know what section 529 accounts have been established by others for the same beneficiary.

7. **Separate Accounting**. A QTP must provide a separate accounting for each beneficiary. Code § 529(b)(3). The program's records must show the total investment in the account and any earnings attributable to it. Prop. Treas. Reg. § 1.529-2(f). With respect to a rollover from another QTP, a transfer of a Coverdell ESA, or a transfer of proceeds of a qualified U.S. Savings Bond, the recipient QTP must determine the basis and earnings of the amount contributed. I.R.S. Notice 2001-81, 2001-2 C.B. 617, clarifies this requirement:

> Accordingly, it is expected that final regulations will clarify that, when accepting a contribution, a § 529 program must ask whether the contribution is a rollover contribution from a Coverdell education savings account, a qualified U.S. Savings Bond, or another § 529 program. If the contribution is a rollover contribution, the § 529 program must determine the earnings portion of the contribution, and add that amount to the earnings recorded in the account to which the rollover contribution is made. Until the § 529 program receives appropriate documentation showing the earnings portion of the contribution, the program must treat the entire amount of the contribution as earnings in the § 529 account receiving the distribution. For this purpose, "appropriate documentation" means: (1) in the case of a rollover contribution from a Coverdell education savings account, an account statement issued by the financial institution that acted as trustee or custodian of the education savings account that shows basis and earnings in the account; (2) in the case of a rollover contribution from the redemption of qualified U.S. Savings Bonds, an account statement or Form 1099-INT issued by the financial institution that redeemed the bonds showing interest from the redemption of the bonds; and (3) in the case of a rollover contribution from another § 529 program, a statement issued by the

distributing § 529 program that shows the earnings portion of the distribution.

II. Income Taxation of Section 529 Savings Accounts

A. Contributions

1. **No Federal Deduction**. Contributions to a section 529 account are not deductible for federal income tax purposes.

2. **State Deductions and Credits**. In some states, contributions are deductible for state income tax purposes, often subject to a cap and sometimes a carryforward is permitted for contributions in excess of the cap. Generally deductions are permitted only for contributions to the QTP in the taxpayer's state of residence. In some states, only contributions by the account owner (or the account owner's spouse or the beneficiary's parent, depending upon the state) are deductible. A handful of states offer tax credits instead of deductions.

3. **Donor Restrictions**. The deduction may be available only for contributions to accounts of which the donor is the account owner. In some states, the deduction may be available only for certain donors, such as a parent or guardian of the beneficiary.

4. **Contribution for Self**. If a contribution is being made to an account of which the account owner is also the beneficiary, the account owner should verify that state law permits a deduction under such circumstances.

5. **UTMA Accounts**. The beneficiary of an UTMA should qualify for any deduction when preexisting funds in a UTMA account are contributed to a section 529 account. The donor should get the deduction when making a contribution to a custodial 529 account.

6. **Caps on Deductions or Credits**. In most states there is a cap on the annual deduction or credit permitted, but a couple of states have no limits. The cap may apply per taxpayer or per designated beneficiary.

7. **Deductibility of Rollovers**. In some states, deductions are not permitted for rollovers from another state's program.

8. **Recapture**. In some states the income tax deduction is "recaptured" if the funds are later moved to another state's program. Recapture may also occur in some states if a nonqualified withdrawal is later taken from the account.

B. Federal Income Tax Exemption. The income earned on a section 529 account is not subject to federal income tax, provided it is used to pay QHEEs. Code § 529(a); Code § 529(c).

C. **State Taxation of Account**. Some states base the state income tax on federal taxable income, federal adjusted gross income or federal tax liability. In these states, the annual income earned on a section 529 account should not be subject to state income tax (absent a special provision in state law subjecting it to income tax). In states that do not base their income tax on federal income concepts, whether or not the annual income is subject to state income tax, would be determined on a state-by-state basis.

D. **State Taxation of Qualified Distributions**. In determining state taxation of a qualified distribution, the relevant state is the state of residence of the beneficiary.

1. **States Without Income Tax**. Some states do not have an income tax and therefore would not tax a section 529 account distribution.

2. **Exemption of All Programs**. Most states exclude distributions from any state program from income tax. Illinois exempts distributions from out of state programs if they meet certain disclosure requirements.

3. **Exemption of Own Program**. All states with an income tax appear to exempt qualified distributions from their own state program from income tax. Alabama appears to be the outlier that will tax distributions from out of state programs. If the beneficiary is a resident of a state offering an income tax exemption only to qualified distributions from its own QTPs, it may be smart planning to roll over the section 529 account to the QTP in the beneficiary's state of residence prior to making a distribution. The account owner should be alert to whether the original state subjects outgoing rollovers to state income tax and whether the QTP in the state in which the beneficiary resides requires that the funds remain in the account for a certain period of time prior to distribution.

4. **States Following IRC**. Some states base the state income tax on federal taxable income, federal adjusted gross income or federal tax liability. The earnings portion of a distribution from any state program would be excluded for federal income tax purposes and therefore would also be excluded from taxation in these states, unless state law adds back such a distribution in determining state taxable income.

5. **States Without Exemption**. In states that (1) have an income tax, (2) do not explicitly exclude qualified distributions from income tax and (3) do not implicitly exclude qualified distributions by basing income tax on federal tax concepts, the earnings portion of the section 529 account will be subject to income tax. The income earned on a section 529 account is not taxed until the funds are withdrawn. Code § 529(a); Code § 529(c). Therefore, account earnings compound on a tax-deferred basis. State taxation occurs at the beneficiary's tax rate. This method of taxation will provide income tax savings in most cases because a beneficiary often will be a college

student in a low income tax bracket, whereas the account owner is often in a higher income tax bracket.

6. **State Definitions of QHEE**. Not all states follow the federal law with respect to the definition of QHEEs, particularly with respect to primary and secondary school expenses. Therefore, a distribution could be qualified for federal tax purposes but not state tax purposes.

E. Annuity Taxation on Nonqualified Distributions. Code section 529(c)(3)(A) provides that any distribution under a qualified tuition program shall be includible in the gross income of the distributee in the manner as provided under Code section 72 to the extent not excluded from gross income under any other provision of this Chapter. Subject to Code sections 72(e)(2)(B) and 72(e)(9), distributions are treated as consisting of two components: 1) principal or contributions, which are generally not taxed, and 2) earnings, which may be subject to tax. Code §§ 72(e)(2)(B) and (e)(9). The earnings portion of the account is equal to the value of the account at a particular time minus the investment portion of the account. Prop. Treas. Reg. § 1.529-3(b). The earnings ratio for the account is equal to the earnings portion of the account divided by the total value of the account. *Id*. The earnings portion of a particular distribution is determined by multiplying the earnings ratio by the amount of the distribution. *Id*. Generally, this would mean that the earnings portion of the distribution would be subject to income tax. Prop. Treas. Reg. § 1.529-3(a).

1. **Earnings**. The proposed regulations define "earnings" as follows:

> *Earnings* attributable to an account are the total account balance on a particular date minus the investment in the account as of that date.

Prop. Treas. Reg. § 1.529-1(c).

2. **Investment in the Account**. The proposed regulations define the "investment in the account" as follows:

> *Investment in the account* means the sum of all contributions made to the account on or before a particular date less the aggregate amount of contributions included in distributions, if any, made from the account on or before that date.

Prop. Treas. Reg. § 1.529-1(c). Note this definition does not limit qualifying contributions only to contributions made by the account owner.

3. **Time of Determination**. I.R.S. Notice 2001-81, 2001-2 C.B. 617, provides:

> In response to comments received on the proposed regulations, and consistent with the Secretary's authority under § 529(c)(3)(D)(iii) to

> adopt a different rule, the Treasury Department and the Internal Revenue Service expect that final regulations will revise the time for determining the earnings portion of any distribution from a § 529 account. It is expected that final regulations will provide that, effective for distributions made after December 31, 2002, programs will be required to determine the earnings portion of each distribution as of the date of distribution. In the case of direct transfers between § 529 programs, this requirement is effective for distributions made after December 31, 2001. In the case of any State program for which this change would require legislation and whose State legislature has a biennial legislative session, the program will have until January 1, 2004, to conform to this method of calculating earnings.

Prior to its repeal by the 2015 Act, Code section 529(c)(3)(D)(iii) provided that, except to the extent provided by the Secretary, the earnings portion of a distribution shall be determined as of the close of the calendar year. See also Prop. Treas. Reg. § 1.529-1(c).

4. **Taxed as Ordinary Income**. Note that the earnings portion is taxed as ordinary income, regardless of what portion of the earnings is attributed to capital gains.

5. **Advance Notice**. However, the proposed rules in the Advance Notice would subject the account owner to income tax on the entire distribution "except to the extent that the account owner can substantiate that the [Account Owner] made contributions to the section 529 account and, therefore, has an investment in the account within the meaning of section 72." Thus a successor account owner who did not make any contributions to the account would be subject to tax on the entire distribution. The ten percent penalty would apply to the entire amount includible in income.

Where an account owner directs a nonqualified distribution to the beneficiary, for example where the beneficiary has completed his or her education, how will the income tax consequences to the beneficiary be determined? Generally, it has been assumed that the beneficiary would pay income tax only on the earnings portion of the account and not on the amount of the contributions made to the account. Presumably, the IRS will treat the beneficiary as having made an investment in the account equal to the amount of the contributions, which were treated as a completed gift to the beneficiary when the contributions were made to the account. This theory works well when the beneficiary receiving the distribution was the beneficiary at the time contributions were made to the account. But if the beneficiary was changed, so that the beneficiary receiving the distribution was not the deemed recipient of the completed gift, by what mechanism does the new beneficiary acquire the old beneficiary's "investment" in the account and why does not the same mechanism apply when the account owner is changed?

6. **State Penalty**. If the QTP imposes a state penalty on the nonqualified distribution (in addition to the federal penalty), the amount of the penalty is subtracted from the earnings attributable to the account.

7. **Documentation of Basis**. Any portion of a section 529 account attributed to a rollover, a Coverdell education savings account or a qualified U.S. savings bond is treated entirely as earnings until the QTP receives appropriate documentation of the basis and earnings portions of such contribution.

8. **Distributee's Tax Rate**. Nonqualified distributions are taxed at the distributee's tax rate. Most states report a nonqualified distribution as a distribution to the account owner. However, some states permit an account owner to direct a nonqualified distribution to the beneficiary, in which case presumably the earnings would be taxed to the beneficiary at the beneficiary's tax rate.

9. **No Aggregation of Distributions**. The aggregation rules that applied if there were distributions from more than one 529 accounts during a year for the same beneficiary were eliminated for distributions after 2014. Notice 2016-13.

10. **Special State Exemptions**. A few states exempt from state income taxation certain nonqualified distributions, generally nonqualified distributions that would not incur a federal penalty because they are made because of a scholarship or the death or disability of the beneficiary. See, *e.g.*, Michigan, Ohio and Virginia.

F. Losses

1. **No Deduction for Losses**. Currently losses on a section 529 account are not deductible. *IRS Publication 970* (2024) states:

> For tax years beginning after 2017 and before 2026, if you have a loss on your investment in a QTP account, you can't claim the loss on your income tax return. You have a loss only when all amounts from that account have been distributed and the total distributions are less than your unrecovered basis. Your basis is the total amount of contributions to that QTP account.
>
> All section 529 accounts within the state for the beneficiary must be liquidated.

2. **Prior Law**. Previously, if a nonqualified distribution was taken from an account that had a loss, the distributee could claim the loss as a

miscellaneous itemized deduction taken on line 23 of Schedule A of Form 1040, subject to the 2%-of-adjusted-gross-income limit. It was not a capital loss. A taxpayer who did not itemize would receive no benefit from the loss. A taxpayer who did itemize, would benefit only if total miscellaneous deductions exceed 2% of adjusted gross income. Miscellaneous itemized deductions were not deductible for alternative minimum tax purposes. Therefore a 529 loss could have caused a taxpayer to incur AMT. A taxpayer who was already subject to AMT would not have been able to use a 529 loss.

G. **Federal Penalty on Nonqualified Distributions**. Code section 529 imposes a ten percent federal penalty on the earnings portion of a nonqualified distribution. Code § 529(c)(6).

1. **Exceptions to Penalty**. Code section 530(d)(4)(B) lists the exceptions to the penalty.

a. **Death of Beneficiary**. The penalty does not apply to a distribution made to a beneficiary (or to the estate of the designated beneficiary) on or after the death of the designated beneficiary. Code § 530(d)(4)(B)(i).

b. **Disability**. The penalty does not apply to a distribution attributable to the designated beneficiary's being disabled (within the meaning of section 72(m)(7)). Code § 530(d)(4)(B)(ii). An individual shall be considered to be disabled if he or she is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration. An individual shall not be considered to be disabled unless such individual furnishes proof of the existence of the disability in such form and manner as the Secretary may require. Code § 72(m)(7).

c. **Scholarship, Allowance or Payments**. The penalty does not apply to a distribution made on account of a scholarship, allowance, or payment described in Code section 25A(g)(2) received by the designated beneficiary to the extent the amount of the payment or distribution does not exceed the amount of the scholarship, allowance, or payment. Code § 530(d)(4)(B)(iii). Code section 25A(D)(2) defines the terms "qualified allowance," and "payment."

(1) **Scholarship**. A "qualified scholarship" is one that is excludable from gross income under Code section 117.

(2) **Allowance**. "Educational assistance allowance means such as allowance under chapter 30, 31, 32, 34, or 35 of title 38,

United States Code, or under chapter 1606 of title 10, United States Code. See Code § 135(d)(1)(B) and § 135(d)(1)(C).

(3) **Payment**. "Payment" means a payment (other than a gift, bequest, devise, or inheritance within the meaning of Code section 102(a)) for such individual's educational expenses, or attributable to such individual's enrollment at an eligible educational institution, which is excludable from gross income under any law of the United States.

d. **Military Academy**. The penalty does not apply to a distribution made on account of the attendance of the designated beneficiary at the United States Military Academy, the United States Naval Academy, the United States Air Force Academy, the United States Coast Guard Academy, or the United States Merchant Marine Academy, to the extent that the amount of the payment or distribution does not exceed the costs of advanced education (as defined by Code section 2005(e)(3)) attributable to such attendance.

e. **American Opportunity and Lifetime Learning Credits**. The penalty does not apply if the distribution was included in income only because the qualified education expenses were taken into account for determining the American Opportunity Credit or the Lifetime Learning Credit. Code §§ 530(d)(4)(B)(v), 530(d)(2)(C)(i)(II), and § 25A.

2. **Operation of Penalty**. The federal penalty works in the same manner as the penalty for nonqualified distributions from a Coverdell Education Savings Account under Code section 530(d)(4). Under section 530(d)(4), taxable income is not reduced by the penalty:

> The tax imposed by this chapter for any taxable year on any taxpayer who receives a payment or distribution from a Coverdell education savings account which is includible in gross income shall be increased by 10 percent of the amount which is so includible.

H. **State Penalties**. Prior to the 2001 Act, state plans were required to impose a penalty on most nonqualified distributions. Although state plans are no longer required to do so, they may do so.

I. **Special Rule for Contributions of Refunded Amounts**. In the case of a beneficiary who receives a refund of any QHEEs from an eligible educational institution, the refund is not treated as a nonqualified distribution if the refund is recontributed to a qualified tuition program of which such individual is a beneficiary, but only to the extent such recontribution is made not later than 60 days after the date of such refund and does not exceed the refunded amount. Code § 529(c)(3)(D).

III. **Gift Taxation of Section 529 Savings Accounts**. The Preamble to the Proposed Regulations states:

> In addition, the estate and gift tax treatment of contributions to a QSTP and interests in a QSTP is generally different from the treatment that would otherwise apply under generally applicable estate and gift tax principles.

Background to the Proposed Regulations, 63 Fed. Reg. 45,019, 45,021 (Aug. 24, 1998).

A. **No Section 2503(e) Exclusion**. Contributions to section 529 accounts after August 5, 1997 do not qualify for the tuition exclusion from gift tax under Code section 2503(e).

B. **Annual Exclusions**. Contributions to a section 529 account are treated as completed present interest gifts from the donor to the beneficiary. Code § 529(c)(2)(A)(i); Prop. Treas. Reg. § 1.529-5(b)(1). The account owner is able to take advantage of the annual exclusions while still retaining the rights to revoke the account, to control distributions and to change the beneficiary of the account. Prop. Treas. Reg. § 1.529, Comment at paragraph [29].

1. **GST Annual Exclusion**. The portion of a contribution excludible from taxable gifts under section 2503(b) also satisfies the requirements of Code section 2642(c)(2) and, therefore, is also excludible for purposes of the generation-skipping transfer tax imposed under Code section 2601. Prop. Treas. Reg. § 1.529-5(b). Therefore, the contributions qualify for the annual exclusion for both gift and GST tax purposes. Code § 2642(c)(1); Prop. Treas. Reg. § 1.529-5(b)(1).

2. **When Is Gift Complete**? Under the gift tax rules, a gift is considered complete when the donor has so parted with dominion and control as to leave in the donor no power to change its disposition. Treas. Reg. § 25.2511-2(a). In the context of contributions to section 529 accounts, a gift should be complete when the donor can no longer revoke the gift, and the donor's only ability to reacquire the funds would be through a nonqualified distribution to the donor if the donor is the account owner. In the unlikely event that a contribution to a section 529 account was made by cash in the 529 program's office, the gift would be complete immediately. If a contribution is made by a wire transfer, payroll deduction or automatic account debit, the gift should be complete when the transfer, deduction or debit is made.

   However, many, if not most, contributions to section 529 accounts will be made by check. Is the contribution considered to be made when the 529 program receives the check, when the 529 program credits the 529 account on its records, when the 529 program cashes the check or when the check is honored by the donor's bank?

The gift tax rules generally applicable to gifts made by check should apply here to determine when a contribution made to a section 529 account by check is considered complete for gift tax purposes. The IRS's position is that when a gift is made by a check to a non-charitable donee, the gift is complete on the earlier of (1) the date on which the donor parts with dominion and control or (2) the date on which the donee deposits the check. Rev. Rul. 96-56, 1996-2 C.B. 161, *modifying* Rev. Rul. 67-396, 1967-2 C.B. 351. (Prior to Revenue Ruling 96-56, the IRS's position was that a noncharitable gift by check was not complete until it was paid, certified or accepted by the drawee bank or negotiated to a third party for value.) The tax court in *Metzger Estate v. Commissioner*, 100 T.C. 204 (1993), held that a gift of a check is a completed gift in the year the check is presented for payment if the taxpayer can establish (1) an intent to make the gift; (2) unconditional delivery of the check; and (3) presentment of the check within such year and within a reasonable time of issuance of the check. Under *Metzger* it is irrelevant whether the check is actually honored in a subsequent tax year. The Fourth Circuit in *Newman Estate v. Commissioner*, 38 F.3d 118 (4th Cir. 1994), added a possible fourth requirement, that the donor be living when the check is honored. *See also Rosano v. U.S.*, 67 F. Supp. 2d 113 (E.D.N.Y. 1999), *aff'd* 245 F.3d 212 (2d Cir. 2001), *cert. denied*, 534 U.S. 1135 (2002) (mem.).

Under Revenue Ruling 96-56 and *Metzger*, a gift by check to a section 529 account should be deemed to be made in the year in which the 529 program deposits the check. If a donor sends a check to the 529 program at the end of one year, but the 529 program does not deposit the check until the beginning of the following year, the gift would be deemed to be made in the following year. Thus caution should be exercised in making year-end gifts to ensure that there is ample time for the 529 program to deposit the check before the end of the year.

C. **Gifts that Do Not Qualify for the GST Annual Exclusion**. To the extent that a gift to a section 529 account does not qualify for the gift tax annual exclusion under section 2503(b), because prior gifts during the calendar year utilized the available annual exclusion, or because the gifts to the section 529 account exceeded the gift tax annual exclusion, the gifts would not qualify for the GST annual exclusion. The proper GST treatment of such excess is not clear. The excess over the annual exclusion should be treated as a completed gift to the beneficiary. This would suggest that for generation-skipping transfer tax purposes the excess should be treated as a direct skip to the beneficiary. However, ordinarily direct skip treatment would not be permitted where the assets might later be distributed to a non-skip person, as would be the case with a section 529 account if the beneficiary is later changed to a non-skip person or the assets are refunded to the account owner who is a non-skip person. If the excess contribution is a direct skip, the donor could either allocate GST exemption or pay GST tax. However, there would appear to be no provision to refund the GST tax or restore the GST exemption used if the funds were later refunded to the account owner who was a non-skip person or the beneficiary was changed to a non-skip person.

D. **Front-Loading**. The donor can make five years of annual exclusion gifts in one year!

1. **Five-Year Averaging**. Section 529 provides that a donor can elect to have contributions to an account treated as if made ratably over five years beginning with the year of the contribution. Code § 529(c)(2)(B); Prop. Treas. Reg. § 1.529-5(b)(2). That means the donor can contribute $95,000 in 2025 without incurring gift tax or, presumably, GST tax. Code section 529(c)(2) provides:

> (2) GIFT TAX TREATMENT OF CONTRIBUTIONS. – For purposes of chapters 12 and 13 –
>
> > (A) IN GENERAL. – Any contribution to a qualified tuition program on behalf of any designated beneficiary –
> >
> > > (i) shall be treated as a completed gift to such beneficiary which is not a future interest in property, and
> > >
> > > (ii) shall not be treated as a qualified transfer under section 2503(e).
> >
> > (B) TREATMENT OF EXCESS CONTRIBUTIONS. – If the aggregate amount of contributions described in subparagraph (A) during the calendar year by a donor exceeds the limitation for such year under section 2503(b), such aggregate amount shall, at the election of the donor, be taken into account for purposes of such section ratably over the 5-year period beginning with such calendar year.

The donor can make the election for some beneficiaries but not others. The instructions to the gift tax return (2024) state, “You can make this election for as many separate people as you made QTP contributions.”

2. **Split Gifts**. Gift-splitting is permitted, so a married donor can contribute up to ten times the annual exclusion amount ($190,000 in 2025) per beneficiary in a single year without incurring gift tax or GST tax. Prop. Treas. Reg. § 1.529-5(b)(2). However, if gift-splitting is elected, both spouses must make the election on their respective returns. The Advance Notice states:

> *Rule 3*. The election may be made by a donor and the donor's spouse with respect to a gift considered to be made one-half by each spouse under section 2513.

The instructions to the gift tax return (2024) state: "If you are electing gift splitting, apply the gift-splitting rules before applying the QTP rules. Each spouse would then decide individually whether to make this QTP election."

Applying the gift splitting rules first is consistent with the IRS's position (informal at this point) that if one spouse dies during the five-year period, only that spouse's portion of the gift is brought back into the estate.

The IRS's position that the split gift election comes first and is made only in Year 1 has some interesting consequences. First, presumably one spouse could elect five-year averaging and the other could not. Second, the portion of the gift attributable to one spouse in any future year would itself be split if a split gift election is made for that year. This would be relevant if one spouse elected five-year averaging and the other did not. It would also be relevant if the spouses divorced and one spouse remarried during the five-year period.

3. **GST**. The reference in the introductory phrase of Code section 529(c)(2) to chapter 13 (the GST rules) would seem to suggest that Code section 529(c)(2)(A) is intended to make clear that contributions to a 529 account qualify for the GST annual exclusion as well as the gift tax annual exclusion and that the five-year election operates for purposes of both GST tax and gift tax. The proposed regulations state that the "portion of a contribution excludible from taxable gifts under section 2503(b) also satisfies the requirements of section 2642(c)(2) and, therefore, is also excludible for purposes of the generation-skipping transfer tax imposed under section 2601." Prop. Treas. Reg. § 1.529-5(b)(1). However, the proposed regulations do not specifically state that to the extent the five-year election is made, the GST annual exclusion applies to the contributions attributed to all five years.

4. **Absorbs Annual Exclusions**. If the donor makes a contribution of five times the annual exclusion amount in Year 1, and makes the election, the donor cannot make additional annual exclusion gifts to the beneficiary in Years 2, 3, 4, and 5, except to the extent the annual exclusion is adjusted for inflation in one of those years. Keep this in mind if the donor is using annual exclusions for other purposes, such as funding an insurance trust.

5. **Minimum Contribution for Proration**. Code section 529(c)(2)(B) permits the five-year election when the "aggregate amount of contributions" to a 529 account on behalf of any designated beneficiary "exceeds the limitation for such year under section 2503(b)." If P makes an outright gift to C on January 1, 2025 of $10,000, and then on June 1, 2025 makes a gift

of $10,000 to a section 529 account for C, can P make the five-year election over the June gift to avoid a taxable gift for 2025? In other words, does the 2503(b) limitation for such year mean $19,000, or $19,000 less any annual exclusion gifts made to such beneficiary earlier in the year? The instructions to the gift tax return (2024) take the former position: "If in 2024, you contributed more than $18,000 to a qualified tuition plan (QTP) on behalf of any one person, you may elect to treat up to $90,000 of the contribution for that person as if you had made it ratably over a 5-year period."

6. **Amount of Election**. Code section 529(c)(2)(B) literally reads as if the amount subject to the five-year election must be the amount contributed to the section 529 account. This may not produce the optimal result. For example, if P makes an outright gift of $10,000 to C on January 1, 2025, and then makes a gift of $21,000 on June 1, 2025 to a section 529 account for C, P may with to make the election only over $15,000 of the 529 contribution, so that P's 2025 gifts to C are:

$10,000	cash
$ 6,000	contribution to 529
<u>$ 3,000</u>	(2025 1/5 portion of remaining $15,000 of 529 contribution)
$19,000	

This uses all of P's 2025 annual exclusion and minimizes the amount of the 529 contribution attributable to the next four years.

The instructions to Form 709 provide that the taxpayer must attach a statement that includes "the amount for which the election is being made." The instructions are explicit that the "portion of the contribution" for which the election is made cannot exceed five times the annual exclusion, but do not provide explicitly that the election must be made over all of the 529 contribution to the extent it is less than or equals five times annual exclusion.

7. **Proration of Excess Over Annual Exclusions**. If the gift equals or is less than five times the annual exclusion amount, and the election is made, the donor reports one-fifth of the total contribution on the initial return, and one-fifth is attributed to each of the next four years. If the gift exceeds five times the annual exclusion, it is not clear when the excess should be reported. Code section 529(e)(2)(B) appears to require that the entire gift, including any excess over five times the annual exclusion, be reported ratably over the five-year period. The Proposed Regulations and instructions to Form 709 (2024), however, require that the excess be

reported as a taxable gift in the first year. Prop. Treas. Reg. § 1.529-5(b)(2). The Advance Notice also takes this position:

> *Rule 2*. The election applies to contributions to a section 529 account on behalf of a [Designated Beneficiary] during a calendar year that exceed the gift tax exclusion amount for that year whether or not in excess of five times the exclusion amount for the year. Any excess may not be taken into account ratably and is treated as a taxable gift in the calendar year of the contribution. . ..

The Advance Notice also provides two examples for the application of Rule 2.

Reporting the excess ratably over the five-year period would have several benefits. First, if the donor's applicable exclusion amount has been exhausted, it would defer gift tax on a portion of the gift. Second, if the applicable exclusion amount increases during the five-year period, a portion of the gift that otherwise would be taxable could be sheltered by the applicable exclusion. Third, if the annual exclusion is adjusted for inflation during the five-year period, a portion of the gift that otherwise would be taxable could be sheltered by the increase in the annual exclusion.

8. **Five-Year Proration Required**. The donor does not have the option to prorate the gift over a lesser number of years. For example, if the donor contributes $30,000 in 2025 and makes the election over the entire gift, the donor will be treated as making a $6,000 annual exclusion gift in each of years 2025-2029. The donor cannot elect to treat the gift as if it were two $15,000 gifts in 2025 and 2026, or as a gift of $19,000 in 2025 and $11,000 in 2026.

9. **Election**. The donor must make the "five-year averaging" election on the Form 709 gift tax return.

    a. **Check Box**. Form 709, Schedule A, Question B has a box to check if you elect to treat transfers to a section 529 account as made ratably over five years. Question B states: "Check here if you elect under Code section 529(c)(2)(B) to treat any transfers made this year to a qualified state tuition program as made ratably over a 5-year period beginning this year. See instructions. Attach explanation."

    b. **Attach Explanation**. An explanation must be attached to the gift tax return that includes the following: (1) total amount contributed per beneficiary; (2) the amount for which the election is being made; and (3) the name of the individual for whom the contribution was made.

c. **Failure to Elect**. The failure to make the election will cause the entire gift to be treated as made in the year of contribution. *Estate of Beyer v. Comm'r*, T.C. Memo 2016-183. In *Beyer* the taxpayer made gifts of five times the annual exclusion in year 1 and never filed a gift tax return for year 1. The taxpayer also made gifts of five times the annual exclusion in a different year for which a gift tax return was filed but did not report the 529 gifts.

10. **Late Election**. The Advance Notice permits a late election if no prior gift tax return has been filed for the year.

> *Rule 1*. The election must be made on the last United States Gift (and Generation-Skipping Transfer) Tax Return (Form 709) filed on or before the due date of the return, including extensions actually granted, or, if a timely return is not filed, on the first gift tax return filed by the donor after the due date. The election, once made, will be irrevocable, except that it may be revoked or modified on a subsequent return that is filed on or before the due date, including extensions actually granted.

11. **Substantial Compliance**. If the donor fails to check the appropriate box on Form 709 to elect five-year averaging, relief may still be granted for substantial compliance if the return otherwise indicates that the donor intended to make the election. Reportedly, David Pratt obtained a 9100 ruling for a client who had reported frontloaded gifts to section 529 accounts for a number of grandchildren and had already used most of her gift tax exemption but failed to make the election.

12. **Future Filing Requirements**. If in any of the four years following the election the taxpayer is not otherwise required to file Form 709, the taxpayer does not need to file Form 709 to report the prorated portion of the gift attributable to that year. The instructions to Form 709 (2024) state:

> However, if in any of the last 4 years of the election, you did not make any other gifts that would require you to file a Form 709, you do not need to file Form 709 to report that year's portion of the election amount.

13. **Second Five-Year Averaging Election**. It is unclear whether a second election can be made with respect to another contribution during the five-year period. An example in the regulations could be read to suggest no, but there appears to be no reason to prohibit a second election. The Proposed Regulations provide:

> (i) Under section 529(c)(2)(B) a donor may elect to take certain contributions to a QSTP into account ratably over a five year period in determining the amount of gifts made during the calendar year.

> The provision is applicable only with respect to contributions not in excess of five times the section 2503(b) exclusion amount available in the calendar year of the contribution. Any excess may not be taken into account ratably and is treated as a taxable gift in the calendar year of the contribution,
>
> * * *
>
> (iv) If in any year after the first year of the five year period described in section 529(c)(2)(B), the amount excludible under section 2503(b) is increased as provided in section 2503(b)(2), the donor may make an additional contribution in any one or more of the four remaining years up to the difference between the exclusion amount as increased and the original exclusion amount for the year or years in which the original contribution was made.

Prop. Treas. Reg. § 1.529-5(b)(2).

The Advance Notice provides a similar example:

> *Example A.* Assume the contributor makes contributions to a section 529 account on behalf of DB in 2007, when the gift tax annual exclusion amount under section 2503(b) is $12,000. If the contributor's aggregate contributions on behalf of DB in 2007 are $30,000, contributor may elect to account for this gift as 5 annual gifts of $6,000 to DB, beginning in 2007. Assuming the gift tax annual exclusion amount remains at $12,000 over the 5-year period covered by the election, the contributor could make additional gifts described in section 2503(b) of up to $6,000 in each of the 5 years to the same beneficiary without the imposition of any gift tax.

The five-year averaging election should be permitted to be made more than once in every five-year period, although clarification is needed on when a second five-year election should be permitted, and the limitations to be applied to such additional elections. (The following examples are in large part the work of Christopher Houston at Ropes & Gray in Boston, Massachusetts.) These examples assume an annual exclusion of $12,000 unless otherwise specified.

> *Example 1.* In Year 1, account owner contributes $40,000 to a section 529 account for designated beneficiary and makes the five-year election, prorating the gift at $8,000 per year. In Year 2, account owner contributes $20,000 to the account. If account owner may make an additional five-year election for the Year 2 contribution, the relevant amounts would be as follows:

Example 1	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Annual Exclusion	12,000	12,000	12,000	12,000	12,000	12,000	12,000
Actual Gift	40,000	20,000					
Year 1 Deemed Gift	8,000	8,000	8,000	8,000	8,000		
Year 2 Deemed Gift		4,000	4,000	4,000	4,000	4,000	
Non-Proratable Gift							
Total Gifts	8,000	12,000	12,000	12,000	12,000	4,000	
Total Taxable Gift	0	0	0	0	0	0	0

Example 1 is the most straightforward and uncontroversial application of the principle that additional five-year elections should be permitted within the term of a prior election, because the combined elections do not attribute to any year a gift in excess of the annual exclusion. It is consistent with the express language and implicit purposes of Code section 529, without any countervailing policy considerations.

> *Example 2A.* In Year 1, account owner contributes $40,000 to a section 529 account for designated beneficiary and makes the five-year election, prorating the gift at $8,000 per year. In Year 2, account owner contributes $30,000 to the account. One possibility is that account owner may make an additional five-year election for the Year 2 contribution, for the full $30,000 amount, since it does not exceed five times the Year 2 annual exclusion amount of $12,000. In that case, the relevant amounts would be as follows:

Example 2A	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Annual Exclusion	12,000	12,000	12,000	12,000	12,000	12,000	12,000
Actual Gift	40,000	30,000					
Year 1 Deemed Gift	8,000	8,000	8,000	8,000	8,000		
Year 2 Deemed Gift		6,000	6,000	6,000	6,000	6,000	
Non-Proratable Gift							
Total Gifts	8,000	14,000	14,000	14,000	14,000	6,000	
Total Taxable Gift	0	2,000	2,000	2,000	2,000	0	0

> *Example 2B.* Same as Example 2A ($40,000 contribution in Year 1 and $30,000 contribution in Year 2), except that account owner is only permitted to make an additional five-year election for the Year 2 contribution with respect to five times the difference between the Year 2 annual exclusion amount and the deemed gift from any prior elections (namely, $20,000, being five times the difference between the $12,000 annual exclusion amount and the $8,000 deemed gift from Year 1). In that case, the relevant amounts would be as follows:

Example 2B	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Annual Exclusion	12,000	12,000	12,000	12,000	12,000	12,000	12,000
Actual Gift	40,000	30,000					
Year 1 Deemed Gift	8,000	8,000	8,000	8,000	8,000		
Year 2 Deemed Gift		4,000	4,000	4,000	4,000	4,000	
Non-Proratable Gift		10,000					
Total Gifts	8,000	22,000	12,000	12,000	12,000	4,000	
Total Taxable Gift	0	10,000	0	0	0	0	0

If in Example 2B the annual exclusion amount had increased to $13,000 in Year 2, account owner could have instead made an additional five-year election in Year 2 with respect to $25,000 (being five times the difference between that $13,000 and the $8,000 deemed gift from Year 1). Then, only $5,000 would have been non-proratable in Year 2, creating a $5,000 taxable gift that year.

Examples 2A and 2B highlight the question of whether the ability to make an additional five-year election during the term of any prior election(s) should or should not be limited by the deemed gifts arising from such prior election(s). The express provisions of Code section 529 do not include such a limitation, and some would argue not only that such a limitation is unnecessary from a policy standpoint, but that Congress could have easily included such a limitation if one was intended. However, others would argue that the ability in Example 2A to defer taxable gifts (and not just the use of annual exclusion) is contrary to the implicit provisions of section 529 or otherwise objectionable from a policy standpoint.

Example 3A. In Year 1, account owner contributes $60,000 to a section 529 account for designated beneficiary and makes the five-year election, prorating the gift at $12,000 per year. In Year 2, the annual exclusion amount increases to $13,000, and account owner contributes $5,000 to the account. One possibility is that account owner may make an additional five-year election for the Year 2 contribution, for the $5,000 amount, particularly insofar as the sum of that amount plus the $12,000 deemed gift from Year 1 (that is, $17,000) exceeds the Year 2 annual exclusion amount. In that case, the relevant amounts would be as follows:

Example 3A	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Annual Exclusion	12,000	13,000	13,000	13,000	13,000	13,000	13,000
Actual Gift	60,000	5,000					
Year 1 Deemed Gift	12,000	12,000	12,000	12,000	12,000		
Year 2 Deemed Gift		1,000	1,000	1,000	1,000	1,000	
Non-Proratable Gift							
Total Gifts	12,000	13,000	13,000	13,000	13,000	1,000	
Total Taxable Gift	0	0	0	0	0	0	0

Example 3B. Same as Example 3A ($60,000 contribution in Year 1 and $5,000 contribution in Year 2), except that account owner is not permitted to make an additional five-year election for the Year 2 contribution, because the $5,000 amount of that actual contribution (taken alone) is less than the Year 2 annual exclusion amount. In that case, the relevant amounts would be as follows:

Example 3B	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Annual Exclusion	12,000	13,000	13,000	13,000	13,000	13,000	13,000
Actual Gift	60,000	5,000					
Year 1 Deemed Gift	12,000	12,000	12,000	12,000	12,000		
Year 2 Deemed Gift							
Non-Proratable Gift		5,000					
Total Gifts	12,000	17,000	12,000	12,000	12,000		
Total Taxable Gift	0	4,000	0	0	0	0	0

Examples 3A and 3B highlight the question of whether or not, in determining whether section 529 account contributions in a given year exceed the annual exclusion amount, one is permitted (or even required) to include the deemed contribution(s) for that year arising from any prior election(s). Different practitioners have read Code section 529 and the proposed regulations to suggest different conclusions on this matters. The issue is whether in Code section 529(c)(2)(B) the phrase "the aggregate amount of contributions" should be construed to mean only actual contributions during the calendar year or also to include contributions attributed to the calendar year by reason of a prior five-year election.

E. **Distributions Are Not Gifts**. Distributions from a section 529 account are not treated as taxable gifts. Code § 529(c)(5)(A). Note, however, that certain changes of beneficiaries can be treated as gifts. In addition, the Advance Notice stated that future rules would address certain potential abuses by making the account owner liable for income tax on the entire amount of the funds distributed for the account holder's benefit except to the extent that the account holder can substantiate that the account holder made contributions to the section 529 account and, therefore, has an investment in the account within the meaning of Code section 72.

F. **State Gift Taxes**. Connecticut imposes a gift tax but appears to recognize a federal five-year election for Connecticut gift-tax purposes.

G. **State Treatment of Distributions**. State programs may not define qualified distributions as broadly as Code section 529. For example, some states may not include kindergarten through twelve grade tuition in qualified distributions. Thus a distribution could be free from federal income tax but still generate state income tax, or cause a state income tax deduction previously granted to be clawed back.

IV. Estate Taxation of Section 529 Savings Accounts

A. **Exclusion from Donor's Estate**. Except as provided below with respect to the five-year averaging election, the value of a section 529 account will not be included in the gross estate of the account owner for federal estate tax purposes. Code § 529(c)(4)(A).

B. **Five-Year Spread**. A donor electing the five-year spread must survive into the fifth year (but not to the end of the fifth year) to have the entire amount of contributions excluded from his or her estate. Code § 529(c)(4)(C); Prop. Treas. Reg. § 1.529-5(d)(2). Code section 529(c)(4)(A) provides "No amount shall be includible in the gross estate of any individual for purposes of chapter 11 by reason in an interest of a qualified tuition program." Code section 529(c)(4)(C), however, provides that "In the case of a donor who makes the election described in paragraph (2)(B) and who dies before the close of the 5-year period referred to in such paragraph, notwithstanding subparagraph (A), the gross estate of the donor shall include the portion of such contributions properly allocable to periods after the date of the death of the donor."

1. **Appreciation**. If the donor dies before the close of the five-year period, the portion of the *contribution* allocable to calendar years beginning after the date of death of the decedent is includible in the gross estate. However, any earnings on the account escape estate tax inclusion. On the other hand, if the account declined in value, the amount includible would still be based on the contributions.

2. **Gift-Splitting**. If gift-splitting was elected, the death of one spouse should not cause inclusion of any part of the contribution attributable to the other spouse.

3. **Source of Payment**. If the estate is taxable, the source for paying the estate tax on the included portion of the section 529 account will depend upon the directions in the Will for payment of taxes, or if none, state law on the apportionment of taxes. If the residue of the estate is responsible for the payment of taxes, there should be no need to deplete the section 529 account to pay its share of taxes.

C. **Inclusion in Beneficiary's Federal Estate**. Code section 529 cryptically says that amounts distributed on account of the death of a beneficiary are subject to estate tax, without defining what is meant by "distributed." The legislative history and the Proposed Regulations suggest that the value of any interest in a section 529 account will be includible in the estate of a deceased beneficiary. This position does not make sense because the beneficiary does not have any control over the account and the beneficiary's estate will not necessarily receive the account funds. The Advance Notice proposes five rules:

> *Rule 1*. If the [Account Owner] distributes the entire section 529 account to the estate of the deceased [Designated Beneficiary] within 6 months of the death of the [Designated Beneficiary], the value of the account will be included in the deceased [Designated Beneficiary's] gross estate for Federal estate tax purposes.
>
> *Rule 2*. If a successor [Designated Beneficiary] is named in the section 529 account contract or program and the successor [Designated Beneficiary] is a member of the family of the deceased [Designated Beneficiary] and is in the same or a higher generation (as determined under section 2651) as the deceased [Designated Beneficiary], the value of the account will not be included in the gross estate of the deceased [Designated Beneficiary] for Federal estate tax purposes.
>
> *Rule 3*. If no successor [Designated Beneficiary] is named in the section 529 account contract or program, but the [Account Owner] names a successor [Designated Beneficiary] who is a member of the family of the deceased [Designated Beneficiary] and is in the same or a higher generation (as determined under section 2651) as the deceased [Designated Beneficiary], the value of the account will not be included in the gross estate of the deceased [Designated Beneficiary] for Federal estate tax purposes.
>
> *Rule 4*. If no successor [Designated Beneficiary] is named in the section 529 account contract or program, and the [Account Owner] does not name a new [Designated Beneficiary] but instead withdraws all or part of the value of the account, the [Account Owner] will be liable for the income tax on the distribution, and the value of the account will not be included in the gross estate of the deceased [Designated Beneficiary] for Federal estate tax purposes.
>
> *Rule 5*. If, by the due date for filing the deceased [Designated Beneficiary's] estate tax return, the [Account Owner] has allowed funds to remain in the section 529 account without naming a new [Designated Beneficiary], the account will be deemed to terminate with a distribution to the [Account Owner], and the [Account Owner] will be liable for the income tax on the distribution. The value of the account will not be included in the gross estate of the deceased [Designated Beneficiary] for Federal estate tax purposes.

The Advance Notice proposes sensible rules for when a section 529 savings account should be included in the estate of the beneficiary. Some of these rules, however, require refinement.

Rule 1 requires inclusion in the deceased beneficiary's estate only if "the entire section 529 account" is distributed to the estate. Does this mean that if all but $100 of the account is distributed to the deceased beneficiary's estate, and then the beneficiary of the $100 remaining in the section 529 account is changed to a member of the family, there is no estate tax inclusion? Further, Rule 1 requires estate tax inclusion only if the distribution is made within six months of death, while Rule 5 only produces a deemed distribution to the account owner to the extent that funds are remaining in the account on the due date for filing the deceased beneficiary's estate tax return. Does this mean that a distribution to the deceased beneficiary's estate more than six months but less than nine months after death does not cause inclusion? Presumably both rules should rely on the same point in time. Presumably, the earnings portion of the distribution would be subject to income tax as income with respect to a decedent. However, no ten percent penalty tax should apply because Code section 530(d)(4)(B)(i) excludes from penalty tax a distribution made to the estate of the designated beneficiary after the designated beneficiary's death.

Rule 2 should apply only where the successor beneficiary is designated at the time of the deceased beneficiary's death and is then living.

Rule 3 should be clarified to state that it may apply with respect to only a portion of an account and to specify the date by which the change of beneficiary must be made (perhaps the due date for filing the deceased beneficiary's estate tax return).

The Advance Notice does not cover the situation where a successor beneficiary is named, either pursuant to the contract or program, or by the account owner after the death of the old beneficiary, and the successor beneficiary is not a member of the family of the old beneficiary. The Advance Notice would treat such a change of beneficiary as a distribution to the account owner and a new gift to a section 529 account by the account owner. Under such circumstances the section 529 savings account should not be included in the estate of the deceased beneficiary.

There also seems to be no rule for what happens if a new beneficiary is designated who is a member of the family of the deceased beneficiary but is in a lower generation than the old beneficiary. Following the underlying theory of the examples in the Advance Notice, if within the requested time period after the designated beneficiary's death a new designated beneficiary is designated who is a member of the family of the deceased designated beneficiary, but is in a lower generation than the old designated beneficiary, the deceased designated beneficiary should be treated as having made a transfer to the new designated beneficiary. Because under the tax theory of Code section 529 the deceased designated beneficiary is making an imputed transfer to the new designated beneficiary, the estate of the deceased designated beneficiary should be permitted to agree to inclusion in the estate of the deceased designated beneficiary. The account owner in such circumstances should be required to report the deemed transfer on an informational gift tax return and attach a consent signed by the personal representative of the deceased designated beneficiary's estate under which the old designated beneficiary agrees to be treated as the transferor of the deemed gift.

To the extent the personal representative of the deceased designated beneficiary's estate does not consent to estate tax inclusion, it is consistent with existing transfer tax principles to impose the transfer tax liability on the person in possession of the transferred property. It is the account owner who has actual access to the property. For administrative convenience, the forthcoming guidance could provide that to the extent the estate of the deceased designated beneficiary does not consent to estate tax inclusion, the account owner must report the transfer on the account owner's gift tax return. For this purpose the account owner should be deemed to be assigned to the deceased designated beneficiary's generation. In a purely theoretical world, because the account owner is only reporting and paying tax on a transfer from the deceased designated beneficiary, the deceased designated beneficiary's estate tax exclusion and GST exemption could be applied against such gift. However, they cannot, practically or legally, be applied without the consent of the estate of the deceased designated beneficiary. Therefore, the best that the forthcoming guidance can do is to permit the account owner to apply the account owner's own gift and GST tax exclusions and exemptions against the deemed transfer.

Rule 4, which prevents inclusion in the deceased beneficiary's estate if there is no successor beneficiary named and the account owner withdraws the funds, should specify the date by which the funds must be withdrawn (and no successor beneficiary designated). The ten percent penalty tax would appear to apply to the extent the distribution is included in the account owner's income. Code section 530(d)(4)(B)(i) states that the penalty tax does not apply if the payment or distribution is "made to a beneficiary (or to the estate of the designated beneficiary) on or after the death of the designated beneficiary." There is no exception for a distribution to an account owner.

Further, if the account owner was not the contributor to the account, under the Advance Notice the IRS would treat the account owner as having no "investment" in the account under Code section 72 and would tax the entire account. This is a harsh result, especially when there is no reasonable alternative for a new beneficiary (e.g., the account was for an only child or the child's siblings have already completed their education), the original account owner died and including the account in the beneficiary's estate would require probate proceedings that otherwise would be unnecessary.

Rule 5 states that if, by the due date for filing the deceased beneficiary's estate tax return, the account owner has allowed funds to remain in the section 529 savings account without naming a new beneficiary, the account will be deemed to terminate with a distribution to the account owner and the account owner will be liable for income tax on the distribution. First, many estates of deceased beneficiaries will not be required to file estate tax returns. Second, the ten percent penalty would appear to apply to the portion of the account includible for income tax purposes. Third, what will be the income tax consequences if the account owner subsequently actually terminates the account, having already paid income tax on the deemed distribution of the account? Fourth, if the account owner subsequently designates a beneficiary for the account, presumably that will be treated as a new gift by the account owner.

Additional rules should be proposed to cover the situation where the account owner is the same individual as the beneficiary. In such case, the entire account should be included in the deceased beneficiary's estate except to the extent (on a proportional basis) that contributions were made to the account by a third party. To the extent contributions were made to the account by a third party, the rules outlined above should apply.

D. **State Estate or Inheritance Tax**. States may differ in whether or not their estate or inheritance tax applies to section 529 accounts. Pennsylvania appears to exempt section 529 accounts from its inheritance tax.

E. **Marital Deduction**. To the extent a portion of a section 529 account is included in the donor's estate, could it qualify for the marital deduction? The following discussion is adapted from Comments of the American College of Trust and Estate Counsel on Section 529 Plans (letter to the IRS), which the author participated in drafting.

C contributes $60,000 to a section 529 account for the benefit of B, C's child, makes the five-year averaging election, and dies in Year 3 of the election period. C's spouse, S, is the successor account owner and has the power to distribute the account to herself. Does the portion of the account included in C's estate qualify for the marital deduction?

If the successor account owner is deemed to be the recipient of the portion of the account included in the contributor's estate, because the successor account owner would have the power to withdraw the section 529 account, the includible portion should qualify for the marital deduction. However, treating the designated beneficiary as the recipient of the portion included in the estate is most consistent with the gift tax treatment of a contribution under section 529, which treats a contribution to an account as a completed gift to the designated beneficiary.

If the beneficiary is treated as the recipient, the Service should create an exception permitting the deemed transfer to be to the distributee to the extent that prior to the time for filing the federal estate tax return, a distribution is made from the account. Thus if the contributor's spouse were the successor account owner and had the power to distribute the account to herself, she could make such a distribution to qualify the included portion for the marital deduction. Similarly, the Service might permit the beneficiary of the included portion to be changed prior to the time for filing the federal estate tax return and treat the new designated beneficiary as the recipient of the included portion.

Unless the decedent's spouse is the successor account owner and a marital deduction is permitted because the spouse can withdraw the section 529 account, a portion of a section 529 account that is included in the decedent's estate because the decedent died during the five-year averaging period will not qualify for the marital deduction. Further, a section 529 account that passes under the decedent's estate plan but is not included in the decedent's estate will not qualify for the marital deduction. If the section 529 account may be used to fund the marital deduction gift, the marital deduction must be reduced by the value of the section 529 account. Code § 2056(b)(2). Therefore, an estate plan should include a provision that the marital deduction gift cannot be funded with assets that do qualify for the marital deduction.

F. **GST Treatment**. To the extent a portion of a section 529 account is included in the donor's estate, are there GST consequences if the beneficiary is a skip person? C contributes $70,000 to an account for the benefit of B, C's grandchild, makes the five-year averaging election, and dies in Year 3 of the election period. C's child A is the successor account owner. Is C's death a generation-skipping transfer? Are future distributions to B generation-skipping transfers?

Code section 2612(c) provides that the term "direct skip" means "a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person." Code section 2613(a) defines "skip person" to mean either "a natural person assigned to a generation which is 2 or more generations below the generation assignment of the transferor" or "a trust if all interests in such trust are held by skip persons, or if there is no person holding an interest in such trust, and at no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person." Code section 2652(b) defines the term "trust" to include "any arrangement (other than an estate) which, although not a trust, has substantially the same effect as a trust." Because Code section 529 treats a contribution to a section 529 account as a completed gift to the designated beneficiary, if the designated beneficiary is a skip person the imputed transfer should be a direct skip.

This would be consistent with Code section 529(c)(2), which for gift tax purposes treats a contribution to a section 529 account as a completed gift to the designated beneficiary notwithstanding the fact that the designated beneficiary later may be changed or that the account may be distributed to the account owner. However, absent the adoption of such a special rule, the transfer would not be a direct skip if the designated beneficiary could be later changed to a non-skip person or if the account could be distributed to the account owner and the account owner is not a skip person with respect to the donor.

However, complicated tax problems could be created for a donor wishing to make a five-year election when the donor will not have sufficient GST exemption remaining at the time of death to allocate to the included portion. To carry out the purpose of encouraging contributions to Code section 529 accounts, the forthcoming guidance could adopt rules similar to the rules proposed in section II, E of the Advance Notice with respect to inclusion in the estate of a deceased designated beneficiary, which would permit certain actions taken during a specified period to determine the recipient of the Code section 529 contributions deemed to be included in the estate. For example, the distribution from the estate would be treated as passing to the account owner if the account owner took a refund during the specified period. Alternatively, the distribution would be deemed to be to a new designated beneficiary if the account owner changed the designated beneficiary during the specified period. Thus the estate could avoid GST tax consequences with respect to the included portion of the contribution where the designated beneficiary is a skip person by, within the specified period, either changing the designated beneficiary of that portion of the section 529 account to a non-skip person or refunding that portion of the section 529 account to the account owner if the account owner is a non-skip person. This is not abusive because if the designated beneficiary was subsequently changed to the former designated beneficiary who was a skip person, transfer tax consequences would ensue.

If the transfer is a direct skip and GST exemption is not allocated to the transfer, then GST tax would be imposed as of the decedent's death, and no GST tax would be imposed upon a subsequent distribution to a beneficiary/skip person who is two generations below the decedent. The tax would be paid by the decedent's estate. The estate plan or state law might direct that such GST tax be paid from the residue, or might direct that such GST tax be assessed against the assets (the section 529 account) subject to tax. Apportioning the GST tax against the assets in the section 529 account would be problematic because it might require that a nonqualified distribution be made from the section 529 account, and subject to income tax and the penalty, in order to pay the GST tax. The imposition of GST tax at the decedent's death would have the potential advantages of (1) taxing the section 529 account while it has a smaller value, (2) avoiding GST tax on the future appreciation of the section 529 account, and (3) permitting the payment of the tax from the residue of the estate. On the other hand, the immediate taxation that may result from treating the transfer as a direct skip has the disadvantages of (1) imposing an unnecessary tax if the section 529 account is eventually distributed to a non-skip person and (2) accelerating the payment of a tax.

G. **Estate Tax Reporting Options**. One could take the position, as described above, that no GST transfer occurs notwithstanding the estate tax inclusion. Unfortunately there is no authority to support this position.

Alternatively, one could take the position that the included portion should be treated as a direct skip because Code section 529 treated the gift as a completed gift to the beneficiary. This position ignores the facts that the designated beneficiary could be changed to a non-skip person and that the section 529 account could be distributed to an account owner who is a non-skip person. If the transfer is a direct skip, GST exemption would be automatically allocated under Code section

2632(b). If no GST exemption was available, GST tax would be imposed, even though the skip person beneficiary might not receive the assets.

One could take the position that no GST transfer occurs at the contributor's death, but only if a distribution is subsequently made to a skip person. This avoids the need to use GST exemption, which might be more effectively used elsewhere. However, GST exemption could be assigned if it is expected that the section 529 account will eventually be paid to a skip person. Alternatively, the account could be distributed to a non-skip person.

H. **Planning**. If it is desirable to ensure direct skip treatment of the includible portion of the section 529 account (to impose GST tax immediately and permit it to be paid by the residue of the estate), this could be accomplished potentially by structuring the section 529 account so that no distribution could be made after the decedent's death to a non-skip person. If the section 529 account was owned at the time of the decedent's death by a trust for the sole benefit of skip persons, the includible portion should be a direct skip. Alternatively, if as a result of the decedent's death the new account owner was the executor or trustee, who under the terms of the estate plan was prohibited from ever making a distribution to the account owner or from changing the beneficiary to a non-skip person, the includible portion should be a direct skip. Further, if direct skip treatment is desired, the estate plan should make clear that the GST taxes are to be paid from the estate residue, and not the section 529 account.

Alternatively, if the decedent has no remaining GST exemption, it may be desirable to structure the account ownership and estate plan so that the estate plan can direct that the beneficiary of any includible portion be changed to a non-skip person, to avoid GST consequences.

Alternatively, Code section 2611(b)(1) provides that the term "generation skipping transfer" does not include any transfer which, if made inter vivos by an individual, would not be treated as a taxable gift by reason of Code section 2503(e) (relating to exclusion of certain transfers for educational or medical expenses)." Therefore, no generation-skipping transfer should occur if the account owner were required to use the included portion of the section 529 account only for tuition or, if withdrawn in a nonqualified distribution, only for tuition or medical expenses. If a trust were the account owner, the trust could contain such terms.

V. Using Section 529 Savings Account Funds

A. Contributions

1. **Definition**. The proposed regulations define "contribution" as follows:

> *Contribution* means any payment directly allocated to an account for the benefit of a designated beneficiary or used to pay late fees or administrative fees associated with the account. In the case of a tax-free *rollover*, within the meaning of this paragraph (c),

into a QSTP account, only the portion of the rollover amount that constituted *investment in the account*, within the meaning of this paragraph (c), is treated as a contribution to the account as required by § 1.529-3(a)(2).

Prop. Treas. Reg. § 1.529-1(c).

2. **In Cash**. Contributions must be made in cash.

3. **Coverdell ESA**. As of 2002, a contribution to a section 529 account for a beneficiary may be made in a year in which a contribution is made to a Coverdell Education Savings Account ("Coverdell ESA," formerly called an Education IRA) for the same beneficiary without producing an excess contribution penalty. Code § 529(c)(3)(B)(vi); Code § 4973(e).

4. **Conversion of U.S. Savings Bonds**. Under some circumstances U.S. savings bonds may be redeemed without incurring federal income tax, if the proceeds are invested in a section 529 account. Under Code section 135, the proceeds of qualified U.S. savings bonds are excluded from income to the extent used to pay qualified higher education expenses paid by the taxpayer during the taxable year. "Qualified higher education expenses" includes contributions to a 529 program or an education IRA if the beneficiary is the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer for whom the taxpayer may take a deduction under Code section 151.

   a. **Qualified U.S. Savings Bond**. A qualified U.S. savings bond is a bond issued after December 31, 1989 (EE or I bonds), to an individual who has attained age 24 before the date of issuance. It must be registered in the individual's name alone, or with such individual's spouse as co-owner. No one else may be named as a co-owner. The individual's dependent child may not be an owner, but may be a beneficiary. Registration of bonds can be changed only in limited circumstances.

   b. **Modified Adjusted Gross Income**. In 2021, the exclusion is phased out for single taxpayers with modified adjusted gross income between $99,500 and $114,500 and for married taxpayers filing jointly with modified adjusted gross income between $149,250 and $179,250. A bond owner who is married filing separately may not claim the exclusion.

   c. **Basis**. The taxpayer's basis in the section 529 account is reduced by the untaxed interest.

   d. **Opportunities for Conversion**. Why convert a qualified U.S. savings bond to a section 529 account, rather than holding the bond and using the proceeds for qualified higher education expenses when incurred? First, the taxpayer may currently meet the modified adjusted gross income limitations, but may not meet those limitations in the year the expenses will be incurred. Second, the section 135 exclusion applies only to tuition and fees. Qualified distributions from a section 529 account may also be used for room, board, books and supplies.

5. **Bond in Child's Name**. Alternatively, a savings bond can be registered in the child's name and the child can pay the tax liability on the bond's earnings.

6. **Matching Grants**. Several states offer matching grants for contributions to section 529 accounts, in the range of $100 to $600 dollars. Matching grants may be one time or may be annual; if annual there may be a cap on the lifetime total amount of grants or the number of years in which grants may be received. Matching grants may be limited to state residents and are often limited to lower income participants. The rules for using matching grant funds may be different than the general rules for contributed funds, so be sure to understand the terms of the grants.

7. **First Steps**. About a dozen states offer a "First Step" program (which may go by other names such as "Baby Steps") under which the state will contribute an amount, generally from $50 to $200, to new section 529 accounts opened for children in that state. The parent may or may not be required to make a small initial contribution to the account. The rules for using First Step funds may be different than the general rules for contributed funds, so be sure to understand the terms of the First Step program. Usually, the account must be opened within a certain period of time after birth or adoption to qualify.

8. **Contributor**. Some QTPs may accept contributions only from the account owner, but most QTPs do not have such a restriction. Code section 529(b)(1)(A) provides that a "person" may contribute to a 529 savings account. The purposed regulations state that "person" has the same meaning as under Code section 7701(a)(1). Prop. Regs. § 51.529-(1)(c). Under Code section 7701(a)(1), "person" includes an individual, trust, estate, partnership, association, company and corporation. See also Treas. Reg. § 301.7701-6(a) including persons acting in a fiduciary capacity.

B. Age and Time Limits. A number of states impose a waiting period by requiring that the account be open for a certain period of time (typically one or two years) before distributions may be made. A few states require that distributions must begin by the time the beneficiary reaches a certain age or must be completed by a certain age or time.

C. Qualified Withdrawals. Qualified withdrawals are those made to pay for the beneficiary's *qualified higher education expenses*. Code § 529(c)(3).

1. **College and Trade School**. Tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution. Code § 529(e)(3)(A)(i).

   a. **Required**. If an expenditure is required by the school's catalogue or included in the school's "cost of attendance" for financial aid purposes, it should be a QHEE. Arguably, expenditures not explicitly included in the cost of attendance arguably should be qualified expenses if they are ordinary and reasonably necessary. However, the Tax Court took a very narrow view of what constituted supplies and equipment required for enrollment or attendance. In *Gorski v. Commissioner*, T.C. Summary Opinion 2005-112 (August 4, 2005), the Tax Court ruled that the purchase of a computer for a college student was not a QHEE under Code section 529(e)(3)(A). The case did not involve a 529 savings account but rather involved the issue of whether the 10% additional tax should be imposed on an IRA withdrawal to the extent it was used to purchase the computer. Early IRA withdrawals are not subject to the 10% additional tax if they are used for QHEE as defined in Code section 529. The Tax Court reasoned that the Code section provides that the supplies or equipment be "required" by the school for attendance. The court concluded that because the university being attended by the child did not require that a student own a computer, it was not a QHEE. The court was not moved by the petitioner's argument that the university only had a limited number of computers available for student use and that his daughter would have to walk back and forth from the library to her dorm room late at night in order to use the school's computers. Nor was the Tax Court moved by the argument that the professors used an Internet based system to post syllabi and course assignments and that certain university information is available only over the Internet.

   b. **Room and Board**. Qualified higher education expenses also include room and board for students who are enrolled in a degree certificate or other program leading to a recognized educational credential and carrying at least half the normal full-time work load for the course of study being pursued. Code § 529(e)(3)(B); Prop. Treas. Reg. § 1.529-1(c). However, Code section 529 limits the amount allowable:

      > The amount treated as qualified higher education expenses . . . shall not exceed (I) the allowance (applicable to the student) for room and board included in the cost of attendance (as defined in section 472 of the Higher

Education Act of 1965 (20 U.S.C. 1087ll), as in effect on the date of the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001) [June 7, 2001] as determined by the eligible educational institution for such period, or (II) if greater, the actual invoice amount the student residing in housing owned or operated by the eligible educational institution is charged by such institution for room and board costs for such period.

Code § 529(e)(3)(B)(ii); see Code § 25A(b)(3).

A student living with parents is entitled to claim room and board as a QHEE, but only if such expenses are actually paid to the parents.

c. **Transportation**. The cost of transportation to and from school is not a QHEE.

2. **Graduate and Professional Degrees**. Code section 529 envisions using section 529 account funds to attend professional or graduate school, as well as undergraduate institutions.

3. **Special Needs Services**. Expenses for special needs services in the case of a special needs beneficiary which are incurred in connection with such enrollment or attendance. Code § 529(e)(3)(A)(ii).

4. **Computer**. Expenses for the purchase of computer or peripheral equipment (as defined in Code section 168(i)(2)(B)); computer software (as defined in Code section 197(e)(3)(B)), or Internet access and related services, if such equipment, software, or services are to be used primarily by the beneficiary during any of the years the beneficiary is enrolled at an eligible educational institution. This shall not include expenses for computer software designed for sports, games, or hobbies unless the software is predominantly educational in nature. Code § 529(e)(3)(A)(iii).

a. **Expenses Included**

Code section 168(i)(2)(B)(i) defines "computer or peripheral equipment" to include any computer and "any related peripheral equipment." Code section 168(i)(2)(B) continues as follows:

(ii) COMPUTER. – The term "computer" means a programmable electronically activated device which –

(I) is capable of accepting information, applying prescribed processes to the information, and supplying the results of these processes with or without human intervention, and

(II) consists of a central processing unit containing extensive storage, logic, arithmetic, and control capabilities.

(iii) RELATED PERIPHERAL EQUIPMENT. – The term "related peripheral equipment" means any auxiliary machine (whether on-line or off-line) which is designed to be placed under the control of the central processing unit of a computer.

(iv) EXCEPTIONS. – The term "computer or peripheral equipment" shall not include –

(I) any equipment which is an integral part of other property which is not a computer,

(II) typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, and

(III) equipment of a kind used primarily for amusement or entertainment of the user.

With respect to software, Code section 197(e)(3)(B) defines "computer software" as "any program designed to cause a computer to perform a desired function. Such terms shall not include any database or similar item unless the database or item is in the public domain and is incidental to the operation of otherwise qualifying computer software."

In addition to the hardware and software, Code section 529(e)(3)(A)(iii) also permits the payment of Internet access and related services from the section 529 account.

b. **Timing of Purchase**. Literally, Code section 529(e)(3)(A)(iii) does not require that the hardware or software be purchased while the 529 designated beneficiary is enrolled at an eligible educational institution but only requires that it be used while the beneficiary is enrolled at an eligible educational institution. At least one commentator has suggested that this new provision of Code section 529 might be used to purchase a computer while the beneficiary is not enrolled at an eligible educational institution, in anticipation that the computer will be used by the beneficiary once he or she enrolls at an eligible educational institution. This would seem to be a result not intended by Congress.

I think it unlikely that the IRS would treat a distribution from a section 529 account as a qualified distribution if it is used to purchase a computer or software when the beneficiary is not yet enrolled at an eligible educational institution (or at least is not so enrolled by the end of the calendar year) because there would be no way to determine in the year the distribution is made whether or not the hardware or software in fact will meet the requirements of Code section 529(e)(3)(A)(iii). The beneficiary might, contrary to expectations, never enroll at an eligible educational institution. Alternatively, the hardware or software might never be used while the beneficiary is enrolled at an eligible educational institution if the hardware or software is damaged, destroyed or becomes obsolete prior to the beneficiary's enrollment. Note that the 2005 expansion of permitted elementary and secondary school expenses does not include a computer or internet services even though it includes online educational materials.

5. **Elementary and Secondary Expenses**. As of January 1, 2018, up to \$10,000 per beneficiary each taxable year, on the aggregate from all 529 accounts for such beneficiary could be used for primary or secondary tuition for the beneficiary. The 2025 Act increased the limit to \$20,000 beginning in 2026 and expanded the expenses that may be paid to expenses in connection with enrollment or attendance at, or students enrolled at, an elementary or secondary public, private or religious school including tuition, curricular materials, books, online educational materials, tutoring, fees for national standardized tests, and educational therapies for students with disabilities. Code § 529(c)(7); Prop. Treas. Reg. § 1.529-1(c).

a. **K-12**. The proposed regulations define "elementary or secondary" to mean kindergarten through grade 12 as determined under state law. See also *IRS Publication 970* (2024). This would exclude preschool.

b. **Expenses Included**.

(1) Tuition;

(2) Curriculum and curricular materials;

(3) Books or other instructional materials;

(4) Online educational materials;

(5) Tuition for tutoring or educational classes outside of the home, including at a tutoring facility, but only if the tutor or instructor is not related to the student and—

(A) is licensed as a teacher in any State,

(B) has taught at an eligible educational institution, or

(C) is a subject matter expert in the relevant subject;

(6) Fees for a nationally standardized norm-referenced achievement test, an advanced placement examination, or any examinations related to college or university admission;

(7) Fees for dual enrollment in an institution of higher education.

(8) Educational therapies for students with disabilities provided by a licensed or accredited practitioner or provider, including occupational, behavioral, physical, and speech-language therapies.

c. **State Law**. Not all states that have an income tax treat distributions for K-12 as exempt from state income tax. Even in a state that bases taxable income on federal taxable income, thereby not directly taxing a distribution for K-12, such a distribution could result in a clawback of any state income tax deduction.

d. **Questions and Comments**

(1) **Tuition**. It appears that only tuition, and not school fees, are included.

(2) **Curriculum and Curricular Materials**. This should include any books or other materials required by the school, and also curriculum purchased by those home schooling.

(3) **Books or Instructional Materials**. This is not limited to books required in the curriculum, or arguable even to only "educational" books.

(4) **Online Educational Materials**. Here the included materials are limited to "educational" materials.

(5) **Tuition for Tutoring**. I cannot charge my grandchild's 529 account for my tutoring, but you can use your children's or grandchildren's 529 accounts to pay for my tutoring. I qualify because I have taught at University of Michigan Law School, an eligible educational institution. There appears to be no limit to the subjects that I may tutor.

(6) **Standardized Tests**. Note, this includes SAT and advanced placement exams.

(7) **Fees for dual enrollment**.

(8) **Educational Therapies for Students with Disabilities**. So long as the provider is licensed or accredited, this is a very broad category covering physical, behavioral, occupational and speech therapies.

6. **Apprenticeship Programs**. The 2020 Act added Code section 529(c)(8), which provides that "qualified higher education expense" shall include qualified postsecondary credentialing expenses. Code § 529(e)(3)(C).

a. **Qualified Postsecondary Credentialing Expenses**. Qualified postsecondary credentialing expenses means –

(1) tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary in a recognized postsecondary credential program, or any other expense incurred in connection with enrollment in or attendance at a recognized postsecondary credential program if such expense would, if incurred in connection with enrollment or attendance at an eligible educational institution, be covered under subsection (e)(3)(A),

(2) fees for testing if such testing is required to obtain or maintain a recognized postsecondary credential, and

(3) fees for continuing education if such education is required to maintain a recognized postsecondary credential.

b. **Recognized Postsecondary Credential**. The term "recognized postsecondary credential" means—

(1) any postsecondary employment credential that is industry recognized and is—

(A) any postsecondary employment credential issued by a program that is accredited by the Institute for Credentialing Excellence, the National Commission on Certifying Agencies, or the American National Standards Institute,

(B) any postsecondary employment credential that is included in the Credentialing Opportunities On-Line (COOL) directory of credentialing programs (or successor directory) maintained by the Department of Defense or by any branch of the Armed Forces, or

(C) any postsecondary employment credential identified for purposes of this clause by the Secretary, after consultation with the Secretary of Labor, as being industry recognized,

(2) any certificate of completion of an apprenticeship that is registered and certified with the Secretary of Labor under the Act of August 16, 1937 (commonly known as the "National Apprenticeship Act"; 50 Stat. 664, chapter 663; 29 U.S.C. 50 et seq.),

(3) any occupational or professional license issued or recognized by a State or the Federal Government (and any certification that satisfies a condition for obtaining such a license), and

(4) any recognized postsecondary credential as defined in section 3(52) of the Workforce Innovation and Opportunity Act (29 U.S.C. 3102(52)), provided through a program described in 529(f)(2)(A).

c. **Recognized Postsecondary Credential Program**. The term "recognized postsecondary credential program" means any program to obtain a recognized postsecondary credential if—

(1) such program is included on a State list prepared under section 122(d) of the Workforce Innovation and Opportunity Act (29 U.S.C. 3152(d)),

(2) such program is listed in the public directory of the Web Enabled Approval Management System (WEAMS) of the Veterans Benefits Administration, or successor directory,

(3) an examination (developed or administered by an organization widely recognized as providing reputable credentials in the occupation) is required to obtain or maintain such credential and such organization recognizes such program as providing training or education which prepares individuals to take such examination, or

(4) such program is identified by the Secretary, after consultation with the Secretary of Labor, as being a reputable program for obtaining a recognized postsecondary credential for purposes of this subparagraph.

d. **Tuition, fees, books, supplies, equipment and other expenses**. Presumably the same rules apply as in the college context for (1) computer equipment and internet access, and (2) special needs services because these are included in Code section 529(e)(3)(A).

In the context of eligible educational institutions, however, room and board is covered under Code section 529(e)(3)(B), so is presumably not covered for apprenticeship programs.

e. **Fees for Testing**. Fees for testing required to obtain or maintain a recognized postsecondary credential would include, for example, fees for a bar exam.

f. **Fees for Continuing Education**. For example, if a state requires a certain number of mandatory CLE hours, the fees paid for those seminars could be paid out of a section 529 account.

7. **Student Loan Repayment**. The 2020 Act added Code section 529(c)(9), which provides that "qualified higher education expense" shall include amounts paid as principal or interest on any qualified education loan (as defined in Code section 221(d)) of the designated beneficiary or sibling of the designated beneficiary.

a. **$10,000 Limit**. Only up to $10,000 in the aggregate of loans for any individual may be repaid under Code section 529.

b. **Sibling**. The term "sibling" means an individual who bears a relationship to the designated beneficiary which is described in Code section 152(d)(2)(B) and includes step-siblings.

8. **Postsecondary Credentialing Expenses**. Qualified postsecondary credentialing expenses, which includes tuition, fees, books, supplies and equipment required for the enrollment or attendance in a recognized postsecondary credential program, fees for mandatory testing and fees for mandatory continuing education. Code § 529(f).

9. **QTP Contributions**. Qualified higher education expenses include contributions to a QTP.

10. **Coverdell ESA Contributions**. Qualified higher education expenses include contributions to a Coverdell ESA.

11. **No Tracing**. Code section 529 does not actually trace the use of the funds distributed from the section 529 account but rather merely compares adjusted qualified education expenses with the amount withdrawn. *IRS IRS Publication 970* (2024), pp. 51, states:

> To determine if total distributions for the year are more or less than the amount of qualified education expenses, you must compare the total of all QTP distributions for the tax year to the [adjusted qualified education expenses.].

Adjusted qualified education expenses (AQEE). This amount is the total qualified education expenses reduced by any tax-free educational assistance. Tax-free educational assistance includes:

- The tax-free part of scholarships and fellowships grants (see *Tax-Free Scholarships and Fellowship Grants* in chapter 1);
- Veterans' educational assistance (see *Veterans' Benefits* in chapter 1);
- The tax-free part of Pell grants (see *Pell Grants and Other Title IV Need-Based Education Grants* in chapter 1);
- Employer-provided educational assistance (see chapter 11); and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

Thus a parent or other individual can pay tuition or other QHEEs directly and still take tax-free withdrawals from the section 529 account.

12. **State Restrictions**. Some states allow qualified withdrawals only after the section 529 account has been open for a certain period of time.

13. **Eligible Educational Institution**. Generally, section 529 account funds may be used at any "eligible educational institution." However, a QTP may limit the schools at which the funds may be used. The restriction to eligible educational institutions does not apply to distributions for elementary and secondary school expenses and apprenticeship programs.

14. **Qualified Higher Education Expenses**. Contributions to a section 529 account must be used for "qualified higher education expenses" in order to receive favorable income tax treatment.

15. **Substantiation**. It is the taxpayer's responsibility to maintain records showing that distributions were used for qualified expenses. *Martinez v. Comm.,* U.S. Tax Ct. (Sept. 28, 2016). Receipts should be retained. This could be burdensome for a student living off campus who is claiming room and board expenses as a QHEE and therefore must save grocery and fast food receipts.

16. **Timing of Withdrawals**. The Advance Notice proposes a rule that, in order for earnings to be excluded from income, any distribution from a section

529 account during a calendar year must be used to pay QHEEs in the same calendar year or by March 31 of the following year.

17. **Contributions of Refunded Amounts**. Sometimes a beneficiary receives a refund from the school. Such a refund can be recontributed to the section 529 account without penalty within 60 days of the refund. Code § 529(c)(3)(D).

18. **American Opportunity and Lifetime Learning Credit**. Qualified higher education expenses are reduced by expenses that are used to claim the American Opportunity Credit or Lifetime Learning Credit. If a section 529 account distribution is used to pay expenses that are then used to claim the American Opportunity or Lifetime Learning Credit on the beneficiary's or parent's income tax return, the distribution will be nonqualified. See *IRS Publication 970* (2024). The American Opportunity or Lifetime Learning Credit may be waived, but it may be better to claim the credit and treat the section 529 account distribution as nonqualified.

19. **Coverdell ESA**. A beneficiary who receives distributions from a Coverdell ESA and a section 529 account in the same year is required to allocate qualified expenses in order to determine the amount excludible from income. Each expense can be used only to protect either the Coverdell ESA distribution or the section 529 account distribution, but not both. Code § 529(c)(3)(B)(vi).

20. **Control Over Distributions**. The account owner typically controls whether or not funds are distributed for education expenses. However, Code section 529 does not require that the account owner have this power; rather, it is the terms of the state program that may grant or deny the account owner this power.

21. **Federal Income Taxation**. Qualified distributions from section 529 account programs are exempt from federal income tax. Code § 529(a); Code § 529(c).

22. **Scholarship, Death or Disability**. A penalty is not imposed on a distribution made on account of the death or disability of the designated beneficiary or on account of a scholarship received by the designated beneficiary (but only to the extent of the amount of the scholarship). Prop. Treas. Reg. § 1.529-2(e)(1). However, the earnings on the section 529 account will be taxed to the distributee. Prop. Treas. Reg. § 1.529-3(a). Therefore it may be preferable to name a new beneficiary than to refund the section 529 account under such circumstances.

D. **Rollovers**. Most states allow an account owner to switch to another state's program by making a rollover. Any rollover from one state program to another must take place within 60 days of the distribution, or it will be treated as a nonqualified distribution. However, a rollover is permitted only once in any given twelve-month period for a beneficiary. Code section 529(c)(3)(C)(iii) states that Code section 529(c)(3)(C)(i)(I) (permitting a rollover without changing the beneficiary) "shall not apply to any transfer if such transfer occurs within 12 months from the date of a previous transfer to any qualified tuition program for the benefit of the designated beneficiary." (A rollover within 12 months of establishing the section 529 account or within 12 months of making a contribution to a section 529 account should not fall within the language of Code section 529(c)(3)(C)(iii).) The reason for this limit is described in Prop. Treas. Reg. section 1.529, comment at paragraph [50], stating the following:

> The Internal Revenue Service is concerned about the use of multiple rollovers to circumvent the restriction on investment direction. In particular, the Internal Revenue Service requests comments on this issue, including whether limits should be placed on the number of rollovers permitted within a certain time period or rollovers back to the original designated beneficiary.

The once-every-12-months limitation is a per-beneficiary limitation, not a per-account limitation. Thus if there are multiple section 529 accounts for the same beneficiary and one is rolled over, a rollover of any other section 529 account for the same beneficiary within the following 12 months would be a nonqualified distribution. An account owner could roll over a section 529 account for a beneficiary without realizing that a section 529 account for the same beneficiary, but with a different account owner, had been rolled over within 12 months.

It is impossible for an account owner of an account for a given beneficiary to know whether other accounts with different account owners exist for such beneficiary, much less whether any such accounts have been rolled over during the past twelve months. Therefore, the final regulations should make clear that Code section 529(c)(3)(C)(iii) applies only if the particular account owner rolled over the same or another account for the beneficiary within the last twelve months. Accounts for the same beneficiary that have different account owners should not be aggregated for this purpose.

1. **Rollover with Beneficiary Change**. A rollover to another state plan can still be made at any time without adverse tax consequences if (a) the beneficiary is changed, (b) the new beneficiary is a "member of the family" of the old beneficiary and (c) the new beneficiary is not in a younger generation than the old beneficiary. Code § 529(c)(3)(C)(i)(II).

2. **Tracing Earnings**. The distributing program must provide to the receiving program a statement setting forth the earnings portion of the rollover distribution within 30 days after the distribution or by January 10th of the year following the calendar year in which the rollover occurred, whichever is earlier. Notice 2001-81, 2001-52 I.R.B. 617.

3. **State Income Taxation**

a. **Outgoing Rollover: Income Tax Deduction Recapture**. In some states, if a state income tax deduction was received for a contribution to a section 529 savings account and the account is then rolled over to a different state, the income tax deduction will be recaptured. In some states recapture applies only if the rollover occurs within a specific period of time after opening the account or after the contribution. How the recapture is calculated if not all contributions to the account qualified for the deduction may vary from state to state.

b. **Incoming Rollovers: Income Tax Deduction**. In some states, rollover contributions (or at least the principal portion of the rollover), as well as original contributions, to the state program might qualify for the state income tax deduction. In other states rollover contributions do not qualify for the state income tax deduction or are only deductible if not previously deducted.

4. **Fees**. QTPs may charge fees on rollovers.

E. Withdrawal and Recontribution. A United States Tax Court case illustrates how easy it is to violate unintentionally the distribution and rollover rules under Code section 529 with disastrous results. In *Karlen v. Commissioner* (T.C. Summary Opinion 2011-129, November 10, 2011), Tim Karlen had 529 accounts for his three children. Tim began to experience some financial difficulty when his income decreased because of the downturn in the national economy and requested distributions of $3,500 from each of the 529 accounts. On the request form, Tim indicated that the withdrawals were "nonqualified withdrawals" rather than "withdrawals for rollover." The 529 plan mailed the three checks to him. After receiving the checks, Tim conferred with his wife about the distributions, and she persuaded him that they should not withdraw the money from the 529 accounts. Tim then informed a representative for the 529 plan that he did not wish to take the distributions. The representative told Tim that because no error had been made by the program in processing his request for distributions, the transactions could not be voided. The representative instructed Tim to endorse the three checks and return them if he wished to redeposit the amounts. Tim did so immediately.

When the 529 program received the three checks, it redeposited each one as a new contribution into the same account from which it had been withdrawn. Thereafter, Tim received a Form 1099-Q, Payments from Qualified Education Programs (Under Sections 529 and 530), from the 529 plan for each of the three distributions.

The IRS argued that the distributions were nonqualified distributions and that even though the uncashed checks were returned to the program, they still constituted nonqualified distributions followed by a recontribution. Further, the recontributions did not qualify as rollovers. Therefore, income tax and the additional penalty tax was assessed on the earnings portion of each distribution. Tim argued that the distributions should not be considered to have been received because he did not cash or deposit the checks, or alternatively that the recontributions should constitute a rollover.

The Tax Court concluded that the receipt of a check, even though it is not cashed or deposited, completed the distributions from the 529 accounts. The Tax Court also found that when Tim returned the checks to be recredited to the accounts, it did not constitute a valid rollover. In order to comply with the rollover rules, the rollover either needs to be to an account for the benefit of a different beneficiary or needs to be to a different program. Code section 529(c)(3)(C)(i) provides:

> (C) CHANGE IN BENEFICIARIES OR PROGRAMS. –
>
> (i) ROLLOVERS. – Subparagraph (A) shall not apply to that portion of any distribution which, within 60 days of such distribution, is transferred –
>
> (I) to another qualified tuition program for the benefit of the designated beneficiary, or
>
> (II) to the credit of another designated beneficiary under a qualified tuition program who is a member of the family of the designated beneficiary with respect to which the distribution was made.

Had Tim consulted his tax counsel when he changed his mind, tax counsel might have suggested that he establish new accounts under a different state program for his children and deposit the proceeds from the distributions in the new accounts within 60 days in order to comply with the rollover rules. Possibly, the rollover rules would have been met even if Tim had simply directed that the distribution from Child A’s account be deposited in Child B’s account, the distribution from Child B’s account be deposited in Child C’s account, and that the distribution from Child C’s account be deposited in Child A’s account.

The Tax Court feebly offered the consolation that Tim’s basis in each account would be increased because of the “new” contribution to the account. The basis, however, is irrelevant if the funds are ultimately used for qualified higher education expenses.

The Tax Court did not address the gift tax consequences of the recontributions to the accounts, presumably because the distributions were well within the limits of the $13,000 gift tax annual exclusion, and presumably the taxpayer and his wife were not making other gifts to their children given their financial difficulties (or at least not other gifts in sufficient amounts to push them over the gift tax annual exclusion).

The Tax Court, however, could not stomach applying the 10% additional tax on the earnings portion of the distribution. The Tax Court found that to "impose a 10-percent additional tax upon petitioners given the unique facts in this case would be like throwing salt into a wound." In my view the Tax Court's legal reasoning in finding that the penalty should not apply is very strained and leaves me wondering why the Court was not willing to stretch equally far in order to find that the return of the checks constituted a rollover.

The lesson is that the rules governing distributions, rollovers and changes of beneficiaries are complex and clients should consult their tax advisors first.

F. **Rollover to Roth IRA**. A Roth IRA Rollover is a direct transfer from an Account to a Roth IRA on or after January 1, 2024, that meets the following requirements:

(1) The Account must have been maintained for the 15-year period ending on the date of the Roth IRA Rollover.

(2) The Roth IRA Rollover must be made in a direct trustee-to-trustee transfer to a Roth IRA maintained for the benefit of the designated beneficiary of the Account.

(3) Each year, the 529-to-Roth IRA Rollover will be subject to annual IRA contribution limits, minus all other IRA contributions made during the year for the same designated beneficiary. Roth IRA Rollovers are subject to the annual contribution limit for Roth IRAs. For 2024 and 2025, the limit is $7,000. In addition, such rollovers may not exceed the amount of compensation the designated beneficiary earned during the year (e.g. wages and self-employment income) for the year. The Roth IRA modified adjusted gross income limits appear not to apply to Roth IRA Rollovers.

(4) The amount of the Roth IRA Rollover may not exceed the aggregate amount contributed to account (and earnings attributable thereto) before the 5-year period ending on the date of the IRA Rollover.

(5) The aggregate amount for all years of Roth IRA Rollovers for the same beneficiary from all 529 QTPs may not exceed $35,000.

G. **Changing Investment Options**

1. **Future Contributions**. The account owner should be able, at any time, to designate a different investment option for future contributions without violating the Code section 529(b)(4) limitation on investment decisions. This was confirmed by private letter ruling 200123065 (Indiana's plan), which permitted the account owner to vary the percentage of contributions

going into each fund once per quarter, but only with respect to future contributions.

2. **Existing Account**. Code section 529(b)(4) provides:

> A program shall not be treated as a qualified tuition program unless it provides that any contributor to, or designated beneficiary under, such program may directly or indirectly direct the investment of any contributions to the program (or any earnings thereon) no more than two times in any calendar year.

3. **Account Aggregation**. The final regulations should state the extent to which accounts will be aggregated for purposes of applying this rule. Because it may be impractical to coordinate investment changes in accounts in different QTPs to occur on the same day, and impractical for different account owners with accounts for the same beneficiary to coordinate investment changes so that they occur on the same day, any aggregation rule should only apply to accounts in the same QTP with the same account owner and the same beneficiary.

H. Changing the Account Owner. The Proposed Regulations define "account owner" as the individual "entitled to select or change the designated beneficiary of an account, to designate any person other than the designated beneficiary to whom funds may be paid from the account, or to receive distributions from the account if no such other person is designated." Prop. Treas. Reg. § 1.529-1(c). Because the account owner generally must approve section 529 account withdrawals, can change the beneficiary and can withdraw the funds himself or herself, the identity of the account owner is important. Most programs permit the account owner to designate a successor account owner when opening the section 529 account.

1. **Voluntary Changes During Account Owner's Life**. Most QTPs permit a change of account owner during the life of the current account owner. Some programs do not permit a change of account owner unless the current account owner dies or becomes incapacitated. See, *e.g.*, Delaware, Louisiana, Massachusetts, and New Hampshire. At least one QTP, *e.g.* Arizona, may report a change of account owner as a nonqualified distribution.

2. **Incapacity of Account Owner**. Programs differ in how the account is managed if the owner becomes incapacitated during life. Some programs permit the designated successor account owner to act. Some programs require a court order to determine ownership or provide that the court appointed guardian of the estate would become the account owner. Some programs permit an agent under a power of attorney to act on behalf of an incapacitated account owner. Some plans require that their own power of attorney forms be used. Some plans have their own power of attorney forms

but may accept other forms. Other plans require that the power of attorney used by the account owner be submitted for approval by the program.

If the program permits an agent under a power of attorney to act on behalf of an incapacitated account owner, or does not adequately address who may act on behalf of an incapacitated account owner, it may be prudent specifically to authorize an agent under a power of attorney to take such actions with respect to the section 529 account. Specific authority is advisable because under state law general grants of authority often do not grant the power to make and revoke gifts, change beneficiary designations or otherwise alter an estate plan, or take fiduciary actions. Authorizing a distribution from a section 529 account to the designated beneficiary could be construed as a gift for property law purposes (because until the funds could be refunded to the account owner) and a fiduciary action. Refunding the section 529 account to the account owner could be construed as revoking a gift. Changing the beneficiary of a section 529 account could be construed as a fiduciary action or altering an estate plan. See Timothy H. Guare, *To What Extent May an Attorney-In-Fact Deal with a Qualified State Tuition Program Account Created by a Principal?*, 139 Tr. & Est., No. 9, 33 (Sept. 2000).

3. **At Original Account Owner's Death**. The program may permit the original account owner to designate a successor account owner. The account owner may need to either designate a contingent account owner on a form provided by the program or name a successor account owner in the original account owner's Will. If at the original account owner's death no contingent account owner is effectively designated as permitted under the plan, the program's policy determines who becomes the account owner. If no successor account owner is named and the program's rules pass ownership to the account owner's estate, the executor would presumably be obligated to pass the section 529 account assets to the beneficiaries under the Will. If the Will does not include a provision dealing with the section 529 account, the assets would pass to the residuary beneficiaries, who may not have been the intended beneficiaries of the section 529 account.

4. **Anti-Abuse Rules**. The Advance Notice of Proposed Rulemaking is concerned about the potential for abuse "where there is a change from one [Account Owner] to a new [Account Owner], thus giving the new [Account Owner] all rights to and control over the section 529 account, including the right to completely withdraw the entire account for the new [Account Owner's] benefit." The Advance Notice does not propose any limits on changes of account owners, although it does propose rules on taxation of distributions to account owners. However, the Advance Notice states that if "concerns regarding abuse continue, the IRS and the Treasury Department will consider adopting broader rules including, for example . . . limiting the circumstances under which the [Account Owner] may name a different [Account Owner]."

I. **Changing the Designated Beneficiary**. Generally, the account owner can change the designated beneficiary at any time. Code § 529(c)(3)(C). In fact, the account owner does not even have to tell the beneficiary that an account has been established for him or her. Some states have age restrictions or other limits on who may be the designated beneficiary. There are no tax consequences to changing the designated beneficiary as long as (1) the new beneficiary is a member of the family of the old beneficiary and (2) for GST tax purposes, the new beneficiary is assigned to the same generation as (or a higher generation than) the old beneficiary. Code § 529(c)(3)(C)(ii); Code § 529(c)(5)(B); Prop. Treas. Reg. § 1.529-5(b)(3)(i).

1. **Family Members**. "Member of the family" is defined to mean:

    a. A son or daughter, or a descendant of either;

    b. A stepson or stepdaughter, or a descendant of either;

    c. A brother, sister, stepbrother, or stepsister;

    d. The father or mother, or an ancestor of either;

    e. A stepfather or stepmother;

    f. A cousin;

    g. A son or daughter of a brother or sister;

    h. A brother or sister of the father or mother;

    i. A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or

    j. The spouse of the designated beneficiary or the spouse of any individual described in paragraphs (1) through (9) of this definition.

    Prop. Treas. Reg. § 1.529-1(c); Code § 529(e)(2); Code § 152(d)(2).

2. **First Cousins**. It is important to note that under the 2001 Act, a first cousin is a "member of the family" of a designated beneficiary. Thus a donor having two grandchildren with different parents may change the beneficiary from one grandchild to the other without adverse tax consequences. Code § 529(e)(2).

3. **Who's Not a Family Member**? "Member of the family" does not include a grandniece or grandnephew, the descendant of a stepchild, or a spouse's niece or nephew.

4. **Income Tax Consequences**. If the new beneficiary is not a member of the family of the old beneficiary, the change in beneficiary is treated as a nonqualified distribution to the account owner. Prop. Treas. Reg. § 1.529-3(c)(1). Code section 529(c)(3)(A) provides that any distribution under a qualified tuition program shall be includible in the gross income of the distributee in the manner as provided under Code section 72 to the extent not excluded from gross income under any other provision of this Chapter. Generally, this would mean that the earnings portion of the distribution would be subject to income tax. However, the proposed rules in the Advance Notice would subject the account owner to income tax on the entire distribution "except to the extent that the account owner can substantiate that the [Account Owner] made contributions to the section 529 account and, therefore, has an investment in the account within the meaning of section 72." Thus a successor account owner who did not make any contributions to the account would be subject to tax on the entire distribution. The ten percent penalty would apply to the entire amount includible in income.

5. **Gift Tax and GST Tax Consequences**

   a. **New Beneficiary Not Family Member**. It is likely that if the beneficiary is changed and the new beneficiary is not a member of the family of the old beneficiary, then the change of beneficiary is treated as a new gift from either the old beneficiary or the account owner to the new beneficiary. Presumably the five-year averaging rule could be applied to this deemed transfer. The Committee Reports state that, unless a change in the designated beneficiary is to a new beneficiary who is both a member of the family of the old beneficiary and assigned to the same generation of the old beneficiary, "a transfer from one beneficiary to another beneficiary (or a change in the designated beneficiary) will be treated as a taxable gift from the old beneficiary to the new beneficiary to the extent it exceeds the $10,000 present-law gift tax exclusion." H.R. REPT. NO. 105-148 (H.R. 2014), at 327-28; H.R. CONF. REPT. NO. 105-220 (H.R. 2014), at 356, 364.

   b. **New Beneficiary in Younger Generation**. Regardless of family relationship, the change of beneficiary is treated as a gift if the new beneficiary is one or more generations below the old beneficiary, and is also treated as a GST transfer if the beneficiary is two generations or more below the old beneficiary. Prop. Treas. Reg. § 1.529-5(b)(3)(ii); Code § 529(c)(5)(B).

   c. **Annual Exclusion**. The deemed gift would be to a section 529 account for the new beneficiary and thus would qualify for the gift tax annual exclusion. Further, the proposed regulations provide that the five-year averaging rule may be applied to this deemed transfer. Prop. Treas. Reg. § 1.529-5(b)(3)(ii).

d. **Who Is Donor**? The statute does not identify who is the donor of the gift. However, the proposed regulations treat the old beneficiary as the donor, even though the account owner controls the change of beneficiary. The Preamble to the Proposed Regulations states:

> Also, because a contribution after August 5, 1997, is a completed gift from the contributor to the designated beneficiary, any subsequent transfer which occurs by reason of a change in the designated beneficiary to the account of another beneficiary is treated, to the extent it is subject to the gift and/or generation-skipping transfer tax, as a transfer from the original designated beneficiary to the new beneficiary. This is the result even though the change in beneficiary or the rollover is made at the direction of the contributor under the terms of the contract.

The Proposed Regulations are consistent with the Committee Reports, which state:

> [A] transfer from one beneficiary to another beneficiary (or a change in the designated beneficiary) will be treated as a taxable gift from the old beneficiary to the new beneficiary to the extent it exceeds the $10,000 present-law gift tax exclusion.

H.R. REPT. NO. 148 (H.R. 2014), at 327 – 328; H.R. CONF. REPT. NO. 105-220 (H.R. 2014), at 356, 364.

Under this analysis, the old beneficiary is responsible for any gift and GST taxes if the new beneficiary is of a lower generation! Prop. Treas. Reg. § 1.529-5(b)(3)(ii). There are legal and practical problems with treating the old beneficiary as the account owner. First, the gift tax is an excise tax on the privilege of transferring property, and thus avoids being an unconstitutional direct tax. However, unless the beneficiary is the account owner, the beneficiary has only a mere expectancy and does not have any property interest to transfer. Further, the old beneficiary is not making the transfer and had no control over the account. Second, on the practical side, how do you impose gift tax consequences on a beneficiary who does not know that he or she has made a gift, and who may even be a minor? The Advance Notice notes that "several comments on the 1998 Proposed Regulations raised concerns about the imposition of tax on the former [Designated Beneficiary]. In many cases, the [Designated Beneficiaries] are minors who may not be aware of the existence of the account for that benefit."

The Advance Notice sets forth an alternative analysis and proposes to assign the tax liability to the account owner by treating a change of beneficiary that is subject to gift tax "as a deemed distribution to the [Account Owner] followed by a new gift." Presumably, the deemed distribution would fall within the rollover rule exception of Code section 529(c)(3)(C)(i) if the new beneficiary is a member of the family of the old beneficiary and therefore would not be treated as a nonqualified distribution. See also § 529(c)(3)(C)(ii).

However, treating the account owner as the transferor for gift and GST tax purposes is inconsistent with the theoretical tax universe of Code section 529, in which a completed gift was made to the old beneficiary, and therefore the old beneficiary should be the transferor of any subsequent gift. An example may help to illustrate the problem.

Assume Grandparent is the account owner of an account for Child. Grandparent then changes the beneficiary to Child's child, Grandchild. In the 529 theoretical tax universe, the gift is from Child to Grandchild, should only be subject to gift tax, and Child should be permitted to use Child's exclusions against the gift. Under the theory of the Advance Notice, the gift is from Grandparent to Grandchild, which is inconsistent with the fact that Grandparent already incurred the gift tax consequences of passing the assets down one generation. Even if Grandparent's initial gift was sheltered by gift tax annual exclusions, the Grandparent relinquished the opportunity to use such exclusions against other gifts the Grandparent may have made to Child, and Grandparent can never recover those exclusions.

Therefore, consistent with the tax theory of Code section 529, the gift should be treated as if it were from the old designated beneficiary. The forthcoming guidance should permit the old designated beneficiary to agree to be treated as the transferor of the deemed gift and to file a gift tax return reporting such transfer if a gift tax return is required. The account owner in such circumstances should only be required to report the deemed transfer on an informational gift tax return and attach a consent signed by the old designated beneficiary under which the old designated beneficiary agrees to be treated as the transferor of the deemed gift.

In the case of a minor designated beneficiary, the regulations should permit a parent or guardian to sign such a consent, to file the minor's gift tax return if one is required and potentially to make the five-year election on behalf of the old designated beneficiary. However, to avoid permitting a parent or guardian to use a minor's lifetime gift tax exclusion or GST exemption, a parent or guardian should only be permitted to report such gifts to the extent they qualify for the gift tax annual exclusion (and when applicable, the GST tax annual exclusion), taking into account any five-year election. Where a parent or guardian files a gift tax return on behalf of a minor designated beneficiary, to the extent the deemed transfer does not qualify for the annual exclusion, it should be reported on the account owner's gift tax return.

To the extent the designated beneficiary does not consent to report the deemed transfer on the designated beneficiary's gift tax return, it is consistent with existing gift tax principles to impose the gift tax liability on the person in possession of the gifted property. Although ordinarily this would be the donee, in the 529 universe it is the account owner who has actual access to the property. For administrative convenience, the forthcoming guidance from the IRS could provide that to the extent the designated beneficiary does not consent to being treated as the transferor of the deemed transfer, the account owner must report the deemed transfer on the account owner's gift tax return. However, the account owner should be deemed to be assigned to the same generation as the old designated beneficiary. In a purely theoretical world, because the account owner is only reporting and, if required, paying tax on a gift from the old designated beneficiary, the old designated beneficiary's annual exclusions, lifetime gift tax exclusion and GST exemption could be applied against such gift. However, they cannot be so applied without the old designated beneficiary's consent. Therefore, to reach a result that approximates the theoretical result, the forthcoming guidance should permit the account owner to apply the account owner's own exclusions and exemptions against the deemed transfer.

In the example above, this means the Grandparent/account owner would be deemed to be in the Child's generation and would be treated as making a transfer down one generation. Thus to the extent the Grandparent did not have annual exclusions available for the deemed gift to Grandchild, only gift tax, and not GST tax, would apply. Further, Grandparent may use Grandparent's gift tax annual exclusions and lifetime exclusion.

J. Nonqualified Distribution

1. **Nonqualified Distribution to Account Owner**. The account owner can direct a nonqualified distribution to the account owner.

a. **Taxation at Account Owner's Rate**. The account owner must pay income tax on the earnings portion of a nonqualified distribution, at the account owner's income tax rate. However, the proposed rules in the Advance Notice would subject the account owner to income tax on the entire distribution "except to the extent that the account owner can substantiate that the [Account Owner] made contributions to the section 529 account and, therefore, has an investment in the account within the meaning of section 72." Thus a successor account owner who did not make any contributions to the account would be subject to tax on the entire distribution. The ten percent penalty would apply to the entire amount includible in income. If the account owner is in a high income tax bracket, consider changing the account owner to a family member in a lower bracket (assuming the program permits such a change) before taking the nonqualified distribution.

b. **Tax Penalty**. If section 529 account funds are withdrawn and not 1) used for qualified education expenses for the designated beneficiary, 2) refunded on account of the death or disability of the designated beneficiary, or 3) refunded on account of a scholarship received by the designated beneficiary, then the earnings from the account are subject to a ten percent federal penalty. Code § 529(c)(6). State penalties may also apply.

c. **State Restrictions**. Some state programs place limitations on when the account owner can request a refund and whether a partial refund is possible. Code section 529, itself, neither prohibits nor requires refunds at the request of the account owner. Code § 529(c)(3).

d. **State Income Tax**. State income taxation varies. Idaho, for example, includes the entire nonqualified distribution in income.

2. **Nonqualified Distribution to Beneficiary**. Some state programs may permit the account owner to direct the distribution to the beneficiary. In this case, the beneficiary would pay income tax on the earnings portion of the nonqualified distribution, at the beneficiary's income tax rate. In many cases the beneficiary's income tax rate would be lower than the account owner's income tax rate, resulting in income tax savings. However, the account owner may not want the beneficiary to have unrestricted control of the funds.

3. **Distribution to Third Party**. Some state programs permit the account owner to direct the distribution to a third party. It is unclear who would pay the income tax and penalty in this case. Code section 529(c)(3) states that any "distribution under a qualified tuition program shall be includible in the gross income of the distributee." The proposed regulations define "distributee" as "the designated beneficiary or the account owner who

receives or is treated as receiving a distribution from a QSTP." Prop. Treas. Reg. § 1.529-1(c). Thus under the proposed regulations, a distribution to a third party could be construed as a distribution to the account owner, followed by a gift from the account owner to the third party. If the third party is a member of the family of the old beneficiary and is in the same generation as the old beneficiary, it may be preferable to change the beneficiary to the third party before directing the distribution to avoid the imputed gift from the account owner. If the third party is a member of the family of the old beneficiary but is in a lower generation than the old beneficiary, it may still be preferable to change the beneficiary before directing the distribution if the account owner is already making annual exclusion gifts to the third party and the old beneficiary's annual exclusions (with a five-year averaging election, if required) could exclude the gift from taxation (assuming the gift is attributed to the old beneficiary).

VI. **Anti-Abuse Rules**. The Advance Notice presages an anti-abuse rule, which may be applied on a retroactive basis, that "will generally follow the steps in the overall transaction by focusing on the actual source of the funds for the contribution, the person who actually contributes the cash to the section 529 account, and the person who ultimately receives any distribution from the account." The favorable tax treatment granted by Code section 529 will be denied if "it is determined that the transaction, in whole or in part, is inconsistent with the intent of Code section 529." We can look forward to examples "that provide clear guidance to taxpayers about the types of transactions considered abusive." The Advance Notice makes reference to the two examples of potential abuse found in the Technical Explanation accompanying Code section 529(g).

A. **Annual Exclusion Abuse**. The Technical Explanation identified as a potential abuse that taxpayers may seek to avoid gift and generation-skipping transfer ("GST") taxes by making contributions to multiple 529 accounts with different designated beneficiaries, potentially using the five-year election, with the intention of subsequently changing the designated beneficiaries of such accounts to a single, common beneficiary and distributing the entire amount to such beneficiary without further tax consequences. The Advance Notice contains a specific example of this abusive technique:

> For example, assume that in 2007, when the gift tax annual exclusion amount under section 2503(b) is $12,000, Grandparents wish to give more than $1 million to Child, free of transfer taxes. Grandparents open section 529 accounts for each of their 10 grandchildren, naming Child the [Account Owner] of each account. Grandparents use the 5-year spread rule of Code section 529(c)(2)(B) to contribute $120,000 ($60,000 from each Grandparent) to each grandchild's account without triggering any gift or generation-skipping transfer (GST) tax liability. The earnings then accumulate on a tax-deferred basis in the accounts and Child may withdraw the balance at any time. If Grandparents survive for 5 years, the account balances will not be included in their gross estates at death. In effect, Grandparents have transferred $1.2 million to Child while claiming no

transfer taxes are due and claiming to use none of their applicable credit amount (formerly the unified credit).

The Advance Notice also notes that similar concerns have been raised where there is a change from one account owner to a new account owner, thus giving the new account owner the right to completely withdraw the section 529 account for the new account owner's benefit.

B. **Deferral Abuse**. The second abuse cited in the technical explanation is that taxpayers "also may seek to use qualified tuition program accounts as retirement accounts with all of the tax benefits but none of the restrictions and requirements of qualified retirement accounts."

C. **Strict Enforcement Threatened**. After proposing an anti-abuse rule, the IRS further threatens:

> If concerns regarding abuse continue, the IRS and the Treasury Department will consider adopting broader rules including, for example, rules limiting the circumstances under which a [Qualified Tuition Program] may permit [Account Owners] to withdraw funds from accounts; limiting the circumstances under which there may be a change in [Designated Beneficiary]; and limiting the circumstances under which the [Account Owner] may name a different [Account Owner].

VII. Selecting a 529 Program and Establishing a Section 529 Account

A. Factors to Consider When Choosing a 529 Program

1. **Residency Requirements**. Does the program permit nonresidents to be donors and beneficiaries? States set their own participation requirements, so the programs vary as to residency restrictions. Most programs allow any United States citizen to open and contribute to an account for a designated beneficiary. A few programs require that the account owner or beneficiary be a state resident when the account is opened (e.g. Louisiana). Some states have two or more plans, one or more that is limited to residents and one or more that is open to nonresidents. Other states may permit only residents to invest directly in a plan, and may require that nonresidents purchase through an advisor or broker.

2. **State Tax Benefits for Contributions**. Are there any state tax benefits to using the program in the state of the donor's residence?

    a. **Income Tax Deduction or Credit**. Does the state offer an income tax deduction or credit for contributions?

        (1) Is there a cap on the amount that can be deducted or credited in any year?

(2) Does the deduction or credit apply to rollovers from another state's QTP?

(3) Is there "recapture" if nonqualified distributions are made from the account? If so, how is the recapture calculated if not all contributions qualified for the deduction or credit?

(4) Is there recapture if the section 529 account is rolled over? If so, how is the recapture calculated if not all contributions qualified for the deduction or credit?

b. **Matching Grants**. Does the state offer matching grants for contributions? Who is eligible for matching grants?

3. **State Tax Benefits for Distributions**. Are there any state tax benefits to using the program in the state of the beneficiary's residence?

a. **Taxation of Distributions**. Are qualified distributions exempt from state income tax? Does the state use the same definition of QHEEs?

b. **Rollover**. If the section 529 account is rolled over to the program in the beneficiary's state of residence at a later date, does the exclusion from income still apply? Is there a waiting period before distributions can be made?

c. **Beneficiary's Residence**. How likely is it that the beneficiary will be a resident of the same state when distributions are made?

4. **Investments**

a. **Manager**. Who is the investment manager?

(1) What is the investment manager's performance, generally?

(2) When does the state's contract with the manager terminate?

b. **Investment Options**. What investment options are available under the program? Can an account be allocated among more than one investment option, or can multiple accounts with different investment options be opened for the same beneficiary? Many state programs offer more than one portfolio, and the account owner can select among the portfolios when establishing the account. For example, a state might offer a bond portfolio, an equity portfolio, and one or more age-based portfolios. Some states offer very conservative certificate of deposit investments. A few states offer guaranteed investment contracts with a guaranteed return. Some states offer specialty portfolios, such as socially responsible portfolios.

(1) **Fund of Funds**. Many portfolios are invested in a combination of mutual funds. Some state programs use only one family of funds. Others allocate any portfolio among various mutual fund managers.

(2) **Age-Based vs. Static Portfolios**. An age-based portfolio is one in which the allocation between stocks, bonds and cash will automatically shift over time as the beneficiary approaches college age.

(3) **Static Portfolios**. A static portfolio is one in which the allocation between types of investments does not change with the beneficiary's age. A static portfolio could be invested in any combination of mutual funds or other investments. However, many states offer the following types of static portfolios: (1) all equity portfolios; (2) balanced portfolios; (3) all bond portfolios; (4) all cash equivalent portfolios.

(4) **Guaranteed Portfolios**. Some plans offer an option that guarantees the investor's principal and a minimum interest rate.

(5) **State Control of Portfolios**. Obviously the expected investment performance of the underlying mutual funds is an important consideration in selecting a state program, but keep in mind that the state can change the funds in which a portfolio is invested at any time.

c. **Changing Investment Options**. Are investment changes permitted to the extent allowed by the IRS?

d. **Security**. Is the program FDIC insured or guaranteed by the state?

(1) Most programs are not.

(2) The few programs that are FDIC insured tend to be very conservative with investment options.

e. **Sales Load**. Is there a sales load? Can it be avoided by investing directly, rather than through a broker? In some states with two plans, one sold directly but open only to residents, and the other open to nonresidents but sold only through advisors, the advisor-sold plan has sales loads but the direct-sold plan for residents does not. The load may be a front-end or a back-end load. Often a program will permit the contributor to select from a menu of sales load and annual fee options, offering options with higher sales loads but lower annual fees. When different investment "classes" are offered, frequently they provide that the annual fee will change after a certain number of years. An alternative to a front-end sales load, which is imposed when the funds are invested, is a back load, which is imposed if the funds are moved out of the portfolio within a certain period of time.

f. **Investment Management Fees**. What investment management fees are charged? Are investment management fees discounted for residents? Management fees for QTPs can be assessed in various ways. Generally, management fees are annual asset based fees, calculated as a percent of the account's total assets.

(1) **Wrap Fees**. A management fee can be charged as an all-encompassing wrap-fee, with no additional expenses charged for the underlying mutual funds.

(2) **Program Plus Fund Fees**. Most QTPs charge both a program fee, assessed at the plan level, and management fees imbedded in the various mutual funds used in the 529 portfolio. Commonly the mutual fund level fees vary depending upon the fund, so the overall fees for an account will depend upon the proportions invested in each mutual fund and the mutual funds selected.

(3) **Fund Fees Only**. Some QTPs may not assess a program level fee but may only assess fees on the underlying mutual fund.

g. **Daily Valuation**. Are accounts credited daily with earnings or on a periodic basis? This can result in differences in investment performance.

h. **Broker's Compensation**. If the section 529 account is being established through a broker or financial advisor, what compensation does the broker or financial advisor receive?

5. **Other Fees**

a. **Enrollment Fee**. Is there a fee for establishing an account? Some states charge a flat fee to open an account, usually in the range of \$10 to \$90.

b. **Annual Maintenance Fee**. Is there an annual maintenance fee? Under what circumstances is it waived? Some states also charge a flat annual account maintenance fee (typically \$10 to \$50) for each account. In some states this fee is waived if the account is over a certain size, or if automatic deposits are made to the account, or for residents. Although such a fee may seem nominal, for a small account it can be significant. For a $1,000 account, a $25 annual fee is a 2.5% annual fee.

c. **Other Fees**. Are there fees for taking certain actions, such as making distributions or changing the beneficiary?

6. **Account Owner**

a. **UTMA/Trust**. Can a custodian under an UTMA account or a trust be the account owner or successor account owner?

b. **Transfer of Account Ownership**. Does the program permit transfer of account ownership? This is important to keep control of the account from the beneficiary if the account owner dies or becomes disabled. When can the account owner be changed? At any time? Upon disability? Upon death? What is the procedure for changing the account owner?

c. **Power of Attorney**. Can an agent under a power of attorney act on behalf of the account owner? Only if the account owner is incapacitated? Is special language required in the power of attorney? See Appendix I.

7. **Contributions**

a. **Contribution Limit**. What is the maximum contribution limit, and is it calculated including or excluding the earnings on the account?

b. **Minimum Contribution**. Is there a minimum initial contribution? Is there a minimum annual contribution? Almost all states require a minimum initial investment, which may range from $5 to $5,000. In some states the minimum applies per investment option. In some states the minimum initial investment restriction does not apply if an automatic account withdrawal or payroll deduction of a certain minimum per month (commonly $25 - $100 per month) is established. There may also be a minimum for each additional contribution. Many states have low initial contribution requirements of $25 or less. A few states require a minimum *annual* investment.

c. **Funding**. Can contributions be made with payroll deductions or automatic bank account transfers?

d. **Contributions from Non-Account Owner**. Can contributions be made by persons other than the account owner?

e. **Crediting**. How quickly are contributions credited to the account?

8. **Qualified Withdrawals**

   a. **Age and Time Limits**. Is there a waiting period before withdrawals can be made? Does the program place time limitations on how long an account may be open? Does the program place an age limit on beneficiaries?

   b. **Other Limits**. Are there any other limits on the frequency or amount of withdrawals?

   c. **Expenses Covered**. Does the program permit qualified withdrawals for any QHEE covered under Code section 529, or are there limitations?

   d. **Method of Distribution**. Will the program reimburse an individual directly, or will it only issue checks jointly to the individual and the educational institution?

9. **Rollovers**. Does the program permit "trustee to trustee" rollovers to/from another state's program?

10. **Beneficiary Age Restrictions**. A few states impose age restrictions on the beneficiary. For example, a program may require that the beneficiary be under age 18 when the account is opened.

11. **Beneficiary Changes**

    a. Can the account owner change the beneficiary?

    b. Are there restrictions on who can be named as the new beneficiary?

12. **Nonqualified Withdrawals**. Can the account owner withdraw the funds? Can the account owner direct a nonqualified withdrawal to the beneficiary? If so, must the distributee for nonqualified distributions be designated when the account is opened, or can the distributee be designated at the time of withdrawal?

13. **Penalty**. Is there a state penalty for nonqualified withdrawals? What is the amount of the penalty for nonqualified withdrawals?

14. **Creditors**. Does state law offer any creditor protection?

VIII. **Entities**. Code section 529(b)(1)(A) provides that a QTP includes a program under which a "person" may make contributions to a section 529 savings account. Proposed Regulation section 1.529-1(d) provides that "person" has the same meaning as under Code section 7701(a)(1). Code section 7701(a)(1) provides that when "person" is used in the Code and not otherwise distinctly expressed or manifestly incompatible with the intent thereof, the term includes "an individual, a trust, estate, partnership, association, company or corporation." The regulations provide that the term also includes a guardian, executor, administrator, conservator or any person acting in a fiduciary capacity. Treas. Reg. § 301.7701-6(a).

A. **Custodial Section 529 Accounts**. A person giving or paying cash to a minor could contribute the funds to a custodial section 529 account established under the QTP as a Uniform Transfers to Minors Act account. The account should be subject to all of the restrictions under the Uniform Transfers to Minors Act and therefore the account owner should not be able to change the beneficiary of the account, or refund the account to the account owner, and the beneficiary should become the account owner upon attaining the statutory age (generally, but not always, age 21).

B. **Transfer of UTMA Funds**. Most programs permit a UTMA or UGMA custodian of a pre-existing UTMA or UGMA account to open a 529 savings account. The Advance Notice states that this "situation should be distinguished from a section 529 account established with the program as an UGMA or UTMA account. There should be no difference in terms of permissibility of such accounts under Code section 529 and the restrictions on such accounts should be the same. The only difference is that if a donor gives money to a custodial 529 account, it is a gift; when a custodian invests funds already in a UTMA account in a section 529 account, it is not a gift but merely a change in investment. The Advance Notice recognizes this:

> Minor beneficiaries of UGMA and UTMA accounts are the beneficial owners of the accounts. In this respect, contributions to a section 529 account from an UGMA or UTMA account would be considered to be contributions to the section 529 accounts by the minor beneficiaries for their own benefit.

The Advance Notice then correctly recognizes that if the beneficiary of a custodial section 529 account is changed (which should only be permitted after the UTMA beneficiary attains the statutory age and becomes the account owner, at which point in time all of the special restrictions on a custodial section 529 account should lapse), such change of beneficiary should be treated as a gift. The Advance Notice would treat this change of beneficiary as a distribution to the UTMA beneficiary, followed by the new contribution of the account balance to a new section 529 account for the new section 529 account beneficiary. However, the Advance Notice proposes to apply this treatment only for transfer tax and not income tax purposes, and for transfer tax purposes the five-year election may be made.

> It is anticipated that the deemed distribution to the contribution, followed by the new contribution of the account balance to a new section 529 account for the new [Designated Beneficiary], will be treated as a rollover (as described in Code section 529(c)(3)(C) and thus will not be subject to income tax or the 10-percent additional tax imposed by Code section 529(c)(6) if the new [Designated Beneficiary] is a member of the family of the former [Designated Beneficiary]. The new contribution by the contributor will be treated in the same way for transfer tax purposes as are

other contributions to section 529 accounts under Code section 529(c)(2). If the change of [Designated Beneficiary] in these situations results in any gift and/or GST tax, the contributor will be liable for the tax and must file gift and/or GST tax returns. However, the contributor may elect to take advantage of the special 5-year rule under Code section 529(c)(2)(B).

Under some circumstances a custodial section 529 account may provide an attractive opportunity to obtain income tax deferral on UTMA investments.

1. **Segregation**. You cannot add custodial monies to a pre-existing noncustodial section 529 account for the beneficiary. This is because the beneficiary is the legal owner of a UTMA account and therefore must also be the legal owner of a section 529 savings account created with UTMA funds. In contrast, the account owner, and not the beneficiary, is the legal owner of a noncustodial section 529 savings account.

   The QTP should refuse to accept a contribution of custodial funds to a noncustodial section 529 account. Even if the program did not refuse such a contribution (for example, because the program did not know the source of the funds), such a transfer would violate the custodian's duties under the UTMA.

2. **Custodial Section 529 Account**. However, a separate custodial section 529 account could be opened with the UTMA monies.

3. **Restrictions**. Transferring UTMA funds to a section 529 account does not remove the funds from the purview of the UTMA. The funds are still subject to the UTMA restrictions. A custodial account owner cannot change the beneficiary of the account, and the beneficiary must become the account owner upon attaining the age at which the custodianship is required to terminate.

4. **Authority of Custodian**. At least one state statute specifically authorizes a custodian of a UTMA account to enter into a section 529 savings account participation agreement. See California Education Code sections 69980(h) and 69986(j) (custodians may "enter into participation agreements in accordance with regulations adopted by the board."). Even without specific authority, a custodian under a UTMA should have the power to invest in a section 529 account. Section 12 of the UTMA provides that a custodian shall "collect, hold, manage, invest, and reinvest custodial property. In dealing with custodial property, a custodian shall observe the standard of care that would be observed by a prudent person dealing with property of another and is not limited by any other statute restricting investments by fiduciaries." Code section 12(d) requires that a custodian "keep custodial property separate and distinct from all other property in a manner sufficient to identify it clearly as custodial property of the minor." Therefore the section 529 account should be titled in the name of the custodian, as a

custodian for [name of minor] under the [name of enacting state] Uniform Transfers to Minors Act." The restriction that custodial property be kept separate and distinct from all other property is not violated by holding property in a common trust fund or a mutual fund and therefore should not be violated by holding custodial property under a section 529 program. See comment to UTMA § 12.

5. **No Gift Tax Consequence**. Because the UTMA assets have already been given to the beneficiary of the UTMA account, there should be no gift tax consequences to contributing UTMA assets to a section 529 account with the UTMA custodian as account owner and the UTMA beneficiary as the section 529 account beneficiary.

6. **Liquidation Required**. However, because only cash can be contributed to a section 529 account, the UTMA investments may first need to be sold, possibly incurring capital gains tax.

7. **States Permitting**. Almost every state permits UTMA accounts.

8. **Evaluating Advantages of Custodial Section 529 Accounts**. In evaluating the potential benefit from investing the custodial funds in a 529 account, you should consider:

    a. **Tax Advantages**. Are the tax advantages of a section 529 account all that significant, even if the funds are ultimately used to fund QHEEs. To the extent income is recognized by the UTMA account while the beneficiary is under age 19, or in some cases while the beneficiary is under age 24, it is taxable at the beneficiary's parent's income tax rates under the "Kiddie Tax" rules. However, to the extent the UTMA account is invested in equities with a low turnover, the recognized income may be quite modest. The Kiddie Tax now applies if (1) the child does not attain age 19 before the end of the tax year, or is a full-time student who will not attain age 24 before the end of the tax year; (2) the child's earned income for the tax year doesn't exceed one-half of the child's support; the child has more than $1,350 (for 2025) of unearned income; (3) the child has at least one living parent at the close of the tax year; and (4) the child does not file a joint return for the year.

    b. **Possibility of Nonqualified Distribution**. Consider the tax impact if the funds are contributed to a section 529 account but are not used for QHEE. All of the earnings portion of a nonqualified distribution from a section 529 account is taxed as ordinary income. In contrast, with a UTMA account, capital gains are taxed at capital gains tax rates. In addition, a nonqualified distribution from a section 529 account is subject to a ten percent penalty.

C. **Executor as Successor Account Owner**. If all rights over the account pass to the executor or personal representative, either under the terms of the QTP when the account owner dies and no successor account owner is effectively designated, or by designating the executor as successor account owner, a number of troubling issues may arise. For example, would the rights over the section 529 account pass under the residuary clause, or would the executor have a fiduciary duty to withdraw the section 529 account, in order to maximize the value of the estate for the probate beneficiaries? If the executor withdraws the section 529 account, who gets the funds? Are the funds then a probate asset, or do they belong to the executor individually? Perhaps these issues can be avoided by including a provision in the Will with respect to section 529 accounts. The provision in the Will might (1) specify who should become the account owner, if permitted by the program, (2) provide that the executor has no fiduciary duty to withdraw the section 529 account, (3) specify to whom the funds should be distributed if the executor does exercise the right to withdraw and (4) if appropriate, limit the executor's right to change the designated beneficiary.

D. **Executor as Contributor**. Wills commonly contain a "Facility of Payment" clause that permits a distribution to an incapacitated or minor beneficiary to be made in ways other than opening a formal guardianship for the beneficiary. Such a provision might permit a distribution to a UTMA account, a parent or other relative, or to a trust for the beneficiary. There is no reason why a Facility of Payment clause could not also permit a distribution to a section 529 account. However, in deciding whether to make a distribution to a section 529 savings account and in selecting an account owner, an executor should consider the broad rights given to the account owner to withdraw the funds or change the beneficiary. In some circumstances, the executor may decide that a distribution to a section 529 account should only be made to a custodial section 529 account, to eliminate the possibility that the funds could be diverted. Alternatively, the executor could distribute the funds to a UTMA account knowing that the UTMA custodian could then invest the funds in a section 529 account if desirable.

E. **Trusts**. See Section XI of this outline.

IX. Charitable and State Programs

A. **Maine**. In 2009, the Harold Alfond Foundation started offering $500 in a 529 savings account for every child born in Maine. As of 2021, there were about 116,000 accounts with $58,000,000 of assets.

B. **Oklahoma**. In 2007, Oklahoma began a pilot program giving over 1,300 children $1,000 accounts. The Center for Social Development at Washington University in St. Louis studied the Oklahoma program and found that households given seed money saved more for college and had greater expectations about higher education. Patricia Cohen, *College Accounts at Birth: State Efforts Raise New Hope*, NYT (April 27, 2021).

C. **Other States**. Pennsylvania instituted a state funded program in 2018 ($100 per child); Nebraska in 2020; Illinois in 2021 ($50 per child). California, Rhode Island and Nevada are instituting programs.

X. **Self-Owned Accounts**. It has long been assumed that an individual may open a section 529 account for himself or herself, and many QTPs permit such accounts. The Advance Notice questions this assumption, but ultimately concedes that self-owned accounts should be permitted:

> Although there is no express statutory intent to prohibit the funding of a section 529 account for the contributor's own QHEEs, the transfer tax provisions of section 529 do not appear to contemplate such a result. . . .
>
> The IRS and the Treasury Department recognize that individuals may want to save for their higher education expenses by contributing to section 529 accounts and that individuals might not have parents or other benefactors who are able or willing to make such contributions on their behalf. . . .
>
> Accordingly, it is anticipated that the notice of proposed rulemaking will allow contributions to section 529 accounts by individuals for their own benefit . . .

The Advance Notice comments that a contribution to a section 529 account by the contributor for the contributor's own benefit cannot be treated as a gift because one cannot make a gift to oneself.

The Advance Notice recognizes the need to impose transfer taxes on a change of beneficiary of a self-owned account, even if the change of beneficiary would not otherwise be taxable under Code section 529. For example, assume A establishes a section 529 account for herself. A should not be able to avoid transfer tax consequences when A subsequently changes the beneficiary to A's niece. The Proposed Regulations should treat the subsequent change of beneficiary to A's niece as if A were making a new contribution to a section 529 account for the benefit of A's niece. As with any initial contribution to a section 529 account, the deemed contribution should qualify for the gift tax annual exclusion, and A should be eligible to make a five-year election.

XI. **Trusts as Account Owners**. Section 529 accounts provide a new investment opportunity for trusts with beneficiaries who have not completed their higher education. Some trusts created in the past may wish to invest some or all of their assets in section 529 accounts. In other instances a donor may create a trust specifically for the purpose of owning one or more section 529 accounts. The trustee would open the section 529 account with cash already in the trust, with the trust as the account owner and the trust beneficiary as the section 529 account beneficiary. Although the trust can be the account owner, the trust itself cannot be the beneficiary because Code section 529 requires that an individual be the beneficiary. The trustee, as the account owner, would then have the power to change the beneficiary of the section 529 account, to direct a qualified distribution from the section 529 account to the beneficiary, to take a nonqualified distribution, to change the investment options, and to roll over the section 529 account to another qualified tuition program, subject to the terms of the trust, the restrictions of the QTP, and the general rules of Code section 529.

A. **Statutory Authority**. The federal statutes authorizing states to establish qualified tuition programs appear to permit contributions to be made by trusts. Code section 529(b)(1)(A) provides that qualified tuition programs include a program under which a "person" may make contributions to a section 529 account. Proposed Treasury Regulation section 1.529-1(c) provides that "person" has the same meaning as under section 7701(a)(1) of the Internal Revenue Code. Section 7701(a)(1) defines "person" to include "an individual, a trust, estate, partnership, association, company or corporation." The regulations provide that the term also includes a guardian, executor, administrator, conservator or any person acting in a fiduciary capacity. Treas. Reg. § 301.7701-6(a).

B. **Advance Notice**

1. **Argument**. The Advance Notice makes the strained argument that "[b]ecause any contribution to a section 529 account is treated as a completed gift, and because the gift tax is imposed only on individuals, it can be argued that the definition of "person" in Code sections 529(b)(1) and 529(c)(2)(A) should be limited to individuals." This argument is strained for several reasons. First, there are no words in the statute expressly limiting the definition of "person" and QTPs have been allowing trusts, estates, custodians and even partnerships and corporations to be account owners and to make contributions. Second, the proposed regulations, which have now been outstanding for a decade, state that "person" has the same meaning as under Code section 7701(a)(1). Prop. Reg. § 1.529-1(c). Third, Code section 529(e)(1)(C), in defining "designated beneficiary," indicates that states, governmental agencies and charities may purchase interests in section 529 accounts. Code section 529(e)(1) provides:

> The term "designated beneficiary" means . . . in the case of an interest in a qualified State tuition program purchased by a State or local government (or agency or instrumentality thereof) or an organization described in section 501(c)(3) and exempt from taxation under section 501(a) as part of a scholarship program operated by such government or organization, the individual receiving such interest as a scholarship.

However, in the IRS's defense, the Technical Explanation to the Pension Protection Act of 2006 states that new Code section 529(f) "also authorizes the Secretary to limit the persons who may be contributors to a qualified tuition program and to determine any special rules for the operation and Federal tax consequences of such programs if such contributors are not individuals."

2. **Concession**. The Advance Notice concedes that it may be willing to permit persons who are not individuals to make contributions to a section 529 account:

> Nevertheless, the IRS and Treasury Department believe it may be possible to interpret sections 529(b)(1) and 529(c)(2)(A) consistently without limiting the class of permissible contributors to individuals by providing special rules for contributions made by corporations, partnerships, estates, trusts and other entities. . . . Accordingly, the forthcoming notice of proposed rulemaking will follow the 1998 Proposed Regulations in providing that the definition of "person" as used in section 529(b)(1) will have the same meaning as under section 7701(a)(1).

3. **Threat**. On the other hand, the Advance Notice indicates the IRS may change its mind:

> The IRS and the Treasury Department welcome comments on whether the definition of "person" in section 529(b)(1) should be limited to individuals and the rules necessary to ensure appropriate transfer tax consequences in situations where persons other than individuals make contributions to section 529 accounts. In addition, comments are welcome as to whether the complexities of any special rules would outweigh the benefits of allowing non-individual contributors.
>
> Comments are also welcome regarding potential income tax consequences when contributions are made by non-individuals, such as a trust or estate, and whether the complexity of any special rules would outweigh the benefit.

4. **Bigger Issue**. However, even if the IRS concedes that "person" has the same meaning as under Code section 7701(a)(1) and that therefore non-individual persons may make contributions to section 529 accounts, the Advance Notice states that the IRS expects to develop rules limiting account owners to individuals.

   a. **How Can They Do This**? How can the IRS limit account owners to individuals while permitting non-individuals to be contributors? The disparate treatment does not intuitively make sense. The IRS is making very clever use of the fact that "account owner" or "participant" is never actually used in the statute, even though by implication there must be some person for each account who can exercise the rights, such as changing the beneficiary or taking a refund, contemplated by the statute. Therefore, apparently the IRS feels it has complete authority to "legislate" who can be the account owner. This is an abrupt departure from the proposed regulations which defined "account owner" as the person who had certain rights and accepted the Code section 7701(a)(1) definition of "person."

b. **Why Would They Do This**? Why does the Advance Notice take this position? The Advance Notice says that the rule limiting account owners to individuals is to prevent misuse by account owners of section 529 accounts. However, this does not make sense. Having a trustee as an account owner limits the possibility for such abuse because the trustee by the terms of the trust has fiduciary duties. In *Kimball v. Kimball*, 2015 Bankr. Lexis 870 (March 19, 2015), an unpublished opinion, the Bankruptcy Court found that were a mother withdrew her children's 529 accounts prior to bankruptcy but in defiance of a marital settlement agreement prohibiting withdrawals without the husband's consent, the mother owed a "donatee support obligation" to the children that was not dischargeable in bankruptcy under I.R.C. § 523(a)(5). The court, however, refused to grant summary judgement under I.R.C. § 523(a)(4) excepting from discharge any "misappropriation of trust funds or money held in a fiduciary capacity," because the marital settlement agreement did not create a trust relationship, nor was the section 529 account established in trust. The court "can find nothing in the statutory language of I.R.C. § 529 that would create the fiduciary relationship required by § 523(a)(4)." Trustees cannot distribute the section 529 account funds to themselves (unless the trust permits).

Perhaps the real concern with permitting a trust as an account owner is whether it is worth the effort, or even possible, to work out the transfer tax and income tax rules to be applied if non-individuals are permitted as account owners. The Advance Notice requests comments "on rules necessary to ensure appropriate transfer tax consequences in situations where persons other than individuals make contributions to section 529 accounts" and "regarding potential income tax consequences when contributions are made by non-individuals, such as a trust or estate."

C. Transfer Tax Treatment. There are two types of trusts that could make contributions to a section 529 account. For convenience I will refer to these types of trusts as revocable trusts and irrevocable trusts. By the term "revocable trust" I mean a trust that has terms such that a transfer to the trust by the grantor will not be treated as a completed gift for gift tax purposes. Although such a trust is generally revocable by the grantor, it is possible that it could be irrevocable if the grantor retained other powers over the trust that would make a gift to the trust incomplete. By the term "irrevocable trust" I mean a trust that has terms such that a gift to the trust by the grantor will be treated as a completed gift for gift tax purposes. Such a trust will almost always be irrevocable by the grantor, although others may have a power to revoke the trust.

1. **Irrevocable Trusts**

a. **Protecting the Generational Toll System**. Code section 529 provides a number of significant exceptions to the transfer tax system. In general, these exceptions allow a donor a greater deal of control over the ultimate disposition of the section 529 account funds than permitted with other gift techniques. First, Code section 529 provides that a contribution to a section 529 account is a completed gift that qualifies for the gift and GST annual exclusions, notwithstanding that the account owner can change the beneficiary or refund the account to himself or herself. If the funds are refunded to the donor, little harm is done to the transfer tax system because the funds will then be part of the donor's taxable estate. Further, the ability to change the beneficiary freely among a group of family members was a benefit clearly contemplated by Congress and intended to induce taxpayers to save by higher education by using section 529 accounts.

Second, Code section 529 provides that the account will not generally be included in the account owner's estate. Again, this does little harm to the transfer tax system because the funds in the account do not pass pursuant to the account owner's estate plan and will eventually be used for higher education, distributed to a beneficiary or account owner and thus become part of their estates to the extent not expended, or be included in the beneficiary's estate.

However, Code section 529 does protect the fundamental integrity of the transfer tax system by providing that if the beneficiary is changed to someone in a lower generation than the old beneficiary, the "taxes imposed by chapters 12 and 13 shall apply." § 529(c)(5)(B). However, in order to apply chapter 12 (the gift tax rules) or chapter 13 (the generation-skipping transfer tax rules), we need to know who is the transferor for transfer tax purposes. If an individual is the transferor, the gift tax will apply and the GST tax will also apply if the new beneficiary is two or more generations below the transferor. If the transferor is a trust, the gift tax rules will not apply, but the GST tax rules will.

Although Code section 529 triggers the transfer tax rules when the new beneficiary is not assigned to the same or a higher generation than the old beneficiary, it does not specify who is treated as the transferor. Given that Code section 529 treated the original transfer to the account as a completed gift to the designated beneficiary, theoretically the transferor of any subsequent transfer must be the old beneficiary. If the donor of the gift is the old beneficiary, then the donor will necessarily be an individual, as only individuals are permitted as beneficiaries of section 529 accounts. This was the position taken in the proposed regulations but has been rejected by the IRS as impracticable in the Advance Notice.

In the Advance Notice the IRS changes course and proposes that the donor of the gift should be the account owner. If a trust is the account owner, the account owner, the deemed transferor, will not be an individual. As only individuals can make gifts, and trusts cannot make gifts, the gift tax rules would not apply, but the GST tax rules would. The GST tax rules protect the fundamental integrity of the transfer tax system and ensure that transfer tax is generally imposed at each generation.

b. **Trusts Make Investments, Not Gifts**. When an irrevocable trust invests its own funds in a section 529 account it should be viewed as making a trust investment, not a gift and not a trust distribution. If an irrevocable trust invests funds already held in the trust in a section 529 account, no transfer tax consequences should result because the funds in the trust already passed through the transfer tax system when contributed to the trust (or when the trust became irrevocable) and because a trust cannot make a gift.

c. **No Gift Tax on Beneficiary Changes**. So long as the trustee remains the account owner and no distribution is made to anyone other than the account owner, nor should any transfer tax consequences result from any change in designated beneficiary. This should be the case even if the new designated beneficiary is in a lower generation than the old designated beneficiary or if the new designated beneficiary is not a member of the family of the old designated beneficiary.

Nor should there be any gift tax consequences to a (nonqualified) distribution from a section 529 account to the trust. The trust is only altering its investments.

d. **GST Tax on Distributions**. The GST tax may apply to a distribution, qualified or nonqualified, from a section 529 account owned by an irrevocable trust if the beneficiary is two or more generations below the transferor's generation. When the irrevocable trust invests funds in a section 529 account, the transferor of the trust for GST tax purposes generally will be the same as the transferor of the section 529 account (a different result may apply when an individual makes a contribution to a trust-owned section 529 account, as described below). In determining the generation assignment of the transferor, Code section 2653(a) provides that if there is a generation-skipping transfer of any property and immediately after such transfer such property is held in trust, for purposes of applying the GST tax rules, the trust will be treated as if the transferor of such property were assigned to the first generation above the highest generation of any person who has an interest in such trust immediately after the transfer. If the original transfer to the trust was not a generation-skipping transfer, the transferor would have his or her natural generation assignment.

> *Example 1.* [1] GP establishes an irrevocable trust for the education of his descendants. GP has two children and one grandchild. Because the trust is not a skip person, and therefore there is no generation-skipping transfer when funds are contributed to the trust, the transferor is assigned to GP's generation.

> *Example 2.* GP establishes an irrevocable trust for the education of his grandchildren and more remote descendants. Assuming no non-skip person has an interest in the trust, the trust is a skip person and therefore there is a generation-skipping transfer when funds are contributed to the trust. Therefore, the transferor is assigned to the generation above the grandchildren's generation, or to GP's child's generation.

A distribution from a section 529 account to a designated beneficiary who is two or more generations below the generation of the transferor of the trust should be treated as either a taxable distribution or a taxable termination (as the case may be, depending on the circumstances of the trust) for GST tax purposes subject to the trust's GST tax inclusion ratio. No GST tax would be due if the trust has a zero inclusion ratio or is grandfathered for GST tax purposes.

> *Example 3.* P establishes an irrevocable trust for the education of his descendants. P has one child, C, and one grandchild, GC, when the trust is established. P makes a taxable gift of cash to the trust. The trust establishes a section 529 account with C as the designated beneficiary. Distributions are made from the section 529 account for C's QHEEs. When C completes C's education, funds remain in

[1] In all examples in this outline, the following abbreviations are used:

GP	Grandparent
P	Parent
C	Child
GC	Grandchild
GGC	Great grandchild

the section 529 account and the trustee changes the designated beneficiary to GC. Distributions are made from the section 529 account to GC for QHEEs. After GC completes GC's education, the trust refunds the remaining section 529 account funds to the trust with a nonqualified distribution. There are no transfer tax consequences to the trust's investment in the section 529 account. When distributions are made to C, P is treated as the transferor of the section 529 account (the contribution to the trust was not a generation-skipping transfer) and is only one generation above C, so no GST tax or other transfer tax consequences result. Nor do any transfer tax consequences result when the trust changes the designated beneficiary from C to GC because a trust cannot make a gift. When distributions are made from the section 529 account to GC, they are taxable distributions for GST tax purposes because GC is two generations below P, the transferor. There are no transfer tax consequences when the trust makes a nonqualified distribution to itself as account owner.

2. **Revocable Trusts**. While a trust is revocable, the gift tax rules, as well as the GST tax rules, can be applied to beneficiary changes of a trust-owned section 529 account because the gift can be imputed to the grantor, who is an individual. This transfer tax treatment is in accordance with the expectations of individuals and their advisors, who are accustomed to viewing a revocable trust as the alter ego of the grantor.

   a. **Contributions Subject to Gift Tax**. Contributions to a section 529 account by a revocable trust should be treated as a contribution by the grantor of the trust to the section 529 account. The transfer tax treatment of a contribution to a section 529 account should not change merely because the grantor uses the grantor's revocable trust as the account owner. Therefore, there should be no transfer tax consequences to a revocable trust if such trust makes a contribution to a section 529 account. The transfer tax consequences of the contribution should be treated as belonging to the grantor. The contribution by a revocable trust to a section 529 account should be treated as a completed gift by the grantor to the designated beneficiary for gift and GST tax purposes.

   b. **Beneficiary Changes Subject to Gift Tax**. The transfer tax consequences of any subsequent change in designated beneficiary by the account owner while the trust is revocable should be governed by the general rules applicable to individual account owners. Thus if the designated beneficiary is changed and the new designated beneficiary is in a generation below the old designated beneficiary, the old designated beneficiary will be treated as having made a gift to the new designated beneficiary. If the designated beneficiary is changed and the new designated beneficiary is two or more generations below the old designated beneficiary, the gift will also be treated as a direct skip for GST tax purposes.

c. **Trust Becomes Irrevocable at Grantor's Death**. A revocable trust will typically become irrevocable at some point in time – usually upon the grantor's death. The assets of a revocable trust are generally includible in a decedent's gross estate for estate tax purposes. However, Code section 529(c)(4)(A) provides that no "amount shall be includible in the gross estate of any individual for purposes of chapter 11 by reason of an interest in a qualified tuition program." Therefore, a grantor's estate should not include for estate tax purposes any interest in a section 529 account, regardless of whether that interest was owned directly or through the grantor's revocable trust.

d. **Trust Becomes Irrevocable During Grantor's Life**. A revocable trust may become irrevocable during the grantor's life if the trust is amended or powers are released such that it is no longer a revocable trust. Because the trust's contribution to the section 529 account was treated as a completed gift from the grantor for gift and GST tax purposes, no transfer tax consequences should occur with respect to a trust-owned section 529 account if the formerly revocable trust becomes irrevocable during the grantor's life.

After the trust becomes irrevocable, the future transfer tax consequences can no longer be attributed to the grantor as the imputed account owner. Further, the transfer tax consequences set forth in Code section 529 cannot apply, because a trust cannot make a gift. However, the GST tax rules can be applied to maintain the integrity of the transfer tax system.

Because the initial transfer to the section 529 account is treated as a completed gift by Code section 529, even if the section 529 account is owned by a revocable trust, the generation of the transferor for GST tax purposes should be determined as of the time of the initial transfer to the section 529 account. Code section 2653(a) provides that if there is a generation-skipping transfer of any property and immediately after such transfer such property is held in trust, for purposes of applying the GST tax rules, the trust will be treated as if the transferor of such property were assigned to the first generation above the highest generation of any person who has an interest in such trust immediately after the transfer. Because the only person who for transfer tax purposes has an interest in a section 529 account is the designated beneficiary, when the designated beneficiary is two or more generations below the grantor, Code section 2653(a) would treat the trust (with respect to the section 529 account) as if the transferor is in the generation above the designated beneficiary. If the transfer to the section 529 account is not a generation-skipping transfer (because the designated beneficiary is not two or more generations below the grantor), the transferor would be assigned to the grantor's natural generation.

A generation-skipping transfer, however, will occur only when funds in the section 529 account are distributed. After a revocable trust has become irrevocable, so long as the trustee remains the account owner and no distribution is made to anyone other than the account owner, no transfer tax consequences should result from any change in designated beneficiary. This should be the case even if the new designated beneficiary is in a lower generation than the old designated beneficiary or if the new designated beneficiary is not a member of the family of the old designated beneficiary. Because the trust cannot make a gift, the Code section 529 rules applicable to changes of beneficiaries cannot apply.

However, the GST tax consequences of any distribution from the section 529 account should be determined by applying the appropriate GST tax rules. If the distributee is two or more generations below the transferor, the distribution will be treated as a taxable distribution or a taxable termination for GST tax purposes. If the distributee is one generation below the transferor, or in the same generation as the transferor, there will be no transfer tax consequences to the distribution.

> *Example 1*. GP's revocable trust establishes a section 529 account for GP's grandchild, GC1. During GP's life, the revocable trust becomes irrevocable. The trust then changes the beneficiary of the section 529 account to GP's grandchild, GC2, and then directs a distribution to GC2. When GP's revocable trust establishes the section 529 account, GP is treated as if he made the gift to the section 529 account directly. Because the transfer was a generation-skipping transfer, the transferor is treated as being in the child's generation (one generation above GC1). There are no transfer tax consequences with respect to the section 529 account when the trust becomes irrevocable or when the trust changes the beneficiary. When the trust makes a distribution from the section 529 account to GC2, no GST tax consequences result from the section 529 account distribution to GC2 because GC2 is only one generation below the transferor's generation.

Example 2. GP's revocable trust establishes a section 529 account for GP's child, C. During GP's life, the revocable trust become irrevocable. The trust then changes the beneficiary to GP's grandchild, GC, and then directs a distribution to GC. When GP's revocable trust establishes the section 529 account, GP is treated as if he made the gift to the section 529 account directly. GP is treated as the transferor for GST tax purposes because the contribution to the section 529 account was not a generation-skipping transfer and the transferor is assigned GP's natural generation. There are no transfer tax consequences with respect to the section 529 account when the trust becomes irrevocable or when the trust changes the beneficiary. When the trust makes a distribution from the section 529 account to GC, GP is treated as the transferor. Because GC is two generations lower than GP, a distribution to GC is treated as a taxable distribution to GC.

Example 3. GP's revocable trust establishes a section 529 account for GP's grandchild, GC1. During GP's life, the revocable trust becomes irrevocable. The trust then changes the beneficiary of the section 529 account to GP's great grandchild, GGC1, and then directs a distribution to GGC1. When GP's revocable trust establishes the section 529 account, GP is treated as if he made a gift directly to the section 529 account for transfer tax purposes. For purposes of applying the GST tax under Code section 2653(a), the transferor is treated as being in the generation above the generation of GC1. There are no transfer tax consequences with respect to the section 529 account when the trust becomes irrevocable or when the trust changes the beneficiary. When the trust makes a distribution from the section 529 account to GGC1 the distribution from the section 529 account is a taxable distribution for GST tax purposes, because GGC1 is two generations below the generation (C's generation) assigned to the transferor.

An irrevocable trust could have one or more section 529 accounts with different transferors, or a section 529 account with the transferor assigned to a different generation than the generation assignment for the non-section 529 account assets in the trust. For GST tax purposes the section 529 account would be treated as a separate trust if it has a different transferor than the remainder of the trust or if it is a substantially separate and independent share of the trust because the trust has beneficiaries other than the designated beneficiary. § 2654(b). This may require some recordkeeping by the trustee account owner and/or by the designated beneficiary for future gift and GST tax purposes.

> *Example 4*. GP's revocable trust establishes a section 529 account for GP's grandchild, GC1. During GP's life, the revocable trust becomes irrevocable. GP is the transferor of the non-section 529 assets of the trust and is assigned to GP's natural generation because the transfer to the trust is not a generation-skipping transfer. However, because the transfer to the section 529 account for GC1 was a generation-skipping transfer, the transferor is assigned to the child's generation (one generation above GC1) with respect to the section 529 account (which is treated as a separate trust for GST tax purposes). If after the trust becomes irrevocable the trust establishes a second section 529 account for GC2, GP will be treated as the transferor of the section 529 account for GC2 and will be assigned to GP's natural generation. Thus, when the trust makes a distribution from GC1's section 529 account to GC1, no GST tax consequences result from the distribution because GC1 is only one generation below the transferor's generation (C's generation). GP already incurred the transfer tax consequences of passing those assets to GC1 when the section 529 account was funded. However, when the trust makes a distribution from GC2's section 529 account to GC2, the distribution will be a taxable distribution (or a taxable termination if the entire section 529 account is distributed) and will be subject to GST tax unless the trust has a zero inclusion ratio or is grandfathered. GP incurred only gift tax consequences with respect to these assets when the trust became irrevocable. Similarly, if the trust makes a distribution to GC1 or GC2 from non-section 529 account assets, the distribution will be a taxable distribution and will be subject to GST tax unless the trust has a zero inclusion ratio or is grandfathered.

3. **Contributions to Trust-Owned Section 529 Accounts**. Under Code section 529, persons other than the account owner may make contributions to a section 529 account. Similarly, with a trust-owned account someone other than the trust may make a contribution to the account. For example, assume a trustee of an existing irrevocable trust is the account owner of a section 529 account with a minor trust beneficiary as the designated beneficiary. A grandparent of designated beneficiary wants to contribute toward designated beneficiary's higher education. For reasons important to grandparent (such as the trustee's superior reliability and judgment), grandparent wants the trustee (rather than the designated beneficiary's parent) to control grandparent's contribution. Setting up another separate

section 529 account for the same designated beneficiary would not subject it to the terms of the trust and would cause extra administrative expense. So grandparent would like to contribute funds to the existing trust-owned section 529 account.

a. **Irrevocable Trusts**. If a donor contributes cash to a section 529 account owned by an irrevocable trust, the donor could be treated as if the donor had made the contribution to the trust for transfer tax purposes and the trust then contributed the funds to the section 529 account. The donor would only be entitled to claim the gift and GST tax annual exclusion if the contribution to the trust itself qualifies therefor, as would be the result for gift tax purposes in the case of a contribution to a Code section 2503(b) or 2503(c) trust or a Crummey trust or to a trust that qualifies under section 2642(c)(2) for GST tax purposes.

However, contributions to a trust do not generally qualify for the special election under Code section 529 that permits a donor to elect to treat a contribution as if it were made pro rata over five years. The comments to the Advance Notice submitted by the American College of Trust and Estate Counsel and the Tax Section of the American Bar Association seek to permit the five-year election for a contribution to a trust-owned section 529 account. These comments propose that the donor be permitted to make the five-year election over the portion of the gift to the trust equal to five times the lesser of (1) the gift tax annual exclusion in effect at the date of the contribution to the trust or (2) the amount of the contribution to the trust that qualifies for the gift tax annual exclusion (and if the designated beneficiary is two or more generations below the donor, the GST tax annual exclusion) in effect at the date of the gift. If the donor makes the five-year election and the designated beneficiary dies prior to the beginning of year 5, the donor would treat the portion of the gift attributed to years after the year of the designated beneficiary's death as a gift to the trust in the year of the designated beneficiary's death that does not qualify for the gift (and, if applicable, GST) tax annual exclusion.

Example 1. P establishes a trust for P's child, C, that qualifies as a section 2503(c) trust. P contributes cash to the trust, which the trust invests in a section 529 account with C as the designated beneficiary. GP, C's grandparent, contributes $60,000 to the section 529 account. Because the trust is a section 2503(c) trust, a contribution by GP to the trust would qualify for the gift tax and GST tax annual exclusions. Therefore, GP may make the five-year election with respect to the contribution to the trust-owned section 529 account.

Example 2. P establishes an irrevocable spray trust for P's children, C1 and C2, and P's future grandchildren. The trust gives the beneficiaries Crummey rights of withdrawal over contributions to the trust, up to $10,000 per year per beneficiary. The trust establishes a section 529 account for each of C1 and C2. P contributes $60,000 to each section 529 account. Because each of C1 and C2 can withdraw up to $10,000 per year, P can make the five-year election with respect to $50,000 for each child, and the remaining $10,000 per child is a taxable gift to the trust. If GP, the grandparent of C1 and C2, contributes $50,000 to each section 529 account, the contributions will be treated entirely as taxable gifts to the trust, because GP's contributions to the trust do not qualify for the GST tax annual exclusion.

Alternatively, one could treat a contribution by a third party to a trust-owned section 529 account in the same way as a contribution by a third party to a section 529 account with an individual as account owner. Under this alternative the contribution would qualify for the gift tax and GST tax annual exclusions (and the five-year election) without regard to whether other contributions to the trust would qualify for such annual exclusions. The general anti-abuse rule proposed in the Advance Notice would prevent any abuse by requiring that any contributions to trust-owned section 529 accounts be intended to be used for the designated beneficiary's qualified higher education expenses.

b. **Revocable Trusts**. If a third-party donor contributes cash to a section 529 account owned by a revocable trust, the donor would be treated as if the donor had made a contribution to a section 529 account for the designated beneficiary with the trust grantor as the account owner. The transfer tax consequences of any subsequent change in designated beneficiary by the account owner while the trust is revocable should be governed by the general rules under Code section 529 applicable to individual account owners. After the trust becomes irrevocable, the GST tax rules would govern the transfer tax consequences. The transferor for GST tax purposes would be (1) assigned to the third-party donor's natural generation if the original contribution to the section 529 account was not a generation-skipping transfer (i.e., the designated beneficiary is not two or more generations below the third-party donor), or (2) assigned to the generation immediately above the designated beneficiary's generation if the original contribution to the section 529 account was a generation-skipping transfer (i.e., the designated beneficiary is two or more generations below the third-party donor). If the section 529 account had contributions from different transferors, the respective portions of the account would be treated as separate trusts for GST tax purposes.

D. **Income Tax Issues**. The income tax treatment of a trust-owned section 529 account should also depend upon whether the trust is revocable or irrevocable. Some of the issues to consider include (1) whether a trust's contribution to a section 529 account constitutes a trust distribution to the designated beneficiary, (2) the tax consequences of distributions from a section 529 account to the designated beneficiary, (3) the tax consequences of a distribution from a section 529 account to the trust, and (4) the income tax consequences of a change of designated beneficiary.

1. **Irrevocable Trusts**

a. **529 Contribution Is Not a Trust Distribution**. The income tax consequences of a contribution to a section 529 account by an irrevocable trust should be based on whether or not the trustee has made or should be considered to have made a distribution to a beneficiary of the trust. "Distribution," by itself, is not defined in the Internal Revenue Code or in the Treasury Regulations. But my Black's Law Dictionary defines it as a "giving out." In other words, the trustee must deliver property to a beneficiary to effect a distribution to such beneficiary. When a trust establishes a trust-owned section 529 account for a beneficiary, the beneficiary does not receive any property or any property interest in the account. The trustee can revest the contribution (as well as its earnings), will control the timing and amount of all distributions to the designated beneficiary and can change the beneficiary. Therefore, a contribution by an irrevocable trust to a section 529 savings account of which the trustee is the account owner should be treated merely as a trust investment and have no income tax consequences for the trust.

b. **529 Distribution to Beneficiary Is Trust Distribution**. If the trust directs a nonqualified distribution to the designated beneficiary, the designated beneficiary will be liable for income tax and the additional 10% tax on the earnings portion of such distribution. If the trust directs a qualified distribution to the designated beneficiary (or the school), no federal income tax consequences would result under Code section 529.

c. **Does 529 Distribution Carry Out DNI**? Will a distribution from a trust-owned 529 account carry out distributable net income ("DNI") from other trust assets?

For income tax purposes, a section 529 account should be treated as a separate share, except in the case where the designated beneficiary is the sole beneficiary of the trust. This result is consistent with the intent of Code section 529, the separate share rules and the administration of QTPs. First, Code section 529(c) provides that except as otherwise provided in Code section 529, no amount should be includible in gross income of a designated beneficiary or contributor. It would be quite odd if, in light of the language, Congress had intended that income from a section 529 account could be included in the gross income of someone other than the account owner, designated beneficiary or contributor, namely someone who was merely a beneficiary of a trust that owned a section 529 account for a different beneficiary.

Second, the separate share rule applies "if different beneficiaries have substantially separate and independent shares." Treas. Reg. § 1.663(c) – 1(a). A separate share is created whenever a trust has more than one beneficiary (whether current, future or contingent) and a section 529 account is created for one of those beneficiaries, because so long as the section 529 account remains in existence, it can only be distributed to the designated beneficiary. It can be revested by the trust, but that would terminate the separate share. (The trust would incur under Code section 529 the income tax consequences that accompany a nonqualified distribution.) A separate share may exist even if the share might not ultimately be received by the beneficiary or if in the future it may be recombined with other shares. Treas. Reg. § 1.663(c) – 3(a).

As a consequence, if a trust has more than one beneficiary, DNI for all section 529 accounts owned by an irrevocable trust for a particular designated beneficiary is determined separately from DNI for the remainder of the trust (and separately from DNI for section 529 accounts owned by the trust for other designated beneficiaries). Thus a distribution from the section 529 account to the designated beneficiary will not carry out DNI from non-section 529 account assets, regardless of whether such section 529 account distribution is qualified or nonqualified. Further, assuming the trust owns only one section 529 account for the designated beneficiary, a nonqualified distribution from a section 529 account to the designated beneficiary will only carry out income from the section 529 account, determined as provided under Code section 529.

However, if there is only one beneficiary of a trust, so that the separate share rule does not apply, conceivably a distribution from a trust-owned section 529 account could carry out DNI. Practically, this should not be much of a problem, if the trustee can make a distribution to the beneficiary to pay income taxes. In the case of a qualified distribution, which would not carry out any income from the section 529 account, one could treat the distribution as any other distribution in determining DNI. However, in the case of a nonqualified distribution, would the beneficiary be liable both for the income taxes under Code section 529 and the DNI carried out with the full amount of the distribution? Perhaps the forthcoming guidance promised by the IRS could simply decide that a section 529 account will be treated as a separate share even when a trust has only one beneficiary.

d. **529 Distribution to Trust**. If a nonqualified distribution is made to the trust, the earnings portion of the distribution will be subject to income tax and, unless one of the special exceptions applies, to the additional 10% tax. Code § 529(c)(3).

e. **Change of Beneficiary to Non-Family Member**. Are there any income tax consequences to the trust if it changes the designated beneficiary of a trust-owned section 529 account and the new beneficiary is not a member of the family of the old beneficiary? Code section 529(c)(3)(A) provides for income taxation of "distributions." One would not normally think of a change of beneficiary as a distribution. Nonetheless, Code section 529(c)(3)(C)(ii) provides that any "change in the designated beneficiary of an interest in a qualified tuition program shall not be treated as a distribution for purposes of subparagraph (A) if the new beneficiary is a member of the family of the old beneficiary." This Code section makes sense only in the sense that if a change of beneficiary is deemed to be a gift under Code section 529, it might reasonably be viewed as also being a distribution. In the case of a change of beneficiary to a member of the family of the old beneficiary who is in a lower generation, which is deemed to be a gift, Code section 529(c)(3)(C)(ii) ensures that there are no income tax consequences. Presumably, by implication, it imposes income tax if a beneficiary is changed to someone who is not a member of the family of the old beneficiary. But it is unclear whether such rule would apply to a change of beneficiary of a trust-owned account, if the change of beneficiary was not a gift, as argued above.

2. **Revocable Trusts**. Because a revocable trust is a grantor trust under Code section 676, there should be no income tax consequences when a revocable trust makes a contribution to a section 529 account. However, if a revocable trust owns a section 529 account that makes a nonqualified distribution to a designated beneficiary, the income tax consequences should flow to the designated beneficiary. There should be no special income tax consequences when a revocable trust becomes irrevocable.

E. Trust Law Issues

1. **Trustee Power**. Does the trustee have the power, under the trust instrument or applicable state law, to establish a section 529 account? Arguably a section 529 account is just a different type of investment, with potentially favorable tax treatment. However, the careful draftsperson will consider including in new trust documents explicit authority to invest in section 529 accounts.

2. **Prudent Investor Rule**. Under the Prudent Investor Rule adopted by many states, an investment in a qualified tuition program is permissible if it is an investment a prudent investor would make "in light of the purposes, terms, distribution requirements, and other circumstances of the trust." RESTATEMENT (THIRD) OF TRUSTS (Prudent Investor Rule) § 27 (1992). Of course the language of the trust document and the law of the governing state must be analyzed in each instance.

   a. **Appropriate Investment**. First, the investment must be appropriate in light of the purposes, terms, distribution requirements, and other circumstances of the trust. An investment in a section 529 account would generally be appropriate where a purpose of the trust is to fund the higher education of a beneficiary or to benefit generally the beneficiary, the trust permits distributions for higher education expenses or distributions for broader purposes such as "best interests" that may include higher education, and it appears likely the beneficiary will incur such expenses.

   b. **Pooled Investment Vehicle**. Second, section 529 account programs are generally pooled investment vehicles similar to mutual funds. The use of pooled investment vehicles is expressly sanctioned by statute in many states, though the language of some such statutes may not be broad enough to include section 529 savings account programs. Similarly, the terms of many trusts sanction the use of pooled investment vehicles. In the absence of statute or trust provisions authorizing or restricting their use, pooled investment arrangements should be permissible investments under the principles of the Prudent Investor Rule. See RESTATEMENT (THIRD) OF TRUSTS (Prudent Investor Rule) § 227 comment m (1992). Even under the older, more restrictive Prudent Person Rule, such an investment may be permitted. Comment to § 227 of the RESTATEMENT (SECOND) OF TRUSTS (1959) states:

      > *n.* *Investment trusts*. In several States trustees are permitted, subject to certain restrictions, to invest in stocks or other securities of management type investment companies. In many of the statutes the company, whether a trustee or corporation, must be qualified under the Federal

Investment Company Act of 1940. Apart from statute it would seem to be not improper for a trustee to make such an investment, provided that it is a prudent one, and that such an investment does not involve any delegation by the trustee of his powers.

c. **Other Factors**. Third, the trustee must examine the proposed investment in a section 529 account program as the trustee would examine any other investment, considering a number of factors, including expectations concerning the investment's total return, the risk of the investment and how it affects the risk of the portfolio overall, and fees. The trustee should also consider any special characteristics of the investment that affect its risk-reward tradeoffs and effective return, such as the presence and utility of tax advantages. See RESTATEMENT (THIRD) OF TRUSTS (Prudent Investor Rule) § 227 comment k.

d. **Fees**. Part of the trustee's examination of the proposed section 529 account investment should include careful consideration of fees. The Prudent Investor Rule directs that the trustee "incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship." RESTATEMENT (THIRD) OF TRUSTS (Prudent Investor Rule) § 227(c)(3). Because the differences in total costs for qualified tuition program investments can be significant, it is important for the trustee to make careful cost comparisons. RESTATEMENT (THIRD) OF TRUSTS (Prudent Investor Rule) § 227 comment m.

3. **Delegation**. Investing in a pooled investment vehicle such as a section 529 account should not violate rules concerning delegation under the Prudent Investor Rule because acquisition, retention, and disposition of the trust's interest in the qualified tuition program are all within the trustee's control. Comment m to the RESTATEMENT (THIRD) OF TRUSTS (Prudent Investor Rule) § 227 states:

> Thus, for this purpose, the relevant securities are the fund shares held by the trustee, not the corporate, government, or other securities held in the pooled fund, much as any stock investment held in trust involves the shares rather than the internal assets of the issuing corporation. Even viewed as a delegation, however, the action would be justifiable and proper (see Comment j, above) as long as the investment is otherwise prudent for the trustee.

Comment j states, in part:

> With professional advice as needed, the trustee personally must define the trust's investment objectives. The trustee must also

make the decisions that establish the trust's investment strategies and programs, at least to the extent of approving plans developed by agents or advisers. Beyond these generalizations, expressed in terms that are necessarily imprecise, there is no invariant formula concerning functions that are to be performed by the trustee personally. . . .

The trustee's authority to delegate is not confined to acts that might reasonably be described as "ministerial." Nor is delegation precluded because the act in question calls for the exercise of considerable judgment or discretion. The trustee's decisions with regard to delegation are themselves matters of fiduciary judgment and responsibility falling within the sound discretion of the trustee. . . .

In deciding what as well as whether to delegate and in selecting, instructing, and supervising agents, the trustee has a duty to the beneficiaries to act as a prudent investor would act under the circumstances. The trustee must exercise care, skill, and caution in establishing the scope and specific terms of any delegation, and must keep reasonably informed in order to monitor the execution of investment decisions or plans.

See also RESTATEMENT (THIRD) OF TRUSTS (Prudent Investor Rule) § 171.

4. **Beneficiary**. When the trustee establishes a section 529 account, generally the trustee must designate one of the trust beneficiaries as the beneficiary of the section 529 account.

   a. **Trust Cannot Be Section 529 Account Beneficiary**. The trustee cannot designate as the beneficiary the trust.

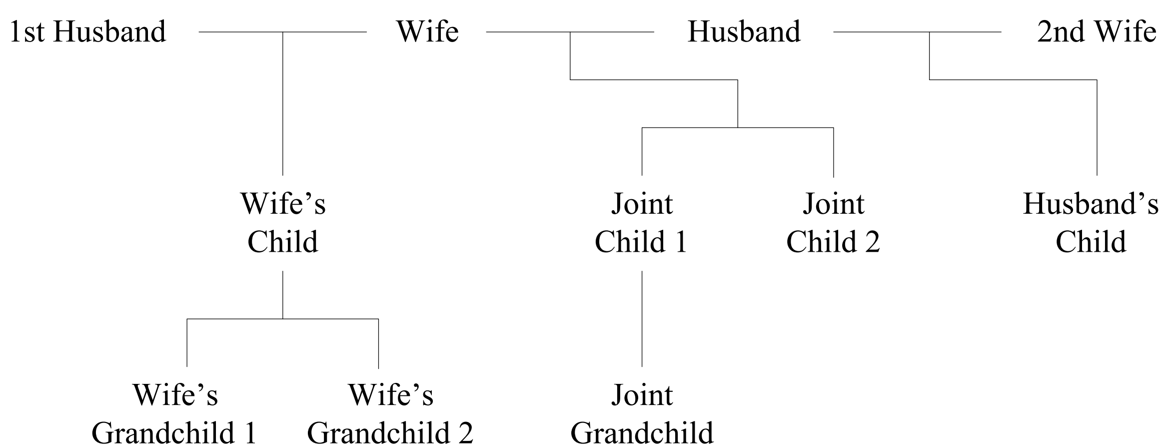
   b. **No Multiple Beneficiaries**. The trustee cannot designate more than one beneficiary for a single section 529 account, although the trustee may establish more than one section 529 account with different beneficiaries if the trust has multiple beneficiaries.

F. Changing the Beneficiary. If the trust is a spray trust for multiple beneficiaries, the trustee could change the beneficiary of the section 529 account from one trust beneficiary to another trust beneficiary, if permitted by the state program. However, the new beneficiary must be a member of the family of the old beneficiary to avoid treatment as a nonqualified distribution, and gift (and possibly GST) tax consequences will result if the beneficiary is in a younger generation than the old beneficiary.

G. Example of Change of Beneficiary Rules. Assume an irrevocable trust was established by Husband and Wife for the child of the Wife by her first marriage (Wife's Child) and the children of Husband and Wife (Joint Child 1 and Joint Child

2), and their respective descendants. Husband and Wife subsequently divorced and Husband remarried and had an additional child (Husband's Child). By court order the trust was modified to include Husband's Child and such Child's future descendants. The trust is primarily for the college education of all of the descendants. Wife's Child has completed her education and has two minor children (Wife's Grandchild 1 and Wife's Grandchild 2). Joint Child 1 has complete his education and has one minor child (Joint Grandchild). Joint Child 2 has completed her education and currently has no children. Husband's Child is a minor and has no children. The Trustee would like to use the trust assets to establish six equal shares, one for each of the three living grandchildren, one for Husband's Child, who has not completed her education, one for the future children of Joint Child 2 and one for the future children of Husband's Child. Can 529 accounts be used for all six shares?

Here's a family tree:



1. **Permissible Trust Investments**. One consideration is whether section 529 accounts are permissible trust investments. If the trust has normal investment provisions most likely they are.

2. **Trusts as Account Owners**. Second, you should consider whether a trust can be an account owner of a section 529 account. Most, though not all, 529 programs permit trusts to be account owners. The Advance Notice of Proposed Rulemaking on Section 529 (published in the *Federal Register*, January 18, 2008), however, indicates that the IRS is considering prohibiting trusts from owning 529 accounts. The Advance Notice is not binding and any such rule would not be effective until incorporated into 529 regulations or at least a published IRS Notice. Further, the Advance Notice promises to give QTPs at least 15 months to make any changes the IRS may require in the future. If the IRS did in the future prohibit trusts as account owners it might grandfather trust accounts already in existence or permit trusts to terminate their section 529 accounts without adverse tax consequences. It is conceivable that the IRS could force trusts to terminate

their section 529 accounts and subject the earnings to income tax, but this seems to me an unfairly harsh result. In any event, the Trustee should be aware that the IRS could change the rules with respect to trust-owned section 529 accounts in the future.

3. **GST Tax Rules**. Next the generation-skipping transfer ("GST") tax considerations of establishing section 529 accounts for grandchildren and of making distributions from such section 529 accounts to grandchildren should be considered. The IRS has not provided guidance on the tax consequences of trusts investing in and making distributions from trust-owned section 529 accounts. If, however, the trust is either grandfathered from GST tax or has a zero inclusion ratio for GST tax purposes because GST exemption was assigned to the trust, there should be no GST tax issues.

4. **Exercise of Trustee's Discretion**. Fourth, the Trustee should consider whether dividing the assets in this manner is a reasonable exercise of the Trustee's discretion that appropriately balances the interests of the beneficiaries, including unborn children and grandchildren. This depends upon the terms of the trust, the law governing the trust and the circumstances of the beneficiaries. It is important to note, however, that just because the Trustee divides the assets into six shares for purposes of establishing the section 529 accounts, the Trustee will not be obligated to distribute all of a beneficiary's account to such beneficiary. The Trustee would retain the right to change the beneficiary of each account (subject to the income and gift tax rules discussed below) or to withdraw the account (subject to the income tax rules) and reinvest the account proceeds as trust assets. Thus the Trustee would still have the ability to modify the proposed education funding plan to take into account after born beneficiaries or to make distributions for purposes other than education if permitted by the terms of the trust.

5. **Accounts for Living Beneficiaries**. For the living grandchildren and Husband's Child who has not completed her education, the trust can establish a separate section 529 account for each beneficiary with the trust as the account owner and the beneficiary as the designated beneficiary. The Trustee should consider what will happen with any section 529 accounts that is not used by the particular beneficiary for his or her qualified higher education expenses. The Trustee should also consider what flexibility the Trustee will have to change the beneficiary of a particular account to provide for after born beneficiaries.

   A beneficiary can be changed without tax consequences if the new beneficiary is in the same generation as the old beneficiary and is a "member of the family" of the old beneficiary. If the new beneficiary is not a "member of the family" of the old beneficiary, the change of beneficiary will be treated as a nonqualified distribution and income tax and a penalty will be imposed on the earnings. So, for example, who is a "member of the family" of Wife's Grandchild 1, to whom the beneficiary on the account for Wife's Grandchild 1 could be changed? Let's take a romp through the tax code. "Member of the family" is defined in Code section 529(e)(2) with respect to the old beneficiary as:

(A) The spouse of such beneficiary;

(B) An individual who bears a relationship to such beneficiary which is described in subparagraphs (a) through (g) of Code section 152(d)(2);

(C) The spouse of any individual described in subparagraph (B); and

(D) any first cousin of such beneficiary.

Code section 152(d)(2) includes the following individuals:

(A) A child or a descendant of a child.

(B) A brother, sister, stepbrother, or stepsister.

(C) The father or mother, or an ancestor of either.

(D) A stepfather or stepmother.

(E) A son or daughter of a brother or sister of the taxpayer.

(F) A brother or sister of the father or mother of the taxpayer.

(G) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

So the beneficiary of the section 529 account for Wife's Grandchild 1 could be changed to (1) Wife's Grandchild 2 or another child Wife's Child might have in the future (who would be a sibling of Wife's Grandchild; see Code section 152(d)(2)(B)); or (2) to Wife's Child, for example if she went back to school (who would be a mother of Wife's Grandchild; see Code section 152(d)(2)(C)).

Could the beneficiary of the section 529 account for Wife's Grandchild 1 be changed to H's Child? While a sister of the mother of the taxpayer (an aunt) would be a member of the family, Wife's Child and Husband's Child are not related by blood and therefore are not considered to be siblings.

Could the beneficiary of the section 529 account for Wife's Grandchild 1 be changed to Joint Child 1 or Joint Child 2? Yes. Code section 152(f)(4) provides that the terms "brother" and "sister" include a brother or sister by the half blood. A Joint Child would fall under Code section 152(d)(2)(F) as a brother or sister of the father or mother of Wife's Grandchild 1.

Could the beneficiary of the section 529 account for Wife's Grandchild 1 be changed to Joint Grandchild? Probably, but it is not clear. Code section 529(e)(2)(D) including first cousins as members of the family was not in the initial version of Code section 529 but was later added. Most of the members of the family are defined by reference to Code section 152, which specifically contains a provision including brothers and sisters of the half blood. Code section 529, however, does not define "first cousin" or contain any provision including cousins by the half blood. Black's Law dictionary defines "first cousin" as the children of the brother or sister or one's father or mother. If one imports the rule in Code section 152 that brothers and sisters of the half blood are included, then Wife's Grandchild 1 and Joint Grandchild are first cousins and therefore Joint Grandchild is a "member of the family" of Wife's Grandchild 1. While this seems a reasonable construction of the term "first cousin" there's no guarantee that the IRS will see things similarly.

Let's now consider a different beneficiary. If the Trustee later wants to change the beneficiary of the account for Joint Grandchild, who are "members of the family" of Joint Grandchild? Members of the family of Joint Grandchild include any future child of Joint Child 1 (who would be a sibling of Joint Grandchild; see Code section 152(d)(2)(B)), Joint Child 1 (who would be a parent of Joint Grandchild; see Code section 152(d)(2)(C)), Joint Child 2 (who would be a sibling of a parent of Joint Grandchild; see Code section 152(d)(2)(F)), any future child of Joint Child 2 (who would be a first cousin of Joint Grandchild; see Code section 529(e)(2)(D)), Wife's Child (who would be a sibling by half blood of a parent of Joint Grandchild; see Code section 152(d)(2)(F)) and maybe Wife's Grandchild 1 (who would be a first cousin by half blood of Joint Grandchild).

If the Trustee later wants to change the beneficiary of the account for Husband's Child, who are members of the family of Husband's Child? Members of the family of Husband's Child include any future child of Husband (who would be a sibling or half sibling of Husband's Child; see Code section 152(d)(2)(B)), Joint Child 1 or Joint Child 2 (who would be half siblings of Husband's Child; see Code section 152(d)(2)(B)), any child of Husband's Child (but this moves the beneficiary down a generation) and maybe any child of Joint Child 1 or Joint Child 2 (who would be a first cousin by half blood of Husband's Child). Wife's Child and Wife's Grandchildren would not be members of the family of Husband's Child.

If the beneficiary of the account for Husband's Child is changed to a future child of Husband's Child, the new beneficiary would be a member of the family of the old beneficiary but the new beneficiary would be in a lower generation than the old beneficiary. Code section 529(c)(5) provides that the gift tax and GST tax apply to any change of beneficiary if the new beneficiary is in a lower generation. However, the gift tax rules do not apply to trusts. Therefore there should be no gift tax consequence of changing the beneficiary to a lower generation in this case. Further, there should be no GST tax consequence of changing the beneficiary to a lower generation; any GST tax consequences should occur, if at all, only when a distribution is made to a beneficiary who is a grandchild or when the last beneficiary in the children's generation dies. Further, if the trust is exempt from GST tax (for example, because GST exemption was allocated to the trust) there should be no GST tax when a distribution is later made to the new beneficiary. Note that the IRS has not yet formulated gift and GST tax rules for trust-owned section 529 accounts, so these conclusions are merely my speculation on how the rules should work.

6. **Accounts for Beneficiaries to be Born in the Future**. Let us consider what to do about the section 529 accounts that the Trustee wants to establish for the unborn children of Joint Child 2 and the unborn children of Husband's Child. Each section 529 account needs a living beneficiary. For the unborn children of Joint Child 2 there are two options. One is to establish a second account for Joint Grandchild, and when a child of Joint Child 2 is born change the beneficiary to the newborn. Because the newborn would be a cousin of Joint Grandchild, and therefore a member of the family, and in the same generation, there should be no adverse tax consequences to the change of beneficiary. The Trustee would need to make certain that the combined balances of the accounts for Joint Grandchild would not exceed the contribution limit established by the QTP.

The alternative option is to establish an account with Joint Child 2 as the beneficiary and when Joint Child 2 has a child change the beneficiary to the newborn. While Joint Child 2's child would certainly be a member of the family, the beneficiary would be moving down a generation. As noted above, the IRS has not formulated rules for a change of beneficiary of a trust-owned section 529 account that moves the beneficiary down a generation. While I think that there should be no tax consequences to a change of beneficiary to a member of the family in a lower generation by a trust-owned account, that is merely my best analysis. Because of this uncertainty, my preference would be to use the first option, which seems to have less uncertainty.

For the unborn children of Husband's Child, who is still a minor, there are also two options. One is to open a second account for Joint Grandchild and change the beneficiary to Husband's Child's child when born. As discussed above, it is not absolutely clear that a first cousin by half blood is a member of the family. If the IRS decided that half blood cousins were not members of the family, then such a change of beneficiary would be considered a nonqualified distribution and subject to income tax and a penalty on the earnings. Further, given the likely age difference between Joint Grandchild and any future child of Husband's Child, Joint Grandchild could be fairly old before the beneficiary is changed. While most 529 plans do not currently impose age restrictions on beneficiaries, age restrictions could become more common in the future if the IRS finds that significant amounts of 529 funds are in accounts with relatively old beneficiaries who are unlikely to use such funds for their own education.

The second option is to put more funds in Husband's Child's account and then when Husband's Child has a child change the beneficiary. This involves moving the beneficiary down a generation, with the risks described above, but may be the better option given the family situation. Again, the Trustee would need to make certain that the combined balances of the accounts for Husband's Child would not exceed the contribution limit established by the section 529 plan.

H. **Advantages of Trust as Account Owner**. There are a number of advantages to having a trust, instead of an individual, own a section 529 account for a beneficiary.

1. **Trust Benefits Only Beneficiaries**. If an individual is the account owner of a section 529 account for a beneficiary, the individual may take a nonqualified distribution and keep the proceeds personally. Alternatively, the individual account owner can change the beneficiary of the section 529 account to another individual. Under current law the account owner appears to have no fiduciary duty to the beneficiary of the section 529 account. So long as the donor is the account owner, there is, of course, no risk of the donor's intent being frustrated. But when the donor becomes incapacitated or dies, the successor individual account owner may be able to frustrate the donor's intent. In contrast, if a trust is the account owner, the trustee is bound by the terms of the trust and has a fiduciary duty to the trust beneficiaries.

2. **Trust Can Limit Uses of Funds**. Some donors to section 529 accounts may wish to ensure that the funds will be used for post-secondary school expenses, or even only for college and graduate school. If a parent is the successor account owner without a trust, the parent could use the funds for religious school, elementary or secondary private school expenses, or home schooling, leaving less funding for higher education. A trust can specify the purposes for which distributions are made. Further, when parents divorce there may be a temptation for the parent who will be paying child support to ask the court to use any available section 529 account funds to offset elementary or secondary school expenses.

3. **Nonqualified Distributions**. If the donor is the account owner and a nonqualified distribution is made to the donor, the funds are back in the donor's estate. If a trust is the account owner and the donor has not retained any rights under or powers over the trust that would cause inclusion of the

trust in the donor's estate, the funds would be trust assets and would not be back in the donor's estate.

Even if the state program permitted a nonqualified distribution to the beneficiary, thus keeping the funds out of the account owner's estate, it might be undesirable to make an outright distribution to the beneficiary. If a trust owns the section 529 account, the proceeds of a nonqualified distribution would be held in trust subject to the terms of the trust.

Further, if the trust is a grantor trust, the nonqualified distribution could be held in trust for future distribution to the beneficiary, but the grantor would pay the income tax essentially as a tax-free gift.

4. **Account Owner Succession**. A trust-owned section 529 account solves the problem of providing for a successor account owner if the account owner becomes disabled or dies. Although many qualified tuition programs permit the designation of a successor account owner, the named successor may be unwilling or unable to act. A trust may contain more elaborate provisions for ensuring that there will always be a trustee willing and able to administer the trust and to act as the account owner of the section 529 account.

5. **Impartiality if Multiple Beneficiaries**. If the donor has established a section 529 account with the intent of changing the beneficiary to a different beneficiary if the original beneficiary does not need all of the funds for QHEEs, this intent may be frustrated if an individual other than the donor becomes the account owner. For example, Son may be unwilling to change the beneficiary of the funds remaining in a section 529 account after his child has completed his education to his niece (the child of Son's sister). However, if a trust is the account owner, the trustee must treat the beneficiaries impartially. The trust instrument can provide specific directions to the trustee, for example directing that trust funds be used primarily for education.

6. **Creditor Protection**. Even if state law does not protect the section 529 account from the beneficiary's creditors, the trust may contain a spendthrift clause that protects the trust assets from the beneficiary's creditors.

I. Disadvantages of Trust as Account Owner

1. **No Front Loading of Trust Contributions**. Code section 529 permits a donor to contribute up to five times the annual exclusion amount and to elect to treat the gift as if it were made pro rata over five years for gift tax purposes. No similar election is available for gifts to a trust, even if the trustee intends to invest the assets in a section 529 account.

2. **Gift Tax Annual Exclusion**. Code section 529 provides that gifts to a section 529 account qualify for the gift tax annual exclusion. However, this provision would not apply to a gift to a trust, even if the trustee eventually

invests the funds in a section 529 account. Therefore, gifts to a trust must qualify for the gift tax annual exclusion under other tax rules. In order to qualify gifts to the trust for the annual exclusion, the trust should be a section 2503(c) trust or should give the beneficiary a withdrawal right over contributions. Gifts to mandatory income trusts can qualify for a partial annual exclusion based on the actuarial value of the income interest.

3. **GST Annual Exclusion**. Code section 529 provides that gifts to section 529 accounts qualify for the GST annual exclusion. However, this provision would not apply to a gift to a trust, even if the trustee intends to invest the assets in a section 529 account. Gifts to trusts qualify for the GST annual exclusion only if (1) they qualify for a gift tax annual exclusion, (2) the trust is for a single beneficiary, and (3) the trust will be included in the beneficiary's estate.

4. **State Income Tax Deduction**. In some states a state income tax deduction is available for contributions to a section 529 account. This deduction would not be available for a gift to a trust. Whether the trust could claim a state income tax deduction for its contribution to a section 529 account would depend on state law.

5. **Income Tax Rates**. In the event of a nonqualified distribution, income taxes on the earnings portion of a trust-owned section 529 account would be paid at the trust's income tax rate, if the trust is a nongrantor trust and does not make a distribution that carries out DNI, or at the grantor's rate if the trust is a grantor trust with respect to the account owner. The trust's or grantor's income tax bracket could be higher than the beneficiary's income tax bracket.

6. **No Refund to Donor**. The donor cannot get the funds back by taking a nonqualified distribution because the funds are owned by the trust.

7. **Liquidation of Investments**. Only cash can be invested in a section 529 account. Therefore a trust with existing non-cash investments must first liquidate the investments and incur the income tax consequences of such liquidation.

8. **Financial Aid**. A beneficiary's interest in a trust is treated as an asset of the beneficiary for federal financial aid purposes. A section 529 account is treated as an asset of the account owner for federal financial aid purposes. Thus a trust-owned account might be assessed at twenty percent, while a parent-owned account would be assessed at a maximum rate of 5.6 percent.

XII. Trust as Successor Account Owner. Is it possible to have the best of both alternatives by naming the individual contributor as the initial account owner and naming a trust as the successor account owner upon the contributor's death or incapacity? (Alternatively, if the contributor is married, the contributor might name his or her spouse as the first successor account owner, and the trust as the second successor account owner.) Thus so long as the contributor is living and not incapacitated, the contributor can still make a nonqualified distribution for his or her own benefit and can retain complete freedom to change the account beneficiary, subject to the tax rules of Code section 529. However, once the contributor can no longer act as account owner, the new account owner will be a trust, and the trustee will have a fiduciary duty only to use the funds for the benefit of the trust beneficiary or beneficiaries. The trustee could not pocket the funds himself or herself, and could not change the beneficiary except as permitted by the trust.

The trust to be named as successor account owner might be the contributor's revocable trust, a special revocable trust created solely for this purpose, or an irrevocable trust.

A. **Change of Account Owner Upon Incapacity**. One should carefully review the program documents to determine (1) whether the account owner may designate a successor account owner to take effect upon the account owner's incapacity and (2) how such incapacity is determined. If it is not possible to designate a successor account owner to take effect upon incapacity, it may be possible to grant the account owner's agent under a durable power of attorney the power to change the account owner, which the agent could then exercise upon the account owner's incapacity. Again, the program documents should be reviewed to see if account owner changes are permitted and under what circumstances they may be made by an agent under a durable power of attorney. Further, the durable power of attorney should expressly grant this power to the agent.

B. **Revocable Trust**. The contributor may have a typical estate planning revocable trust that permits distributions to the grantor during the grantor's life, and upon the grantor's death provides for the revocable trust assets (including any assets added to the revocable trust by reason of the grantor's death) to be distributed to one or more beneficiaries. The trust becomes irrevocable upon the grantor's death.

1. **Gift Tax Consequences of Becoming Account Owner**. If the revocable trust becomes the account owner by reason of the contributor's incapacity, no gift tax consequences should result from the change of account owner. First, the Code section 529 contribution was treated as a completed gift to the Code section 529 beneficiary when initially made. Second, under current law there is no provision for imposing gift tax upon a change of account owner.

2. **Estate Tax Consequences of Account Owner Upon Incapacity**. If the revocable trust becomes the account owner by reason of the contributor's incapacity, would the section 529 account be included in the contributor's estate upon the contributor's subsequent death? The answer should be no, at least if the 529 account cannot be used to pay estate taxes, debts and claims. Code section 529(c)(4) provides: "No amount shall be includible in the gross estate of any individual for purposes of chapter 11 [the estate tax chapter] by reason of an interest in a qualified tuition program." The Proposed Regulations provide: "Except as provided in paragraph (d)(2) of

this section [regarding the five-year election], the gross estate of a decedent dying after June 8, 1997, does not include the value of any interest in a QSTP which is attributable to contributions made by the decedent to such program on behalf of any designated beneficiary." Prop. Treas. Reg. § 1.529-5(d)(1). There seems little doubt that Code section 529 was intended to override the more general provision of section 2031, which includes in a decedent's estate the "value at the time of his death of all property, real or personal, tangible or intangible, wherever situated."

Some individuals, however, have expressed concern that a section 529 account owned by a revocable trust would be included in the grantor's estate under Code section 2036 or Code section 2038, which would generally apply to include assets of a revocable trust in the grantor's estate.

Code section 2036(a) provides:

> *(a) GENERAL RULE. – The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death –*
>
> > *(1) the possession or enjoyment of, or the right to the income from, the property, or*
> >
> > *(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.*

Code section 2038(a)(1) provides:

> *(1) TRANSFERS AFTER JUNE 22, 1936. – To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable), by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3-year period ending on the date of the decedent's death.*

While I believe that the very specific language of Code section 529 should override Code sections 2036(a) and 2038(a)(1) just as easily as it bulldozes Code section 2031, I know of no authority on point.

If the revocable trust would permit the trustee to take a nonqualified distribution from the section 529 account after the grantor's death and use the proceeds to pay the grantor's debts or estate taxes, then one might also worry about whether Code section 529 overrides Code section 2041, which includes in the grantor's estate property over which the grantor had a general power of appointment. A "general power of appointment" generally means any power exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate and includes a power exercisable to pay the estate tax, or any other taxes, debts, or charges which are enforceable against the estate. Again, Code section 529 appears to override all of the estate tax inclusion provisions of the Code, including Code section 2041, but there are not yet any favorable rulings or cases on point. Further, one might question, as a policy matter, why a section 529 account should be excluded from a contributor's estate to the extent it is used to pay debts or taxes.

3. **Estate Tax Consequences if Account Owner Upon Death**. If the revocable trust becomes the account owner by reason of the contributor's death, Code sections 2036 and 2038 should have no potential application, but Code section 2041 could still be at issue. Any potential application of Code section 2041, however, could be avoided by prohibiting the trustee from using section 529 account to pay debts or taxes.

4. **Drafting Considerations**. If, notwithstanding any tax concerns, a revocable trust is designated as the successor account owner of a section 529 account, careful attention must be given to ensure that the trust contains appropriate provisions permitting the trustee to manage the section 529 account as the grantor intends.

First, if the trust may become the account owner during the grantor's life, the trust should explicitly permit a distribution from the section 529 account to the designated beneficiary. Second, if the grantor wants the trustee to have the ability to change the beneficiary, the trust should state who are permissible alternative beneficiaries and under what circumstances the grantor would want the beneficiary changed. Third, the trust should state whether or not the trustee has the power to take a nonqualified distribution and retain the proceeds in the revocable trust, potentially for use in satisfying the grantor's needs. Fourth, if it may be desirable to make additional gifts to the section 529 account during the grantor's incapacity, the trust should explicitly grant such power to the trustee. The grantor may also wish to grant such gift-making powers to the grantor's agent under the grantor's durable power of attorney.

Upon a grantor's death, the revocable trust assets are generally distributed to one or more trusts or beneficiaries. The trust should contain explicit instructions as to which successor trust or beneficiary should become the account owner on the grantor's death. The section 529 account should pass only to a trust of which the designated beneficiary is a beneficiary, which is permitted to make distributions for the beneficiary's higher education. The section 529 account should not pass to a trust qualifying for the marital deduction (unless the spouse is the designated beneficiary). Once the section 529 account is transferred to the successor trust, the trustee will not have authority to change the beneficiary of the section 529 account to someone who is not a beneficiary of that trust, unless the trust explicitly permits otherwise. Careful consideration should be given to defining the permissible class of successor beneficiaries, particularly if a subtrust with a smaller class of beneficiaries becomes the successor account owner upon the death of the grantor.

The revocable trust should also contain provisions authorizing the trustee to hold a section 529 account as an investment, to change investment elections, and to rollover the account to a different QTP.

C. **Irrevocable Trust**. The contributor may establish an irrevocable trust that can be designated as the successor account owner. For purposes of this discussion we will assume that the contributor is not and cannot become the trustee of the irrevocable trust and that the contributor has no power to alter, amend or revoke the trust or to designate the persons who shall possess or enjoy the trust property or to change their interests.

If the irrevocable trust becomes the account owner by reason of the contributor's incapacity, under current law no gift tax consequences should result from the change of the account owner. However, under the Advance Notice, any nonqualified distribution taken by the trust might be entirely subject to income tax, because the trust did not originally contribute the funds to the section 529 account.

The section 529 account should not be included in the contributor's estate because Code section 529(c)(4) provides: "No amount should be includible in the gross estate of any individual for purposes of Chapter 11 by reason of an interest in a qualified tuition program." Further, Code sections 2036, 2038 and 2041 are of no concern because we have assumed that the contributor retained no power over or interest in the trust.

As described above with respect to a revocable trust, the irrevocable trust should be carefully drafted to contain appropriate provisions permitting the trustee to maintain and manage the section 529 account as the grantor intends.

XIII. Effect on Financial Aid

A. **Federal Financial Aid**. Generally, a student's federal financial need is determined by the difference between the cost of attendance at the educational institution and the student's Student Aid Index ("SAI") less non-federal financial aid. Federal Need Analysis Methodology for the 2025-26 Award Year (September 3, 2024). The SAI for dependent students considers (1) the parents' contribution (from income and assets); (2) the student contribution from income; and (3) the student contribution from assets. The SAI is calculated based on information submitted on a Free Application for Federal Student Aid (FAFSA).

B. Section 529 Accounts

1. **Treatment as Asset**. Qualified education benefits are an asset of the owner, except when the owner is a dependent student, in which case they are treated as an assets of the parent. A "qualified education benefit" is defined as a qualified tuition program (as defined in Code section 529(b)(1)(A)), another prepaid tuition plan offered by a state, or a Coverdell education savings account. Section 529 accounts for beneficiaries other than the student also are not considered.

2. **Income Treatment**. As long as distributions from a section 529 account do not exceed QHEEs, they will not appear in next year's taxable income. They also should not be treated as untaxed income for federal financial aid purposes. This treatment applies to all section 529 accounts regardless of who is the account owner.

3. **American Opportunity Credit & Lifetime Learning Credit**. If amounts saved through a section 529 account are used to pay for college, the student or student's parents are still eligible to claim either the American Opportunity Credit or the Lifetime Learning Credit. I.R.S. Notice 97-60, 1997-2 C.B. 310; Joint Committee on Taxation, *Overview of Present Law and Issues Relating to Tax and Savings Incentives for Education* (JCX-12-99), March 2, 1999.

C. State and School Financial Aid. States and schools may use different methods to determine non-federal financial aid.

1. **CSS**. College Scholarship Service ("CSS"), used by a number of schools for institutional aid, calculates financial aid differently than the federal methodology. Unlike the FAFSA, which excludes section 529 accounts owned by the student's parents for other beneficiaries, the CSS profile asks about all parent-owned section 529 accounts.

2. **Customization**. Schools using the CSS may customize it.

D. Trusts. The Federal Student Financial Aid Handbook (2025 – 2026) provided to colleges and universities by the Department of Education requires the following reporting for trusts on FAFSA:

> **Trust funds** are considered an asset of the named beneficiary of the trust, even if the beneficiary's access to the trust is restricted. If the settlor

of a trust has voluntarily placed restrictions on its use, then the beneficiary should report its present value as an asset, as discussed below. If a trust has been restricted by court order, however, the beneficiary should not report it. An example of such a restricted trust is one set up by court order to pay for future surgery for the victim of a car accident.

How the trust must be reported depends on whether the beneficiary receives or will receive the interest income, the trust principal, or both. In the case of a divorce or separation where the trust is owned jointly and ownership is not being contested, the property and the debt are equally divided between the owners for reporting purposes unless the terms of the trust specify some other method of division.

If a beneficiary receives **interest only** from the trust, any interest received in the base year must be reported as income. If the interest accumulates and is not paid out, the recipient must report an asset value for the interest they will receive. The trust officer can usually calculate the value of the interest the person will receive while the trust exists. This value represents the amount a third person would be willing to pay for the interest income.

The person who will receive **principal only** from the trust must report the present value of his or her right to that principal as an asset. For example, if a $10,000 principal reverts to a student's parent when the trust ends in ten years and the student is receiving the interest, the student would report the interest received as income and the present value of the student's parent's rights to the principal is reported as an asset of the parent (if the student is required to report parental data) on the student's FAFSA form. The present value of the principal can be calculated by the trust officer; it's the amount that a third person would pay for the right to receive the principal ten years from now-basically, the amount that one would have to deposit now to receive $10,000 in ten years.

If a beneficiary receives both **interest and principal** from the trust, the beneficiary should report the present value of both interest and principal, as described in the discussion of principal only. If the trust is set up so that the interest accumulates within the trust until it ends, the beneficiary should report the present value of the interest and principal that they are expected to receive when the trust ends as an asset.

In some cases, ownership of an asset may be **divided or contested**, which can affect how the owner reports the asset. If the owner has only part ownership of an asset, the owner should report only the owned part. Generally, the value of an asset and debts against it should be divided equally by the number of people who share ownership unless the share of the asset is determined by the amount invested or the terms of the arrangement specify some other means of division.

XIV. Creditor Protection. Creditor protection for section 529 accounts is provided by federal law in the case of bankruptcy (with significant limitations) and in at least 31 states by statute or regulation in the case of creditors' claims generally (which includes creditors' claims brought outside of bankruptcy proceedings).

A. Federal Bankruptcy Protection. Section 529 accounts generally will not be subject to the claims of creditors in the event of the bankruptcy of the beneficiary if the beneficiary is not the account owner because the beneficiary does not have any legal or equitable interest in the account. In the event of the bankruptcy of the account owner, all or part of the account may be excluded from the bankruptcy estate by federal law, or may be exempt by special state bankruptcy exemptions. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Legislation") provides some significant exclusions from the bankruptcy estate for contributions to section 529 accounts for certain family members where such contributions were made at least two years prior to bankruptcy, and limited protection for contributions to such accounts made between one and two years prior to bankruptcy. This provision of the Bankruptcy Act applies to bankruptcy cases filed on or after October 17, 2005 (180 days after enactment).

1. **Exclusions from Bankruptcy Estate**. The 2005 Legislation excludes from property of the bankruptcy estate under Bankruptcy Code Section 541(b):

> (6) funds used to purchase a tuition credit or certificate or contributed to an account in accordance with section 529(b)(1)(A) of the Internal Revenue Code of 1986 under a qualified State tuition program (as defined in section 529(b)(1) of such Code) not later than 365 days before the date of the filing of the petition in a case under this title, but –
>
> > (A) only if the designated beneficiary of the amounts paid or contributed to such tuition program was a child, stepchild, grandchild, or stepgrandchild of the debtor for the taxable year for which funds were paid or contributed;
> >
> > (B) with respect to the aggregate amount paid or contributed to such program having the same designated beneficiary, only so much of such amount as does not exceed the total contributions permitted under section 529(b)(7) of such Code with respect to such beneficiary, as adjusted beginning on the date of the filing of the petition in a case under this title by the annual increase or decrease (rounded to the nearest tenth of 1 percent) in the educational expenditure category of the Consumer Price Index prepared by the Department of Labor; and

(C) in the case of funds paid or contributed to such program having the same designated beneficiary not earlier than 720 days nor later than 365 days before such date, only so much of such funds as does not exceed $6,425 (the excluded amount of $6,425 is the adjusted dollar amount in effect under section 541(b) of the Code as of April 1, 2016, and such amount shall be further adjusted at each 3-year interval ending on April 1 thereafter to reflect the change in the Consumer Price Index for All Urban Consumers prepared by the Department of Labor);

In addition, with respect to determining whether the section 529 account beneficiary stands within one of the required relationships to the donor, the 2005 Legislation adds the following provision to Bankruptcy Code Section 541:

> (e) In determining whether any of the relationships specified in . . . paragraph (6)(A) of subsection (b) exists, a legally adopted child of an individual (and a child who is a member of an individual's household, if placed with such individual by an authorized placement agency for legal adoption by such individual), or a foster child of an individual (if such child has as the child's principal place of abode the home of the debtor and is a member of the debtor's household) shall be treated as a child of such individual by blood.

a. **Scope**. To summarize, contributions made to a section 529 account for a child, grandchild, stepchild or stepgrandchild more than two years prior to filing the bankruptcy petition are protected to the extent they do not exceed the amounts permitted to be contributed per beneficiary by the program. Funds contributed to a section 529 account for a child, grandchild, stepchild or stepgrandchild more than 365 days but less than 720 days prior to filing bankruptcy are protected only up to $8,575 (for 2025) per beneficiary. Contributions made to a 529 account within one year prior to a bankruptcy filing, however, are included in the property of the estate. *In re Werth*, 468 B.R. 412, 413 (Bankr. D. Kan. 2012).

b. **Exclusion, Not Exemption**. It is important to note that this is an exclusion from the property of the bankruptcy estate, not an exemption. The rules about what is included and what is excluded from the bankruptcy estate apply to all bankruptcy petitioners, regardless of whether they elect federal or state exemptions. The choice between federal and state exemptions applies only to property of the bankruptcy estate as determined under federal law.

c. **No Retroactive Application**. The Code section 541(b)(6) exclusion thus applies only to bankruptcy cases filed on or after October 17, 2005 (the effective date of the 2005 Legislation). *In re Sanchez*, No. 05-48721-JBR, 2006 WL 395225, at *1 (Bankr. D. Mass. Feb. 14, 2006). Both the Eighth Circuit and the bankruptcy court have held that Code section 541(b)(6) does not apply retroactively, even if the debtor filed his or her petition just days before the effective date. *See In re Addison*, 540 F.3d at 820 (denying exclusion for a 529 account where the petition was filed on October 14, 2005); *see also In re Sanchez*, 2006 WL at *1 n.1 ("There is no basis for determining that funds deposited into a Section 529 Plan are excluded from property of the estate prior to the recent amendments to the Bankruptcy Code.").

2. **Inclusion in Bankruptcy Estate Under Prior Law**. Section 529 accounts are included in the bankruptcy estate under Bankruptcy Code Section 541(a)(1), except as provided under Code sections 541(b) or (c). Under Code section 541(a)(1), property of the estate includes "all legal or equitable interests of the debtor in property as of the commencement of the case." Because the owner of a section 529 account controls the contributions and earnings credited to the account and can make distributions to himself or herself, he or she retains sufficient legal and equitable interest in the account to render it property of the estate under Code section 541(a)(1). *See In re Addison*, 540 F.3d 805 (8th Cir. 2008); *In re Bourguignon*, 416 B.R. 745, 750 (Bankr. D. Idaho 2009); *In re Quackenbush*, 339 B.R. 845 (Bankr. S.D.N.Y. Apr. 5, 2006); *In re Sanchez*, No. 05-48721-JBR, 2006 WL 395225 (Bankr. D. Mass. Feb. 14, 2006).

3. **Spendthrift Provision**. The Bankruptcy Code also excludes from the property of the estate a debtor's beneficial trust interest. Section 541(c)(2) makes a "restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law" enforceable in bankruptcy cases. In order for a section 529 account to qualify for this exclusion, (1) the debtor must have a beneficial interest in the account and (2) the account must be subject to sufficient restrictions on the transfer and assignment of the beneficial interest under nonbankruptcy law. *In re Bourguignon*, 416 B.R. at 750-51.

a. **Beneficial Interest**. The first requirement is satisfied if the debtor is the designated beneficiary of the account (in addition to presumably being the account owner). *Id.* at 750. Because the account owner is usually not the designated beneficiary, Section 541(c)(2) is of limited applicability.

b. **Spendthrift Trust Restrictions**. The account satisfies the second condition if it is a spendthrift trust that prohibits the assignment of the beneficiary's interest and prevents creditors from attaching that interest. *Id.* at 751 & n.9. Some states, including Minnesota and Idaho, classify section 529 accounts as spendthrift trusts. Some spendthrift provisions are sufficient to trigger the section 541(c)(2) exclusion. *See In re Addison*, 540 F.3d at 820; *see also In re McFarland*, No. 04-01623, 2004 WL 4960367, at *2 (Bankr. D. Idaho, Sept. 3, 2004). Spendthrift provisions that protect section 529 accounts from the state's creditors, but not from the creditors of the account owner or beneficiary, however, do not provide sufficient restrictions on the transfer of a beneficial interest under Section 541(c)(2). *See In re Addison*, 540 F.3d at 820. Further, federal and state law provisions that prohibit the account owner or the beneficiary from directing the fund's investments or using the section 529 account as collateral for loans but that do not prevent attachment by creditors are not sufficient restrictions on the transfer of a beneficial interest for the purposes of Section 541(c)(2). *Id.* at 751.

4. **Third-Party Contributions**. Sometimes persons other than the account owner make contributions to a section 529 account. Third-party contributions to a section 529 account are also considered property of the estate of the account owner if those contributions are not excluded under Sections 541(b) or (c). *In re Bourguignon*, 416 B.R. at 755. This rule applies regardless of whether the 529 account's plan description explicitly includes third-party contributions in the account owner's bankruptcy estate, because the Bankruptcy Code conditions exclusion on the timing, not the source, of contributions. *Id.*

5. **Support Obligations**. Bankruptcy Code Section 523(a)(5) accords special treatment to domestic support obligations by providing that debts for such obligations are not dischargeable in bankruptcy proceedings.

   a. **Nondischargeable**. In *Kimball v. Kimball*, 2015 Bankr. Lexis 70 (March 2015), a divorce settlement agreement provided in detail that the section 529 accounts held by the divorcing spouses would be used only for the education of their minor children. Post divorce, mother withdrew virtually all of the 529 funds for her personal use and subsequently filed for bankruptcy. The court held that the obligation under the marital settlement agreement was a support obligation under section 523(a)(5) and was not discharged in bankruptcy.

   b. **Use of 529 Funds to Satisfy Support Obligations**. The nondischargeability of these obligations does not, however, entitle a debtor to use a section 529 account to set aside pre-petition assets to satisfy post-petition support obligations. *In re Werth*, 468 B.R. at 413. Section 502(b)(5) specifically disallows claims against the bankruptcy estate for debts for domestic support obligations that are unmatured on the date of the petition filing. Accordingly, a debtor must pay support obligations that mature after the filing of a bankruptcy petition out of his or her post-petition income, not from the property of the estate. *Id.* The bankruptcy court considers an obligation to pay post-secondary educational expenses for a child who is not yet attending college at the time the bankruptcy petition is filed to be an unmatured, post-petition support obligation. *See id.*; *Coggin v. Coggin* (*In re Coggin*), 30 F.3d 1443, 1452 (11th Cir. 1994), *abrogated on other grounds*, *Kontrick v. Ryan*, 540 U.S. 443 (2004). Thus, if a section 529 account is included in the property of the estate, the debtor cannot claim an exemption for that account on the ground that he or she is setting aside money for future post-secondary educational expenses. *In re Werth*, 468 B.R. at 413; *see also In re Coggin*, 30 F.3d at 1452 ("The overall plan and concept of bankruptcy . . . is that the assets of the Estate are to be used only to pay the legitimate Claims of the Creditors in existence as of the filing of the Petition.").

Third-party contributions to a section 529 account are also considered property of the estate of the account owner if those contributions are not excluded under Sections 541(b) or (c). *In re Bourguignon*, 416 B.R. at 755. This rule applies regardless of whether the 529 account's plan description explicitly includes third-party contributions in the account owner's bankruptcy estate, because the Bankruptcy Code conditions exclusion on the timing, not the source, of contributions. *Id.*

6. **State Exemptions**. Bankruptcy Code Section 522(b) allows debtors to elect to claim either federal or state exemptions from the bankruptcy estate. Most states, including Idaho, require debtors to use the state exemption scheme. Thus, even where a section 529 account is not excluded from the property of the estate, a debtor may nevertheless protect the account from the claims of creditors if a state exemption applies.

a. **State Exemption Applies**. For example, section 529 accounts established under Idaho's college savings program are exempt from the bankruptcy estate under Idaho Code § 11-604A. In *In re McFarland*, No. 04-01623, 2004 WL 4960367 (Bankr. D. Idaho, Sept. 3, 2004), the debtors claimed that their daughters' 529 savings accounts were exempt because Idaho law protects employee benefit plans from creditors' claims. The bankruptcy court found that the statute's definition of employee benefit plans "expressly includes" Idaho's 529 savings accounts. *Id.* at *2.

b. **No State Exemption Exists**. If a debtor claims state exemptions, the bankruptcy court will deny his or her claim if state law does not include an applicable exemption. For example, Massachusetts law provides that the "right or interest of any person" in certain retirement plans is exempt from the claims of creditors under Mass. Gen. Laws Ann. ch. 235, § 34A. The bankruptcy court held that this statute does not apply to 529 accounts. *In re Sanchez*, 2006 WL at *1. An exemption is also not available in bankruptcy proceedings if it only protects 529 accounts from claims by creditors of the state. *In re Addison*, 540 F.3d at 820.

c. **State Exemption Does Not Apply**. Where a state exemption for section 529 accounts does exist, the bankruptcy court can deny a claimed exemption if the contributions do not meet the timing requirements of the applicable statute. Under Kan. Stat. Ann. § 60-2308(f), Kansas law prohibits exemptions for contributions to section 529 accounts made within the year preceding the filing of a bankruptcy petition. The court concluded that accounts opened less than five months before filing for bankruptcy are nonexempt estate property. *In re Werth*, 468 B.R. at 413.

A debtor's exemption claim may also fail if the bankruptcy court narrowly construes the statutory exemption. For example, In *Cirilli v. Bronk* (*In re Bronk*), 444 B.R. 902 (Bankr. W.D. Wis. 2011), the court had to interpret two Wisconsin statutes in order to determine whether the account owner could claim an exemption under state law for his grandchildren's 529 accounts. Wis. Stat. § 815.18(3)(p) exempted from the claims of creditors "[a]n interest in a college savings account" under Wis. Stat. § 14.64 (now Wis. Stat. § 16.641), but Wis. Stat. § 14.64(7)(a) (now Wis. Stat. § 16.641(7)(a)), provided that a "beneficiary's right to qualified withdrawals under this section is not subject to garnishment, attachment, execution or other process of the law." The bankruptcy trustee argued that Section 14.64(7)(a) limited the exemption to apply only to the beneficiary's right to qualified withdrawals, while the debtor argued that the statutes together provided a broad, unlimited exemption that could be claimed by the account owner as well as any beneficiaries. *Id.* at 918. The court found that the statutes were ambiguous, and so it examined a related statute concerning tuition trust funds, Wis. Stat. § 14.63(8) (now Wis. Stat. § 16.64(8)). Section 14.63(8) exempted from the claims of creditors both "[m]oneys deposited in the tuition trust fund and a beneficiary's right to the payment of tuition, fees and . . . costs."

The court ultimately adopted the trustee's narrow construction of the statute. Given that Section 14.63(8) was amended at the same time the state legislature enacted Wis. Stat. §§ 815.18(3)(p) and 14.64, "[a]ny other result would ignore the distinction the legislature made between the 'monies deposited' and the 'beneficiary's right' to withdrawals." *Id.* at 924. As a result, Wisconsin law only exempts the beneficiary's right to qualified withdrawals from a section 529 account under Wis. Stat. § 16.641.

Under the holding of *In re Bronk*, the state exemption would rarely apply to section 529 accounts in bankruptcy proceedings. Because an account owner retains control over contributions to and distributions from a 529 account, the designated beneficiary will generally never have the right to make qualified withdrawals. Statutes like Wisconsin's reinforce the fact that a beneficiary's interest in a 529 account is not attachable by creditors, but the account remains part of the account owner's bankruptcy estate. It appears that such statutes only exempt section 529 accounts if the account owner is also the designated beneficiary—for example, if a person opens an account to provide for his or her own educational expenses.

7. **Fraudulent Transfers**. It is also important to note that, notwithstanding the special protections for section 529 accounts in Bankruptcy Code Section 541, transfers to section 529 accounts could still be disregarded if they are fraudulent transfers under either federal law or applicable state law. Under Bankruptcy Code Section 548 prior to the 2005 Legislation, a fraudulent transfer or obligation made or incurred within one year before the petition date could be avoided without resort to state law. The 2005 Legislation extends the reachback period to two years. This provision is effective for bankruptcy petitions filed on or after April 20, 2006. In addition, Bankruptcy Code Section 544(b)(1) provides that a trustee may avoid a fraudulent transfer under applicable state law. The applicable law in nearly all states is the state's version of the Uniform Fraudulent Transfer Act (UFTA). *See Fraudulent Transfer Act*, UNIFORM LAW COMMISSION, http://www.uniformlaws.org/Act.aspx?title=Fraudulent Transfer Act. The reachback period under the UFTA is four years.

Since direct evidence of actual intent is rarely available, the bankruptcy court may consider "badges of fraud," which are elements that provide circumstantial evidence of the debtor's intent to hinder, delay, or defraud creditors. *Nazar v. Wills* (*In re Wills*), Nos. 06-05337, 05-17977, 2008 WL 4498802, at *7 (Bankr. D. Kan. Oct. 1, 2008). The badges of fraud include whether the debtor (1) made the transfer to an insider (e.g., a relative), (2) retained possession or control over the transferred property after the transfer, (3) concealed the transfer, (4) had been sued or threatened with suit prior to the transfer, (5) transferred substantially all of his or her assets, (6) absconded, (7) removed or concealed assets, (8) received consideration reasonably equivalent to the value of the transferred asset, (9) was insolvent or became insolvent after the transfer, (10) made the transfer shortly before or after incurring substantial debt, and (11) transferred essential business assets to an insider through a lienor. *Id.* Sufficient badges of fraud must be present in order to establish actual intent, and the insolvency of the debtor is a particularly significant factor. *Id.* at *10. For example, the bankruptcy court held that a debtor's transfers of section 529 accounts to a family trust prior to filing for bankruptcy were not fraudulent under state law where the trustee failed to prove the debtor's insolvency, despite the fact that four other badges of fraud were present. *Id.*

With respect to creditors whose claims arise prior to a transfer, state laws generally provide that the transfer is fraudulent if the debtor (1) receives less than reasonably equivalent value in exchange for the transfer and (2) was insolvent at the time of the transfer or became insolvent as a result of it. *See id.* at *12. Proof of the debtor's insolvency is a "necessary element" of a fraudulent transfer claim under such provisions. *Id*.

The bankruptcy court can also deny a discharge and disallow claimed exemptions if the debtor fraudulently transfers nonexempt assets to a section 529 account. Under Bankruptcy Code Section 727(a)(2)(A), a discharge will be denied if the court finds that (1) the debtor transferred, removed, destroyed, mutilated, or concealed his or her property (2) in the year prior to filing a bankruptcy petition and (3) acted with intent to hinder, delay, or defraud creditors. All three elements must be present in order to deny a discharge under Section 727(a)(2). *See In re Bronk*, 444 B.R. at 909. State laws may provide similar requirements for disallowing exemptions. *See id.*

To determine whether a debtor acted with actual intent to defraud creditors in carrying out pre-petition transfers, the court looks to the debtor's conduct extrinsic to the conversion. *Id.* at 912. Relevant factors include whether the debtor (1) purchased the exempt property on credit, (2) transferred the property following entry of a large judgment against him or her, (3) engaged in a "pattern of sharp dealings" with his or her creditors before bankruptcy, and (4) became insolvent as a result of the transfer. *Id.* at 912.

Even where a debtor transfers nonexempt assets to a section 529 account prior to filing for bankruptcy in order to claim the assets as exempt, the court may find that the debtor did not act with actual intent to defraud. For example, the debtor in *In re Bronk* admitted to transferring proceeds from a mortgage on his home to several 529 accounts established for the benefit of his grandchildren, and that he did so in order to protect nearly $100,000 from creditors. *Id.* at 916. Furthermore, he transferred the assets less than three months before filing for bankruptcy and had incurred substantial medical debts prior to the transfers. *Id.* at 908. Despite the presence of these badges of fraud, the court allowed the debtor's discharge and did not disallow his claimed exemptions because he carried out the transfers on the advice of his attorney, and he had not concealed assets, misrepresented his intentions, borrowed money to purchase exempt property, or engaged in "underhanded tactics" against his creditors. *Id.* at 916-17.

While the court expressed some misgivings about the conversion of nonexempt assets to exempt assets, its sympathy for the debtor in this case clearly outweighed any concerns it had about preventing fraud. The court repeatedly emphasized that denial of discharge is an "extreme remedy" to be reserved for dishonest debtors. *See id.* at 908, 918. In its view, however, Bronk was not a dishonest debtor, but rather an "elderly man" trying to provide for himself in the wake of his wife's death and in the face of "mounting medical bills." *Id.* at 917. *In re Bronk* appears to be an extraordinary case that likely demonstrates the outer boundary of what constitutes permissible pre-bankruptcy planning.

8. **UTMA or UGMA Owned Account**. A section 529 account owned by a UTMA or UGMA account should be considered property of the beneficiary and not of the account owner. *In re Quackenbush*, 339 B.R. 845 (Bankr. S.D.N.Y. 2006); *In re Altchek*, 124, B.R. 944 (Bankr. S.D.N.Y. 1991).

B. State Creditor Protection Statutes.. Attached as Appendix II is a chart of the state statutes I have identified that provide creditor protection to section 529 accounts. This chart is a work in progress and may not identify all states that provide creditor protection. Please let me know of any additional states that should be included in the chart, or of any errors in identifying or describing the relevant statutes.

1. **Limited State's Own Program**. Most of the states limit the creditor protection to programs established within that state. However, Arizona, Florida, Louisiana, Michigan, New Mexico, North Carolina, Ohio, Tennessee and Texas appear to provide creditor protection to section 529 accounts established under any state's program.

2. **Whose Creditors**? A number of state statutes protect section 529 accounts from creditors' claims generally, without specifically limiting the protection to the claims of creditors of the beneficiary, the claims of creditors of the account owner or the claims of creditors of the contributor. Presumably, the statutes of such states would protect the account from the creditors of any of the beneficiary, account owner or contributor.

   Where the beneficiary is not the contributor or the account owner, the beneficiary does not generally have any rights over the account (except in the case of a custodianship account, in which case the beneficiary generally has the right to become the account owner upon attaining the statutory age). No specific protection from the creditors of the beneficiary would thus seem to be needed, except in the case of custodial accounts. For custodial accounts held for beneficiaries who are minors under state law, protection would not generally be needed because generally minors cannot incur enforceable debts (with some exceptions). Nonetheless, a statute that expressly protects an account from the creditors of a beneficiary may provide some protection in the event of a custodial account where the beneficiary incurs debts after attaining majority but before attaining the statutory age for distribution of a custodial account.

Protection from the creditors of the account owner is critical, because the account owner generally has the right to withdraw the account.

If the contributor or donor is not the account owner, generally the creditors of the contributor would not have rights to reach the account assets because the contributor has no property rights over the account. However, protection from the creditors of the account owner could be important if the creditor could establish that the transfer was made in fraud of creditors. Only a few of the state statutes specifying who receives creditor protection expressly include a donor who is not an account owner.

3. **Abuse Avoidance**. Surprisingly, not many of the states limit the creditor protection in ways that would avoid abuse of section 529 accounts as loopholes from creditor claims. In many of the states with creditor protection one seemingly could deposit funds in a section 529 account, perhaps even after a creditor had begun an action against the debtor, to protect the assets. The debtor could be the account owner, with the ability to withdraw the funds at a later time. With the ability to contribute up to five times the annual exclusion amount per beneficiary in one year without gift tax consequences, section 529 accounts conceivably create a very large loophole to avoid creditors' claims. The debtor might even be able to name himself or herself as the beneficiary and still obtain the protection.

   Some states, however, impose limitations on the protection from creditors. A number of states provide no protection to funds deposited within a certain period prior to the bankruptcy or impose dollar amount limitations.

   A few states also provide that the exemption is not applicable to avoid child support payments or divorce claims.

C. **IRS Claims**.. Although section 529 accounts are treated as completed gifts for gift tax purposes, the accounts remain the property of the account owner and are therefore subject to levy by the IRS. *Taylor v. IRS*, U.S. Dist. Ct. NDNY (March 21, 2013). While a section 529 account owned by a UTMA account may be treated as owned by the beneficiary, there must be evidence that the account was so titled. *Id*.

D. **Spendthrift Provisions**.. Some programs do not have creditor protection statutes, but accounts are subject to spendthrift provisions.

XV. Medicaid.. Each state administers Medicaid with its own rules. To qualify for Medicaid, the applicant must meet certain qualifications. Generally, the applicant must be over 65, blind, disabled or the parent of a minor child and must meet the financial need tests.

A. Financial Needs Test.. When a person applies for Medicaid, the state values the applicant's "resources" to determine if they are less than the state's threshold amount, which may be as low as $2,000 or $3,000. Certain assets, such as a homestead or a car, are considered exempt. The federal regulations define "resources" as "cash or other liquid assets or any real or personal property that an individual owns and could convert to cash to be used for support or maintenance." 20 Code of Federal Regulations § 416.120, § 416.1201. The federal regulations further explain:

> (1) If the individual has the right, authority or power to liquidate the property or his or her share of the property, it is considered a resource. If a property right cannot be liquidated, the property will not be considered a resource of the individual (or spouse).

20 CFR § 416.1201(a)(1).

Because the applicant could withdraw the section 529 account assets and use the proceeds for support or maintenance, it would seem that section 529 account assets should be counted as a resource. Each state, however, will reach its own conclusion on whether to count section 529 account assets. It appears that New York has determined that section 529 accounts are counted as part of the applicant's assets, minus any penalties for a nonqualified withdrawal. However, federal, state and local income taxes are not deductible in determining the resource value. In contrast, the state of Michigan announced in 2005 that section 529 account funds would be disregarded. Program Eligibility Manual (PEM) Item 400.

B. Changing Account Owner.. What should an individual who is the account owner of section 529 account assets and who wishes to qualify for Medicaid do? If the state program allows the account owner to be changed, and not all state programs allow the account owner to be changed absent certain specific circumstances, then the potential applicant could change the account owner to another individual.

1. Although under current law it does not appear that this would be a gift from the old account owner to the new account owner for gift tax purposes, it may still be considered a transfer of assets for less than fair market value for Medicaid eligibility purposes. For Medicaid eligibility purposes, transfers (other than transfers in trust) made by the applicant within the last 36 months are subject to a "look back rule." To make matters worse, transfers funding an irrevocable trust that does not permit payments to the grantor are subject to a 60-month look back period if the trust is created on or after August 11, 1993. It is conceivable that certain section 529 account programs could be considered trusts for Medicaid purposes and that the action of changing the account owner to someone else, thereby

relinquishing control over the account, could be considered the equivalent of funding an irrevocable trust.

Under the Deficit Reduction Act of 2005, which became law February 8, 2006, the look-back period for all transfers is 60 months.

If an applicant for Medicaid is determined to have assets in excess of the threshold amount because of transfers within the look-back period, then the applicant is disqualified for a period determined by dividing the value of the transferred assets by the average monthly private-pay rate for nursing facility care in the state. This penalty period can be longer than the look-back period. Thus a potential applicant should generally wait until the expiration of the look-back period before applying for Medicaid.

2. However, under the Advance Notice, if the new account owner later distributed the 529 funds to himself or herself, the entire account would be subject to income tax (except to the extent the new account owner made contributions to the section 529 account).

C. **Nonqualified Distribution**.. Alternatively, the potential Medicaid applicant could make a nonqualified distribution to himself from the section 529 accounts, pay the income tax and penalty on the earnings, and use the proceeds for his support for as long as possible. When the potential applicant's assets, including the section 529 account, are exhausted, he could then apply for Medicaid.

XVI. Resources

A. Articles

1. Bart, *Code Section 529 College Savings Accounts: More Than a Decade Without Final Rules*, 42ND ANNUAL HECKERLING INSTITUTE ON ESTATE PLANNING, Chapter 9 (University of Miami, 2008).

2. Bart, *The Best of Both Worlds: Using a Trust to Make Your 529 Savings Accounts Rock*, 34 ACTEC JOURNAL 106 (2008).

3. Bart, *Saving for Education: Creating Educational Dynasty Trusts Using 529 Plans*, 40th Annual Notre Dame Tax and Estate Planning Institute, South Bend, Indiana (November 14, 2014).

4. Bart, *Saving for Education: Creating Educational Dynasty Trusts Using 529 Plans,* 40 ACTEC LAW JOURNAL 197 (Fall/Winter 2024).

B. College Cost Calculators

1. www.calculators.net

2. www.savingforcollege.com

3. www.usa.gov

4. Estate Planning Tools (Brentmark; www.brentmark.com)

C. School Locator

1. http://nces.ed.gov

2. https://FSApartners.ed.gov

3. www.savingforcollege.com/eligible_institutions

D. Compare 529 Plans

1. www.collegesavings.org

2. www.savingforcollege.com/compare_529_plans

3. www.scholarsedge259.com

E. Links to State 529 Programs

1. www.collegesavings.org

2. www.savingforcollege.com

F. Financial Aid Information

1. www.finaid.org

2. www.ed.gov/finaid

3. www.collegeboard.com/highered/fa

4. https:/studentaid.gov

G. Savings Calculators

1. www.savingforcollege.com

2. Estate Planning Tools (Brentmark; www.brentmark.com)

XVII. Trump Accounts. The 2025 Act created one more type of savings account, called a Trump Account (a "TA"). The incentive to establish such an account is largely limited to the $1,000 seed deposit from the federal government for children born in 2025-2028. Other, limited, contributions to a TA are permitted. The funds cannot be used until the child turns age 18, when the account is then essentially treated as an IRA. While the funds within a TA grow income tax free, they are taxed as ordinary income (except for the amount of certain contributions). Except as specifically provided in Code section 530A or regulations or other IRS guidance, a "Trump account shall be treated . . . in the same manner as an individual retirement account under section 408(a)." Code § 530A(a).

A. **TA Program**. Accounts may be established as of January 1, 2026, with contributions beginning July 4, 2026. The TA Program is expected to be operational in July 2026. It will be overseen by Treasury and administered by participating private banks.

B. **Investments**. TAs must be invested in "eligible investments" until January 1 of the year in which the beneficiary attains age 18. "Eligible investments" are "qualified indexes" that do not use leverage and meet such other requirements as the Secretary determines. "Qualified index" means the S&P 500 or any other index that is comprised of equity investments in primarily U.S. companies and for which regulated futures contracts are traded on a qualified board or exchange. Industry or sector specific indexes are not permitted. The index may be based on market capitalization.

C. **Expenses**. The investment funds must have an expense ratio of 10 basis points or less (.1%).

D. **Who Qualifies?** TAs may only be established for U.S. citizens who are under the age of 18 years (for the entire year in which the contribution is made) and who have a social security number. The parents (or the parent filing income tax returns while the child is a minor) must have a social security number.

E. **Contributions.**

1. **Government Seed Funding**. Qualifying children born in 2025 through 2028 will receive a $1,000 seed deposit from the federal government.

2. **Annual Limit**. Additional contributions from individuals and employers are limited to $5,000 annually for each child. This limit will be adjusted for inflation beginning in 2028.

3. **Individuals**. Family members or other individuals may contribute to the account, subject to the $5,000 limit for aggregate annual contributions for a child. Such contributions are not tax deductible; they are made from after-tax funds.

4. **Employers**. Employers may make contributions of up to $2,500 to accounts for their under age 18 employees and the dependents of their employees. The $2,500 limit will be adjusted for inflation beginning in 2028. Employer contributions are not included in the employees' income.

5. **Charities and States**. Charitable 501(c)(3) organizations and state and local governments may also make contributions to TAs. Their contributions do not count towards the $5,000 annual limit. These programs must make contributions on an equal basis to a general class of beneficiaries, such as

all children living in a certain "qualified geographic area." A "qualified geographic area" means a geographic area in which at least 5,000 account beneficiaries reside and which is designated by the Secretary as a qualified geographic area.

6. **Beneficiary's Income Tax**. Qualified contributions are not included in the beneficiary's income tax when made to a TA.

F. **Withdrawals**. No withdrawals are permitted before January 1 of the year in which the beneficiary attains age 18, except for certain rollovers to ABLE accounts. Once the beneficiary attains age 18, withdrawals are subject to essentially the same rules as exist for IRAs.

G. **Rollover to ABLE Account**. A qualified ABLE rollover contribution may be made in the year in which the beneficiary attains age 17 by a trustee-to-trustee transfer of the entire TA.

H. **Gift Taxes**. Contributions from individuals will be subject to the gift tax rules but presumably will qualify for the gift and GST tax annual exclusions.

I. **Estate Taxes**. If the beneficiary of a TA dies before the first day of the year in which the beneficiary attains age 18 and the TA is payable to the beneficiary's estate, the TA will be includible in the beneficiary's income for the year of death and presumably will be included in the beneficiary's estate for estate tax purposes. If the TA is payable to someone else, it will be includible in such person's taxable income.

J. **Income TaxesContributions**. The government seed funding will not be subject to income tax. There is no income tax deduction for contributions from individuals. Employer contributions are not subject to income tax.

2. **Accumulation**. No income taxes are imposed on the funds while they are in the TA.

3. **Distributions**.

a. Individual Contributions. Withdrawals from the portion of the TA attributed to individual contributions will be taxed as ordinary income to the extent they exceed the amount of the contribution. This is similar to how Roth IRA withdrawals are taxed.

b. **Other Contributions**. Withdrawals from the portion of the TA attributed to seed funding, employer funding or funding from charities or governmental funding will be taxed in their entirety as ordinary income.

c. **Nonqualified Withdrawals**. Withdrawals made before the beneficiary attains age 59 ½ will be subject to a 10% additional tax unless they fall within an exception. The exceptions are similar to those for early IRA withdrawals and include purchasing a first home (limited to $10,000), disaster recovery from a federally declared disaster, birth and adoption expenses, and college and other educational expenses. The exception for college tuition is unlimited in amount.

APPENDIX I

LANGUAGE TO INCLUDE IN POWER OF ATTORNEY
(Language in brackets is optional)

Gifts. My agent shall have the power to make gifts on my behalf to any one or more of my spouse, my descendants and their spouses, and charity to the extent that, in my agent's judgment, I would have made such gifts if I were able. Gifts to a donee under the preceding sentence and any other gifts to such donee from or on behalf of my spouse or me of which my agent has actual knowledge (other than gifts to charity or gifts that qualify for the gift tax exclusion under section 2503(e) of the Internal Revenue Code of 1986, as amended from time to time (the "Code"), or corresponding provision of any subsequent tax law) shall not exceed in any calendar year the amount of the federal gift tax annual exclusion available to my spouse and me, taking into account any election under section 529(c)(2)(B) of the Code. To the extent necessary to make such gifts, my agent may request the trustee of any revocable trust of which I am the grantor to pay income or principal of such trust to my agent or directly to the donee of such gift. Gifts permitted under this paragraph to an individual may be made to any trust established for such individual (provided that gifts to such trust qualify for the gift tax exclusion under section 2503(b) of the Code), a Uniform Transfers to Minors Act account for such individual (regardless of who is the custodian), a tuition savings account or prepaid tuition plan as defined under section 529 of the Code ("529 Account") for the benefit of such individual (without regard to who is the account owner of or responsible person for such account), a Coverdell Education Savings Account for the benefit of such individual, an account established under the Achieving a Better Life Experience Act ("ABLE Account") for such individual, or a Trump Account for such individual.

529 Accounts.

(a) If I am the account owner or participant (the "account owner") for a 529 Account, or if my agent is the account owner of a 529 Account to which I or my agent on my behalf has made gifts, my agent shall have the power to exercise all rights granted to an account owner of a 529 Account, including but not limited to (1) refund the 529 Account to me, (2) approve or fail to make a qualified or nonqualified withdrawal to the beneficiary, (3) change the beneficiary [provided the new beneficiary of the account or plan is one of my descendants, the spouse of one of my descendants or a sibling or cousin of the old beneficiary], (4) change the account owner [but only upon the death or permanent incapacity of the account owner] [and] [provided the new account owner is my spouse, one of my descendants, the spouse of one of my descendants, the beneficiary, a sibling, parent or guardian of the beneficiary, or the trustee of a trust of which the beneficiary is a beneficiary], (5) change investment options, (6) rollover the 529 Account to another 529 Account or ABLE Account for the same beneficiary or another beneficiary to whom the beneficiary could be changed under this paragraph, (7) pay back student loans of the beneficiary and the beneficiary's siblings, and (8) rollover the 529 Account to a Roth IRA for the beneficiary.

(b) [Notwithstanding the preceding provisions of this paragraph, my agent shall have the power to change the beneficiary of a 529 Account only in one of the following circumstances:

(1) Upon the death or permanent incapacity of the beneficiary;

(2) Upon the graduation of the beneficiary from an institution of higher education if the beneficiary signs a written statement that he or she does not plan to pursue additional higher education;

(3) Two and one-half years after the graduation of the beneficiary from an institution of higher education if the beneficiary is not then enrolled in an institution of higher education; or

(4) Upon receipt of written consent from the beneficiary, from the parent or legal guardian of a minor beneficiary or from the legal guardian or agent under a power of attorney of an incapacitated adult beneficiary.]

(c) [Notwithstanding the preceding provisions of this paragraph, in no event shall my agent have the power to name himself or herself as beneficiary or to make distributions to himself or herself.]

(d) In the event the governing rules for a 529 Account permit me to designate an account owner in the event of my incapacity, my agent shall have no power over such 529 Account while a successor account owner so designated is acting.

FACILITY OF PAYMENT CLAUSE FOR TRUSTS

Payments to Beneficiaries Under a Disability. The trustee may make any distributions of income or principal to a beneficiary who at the time of distribution is under legal disability or who, in the judgment of the trustee, is unable to use such distribution properly in such one or more of the following ways as the Trustee deems best: (a) directly to such beneficiary; (b) by the trustee expending such income or principal directly for the benefit of such beneficiary; (c) the legal guardian or conservator of, or custodian under a Uniform Transfers (or Gifts) to Minors Act for, such beneficiary; (d) to a 529 Account, a Coverdell Education Savings Account or ABLE Account under the Achieving a Better Life Experience Act for the benefit of such beneficiary; (e) to any agent under a power of attorney created by such beneficiary; and (f) to a relative of, or person residing with, such beneficiary. The trustee shall not be required to see to the application of any distribution under the preceding sentence, and the receipt of any such distributee shall fully discharge the trustee. Whenever the trustee is empowered by this instrument to make a distribution to a custodian under a Uniform Transfers (or Gifts) to Minors Act, the trustee may designate any person, including a trustee individually, as such custodian and make the distribution to such person. Whenever the trustee is empowered by this instrument to make a distribution to a 529 Account or to a Coverdell Education Savings Account, the trustee may designate any person, including the trustee individually, as participant or account owner of or responsible person for such account, but the designated beneficiary of the account must at all times be the beneficiary to whom the distribution was made.

A “529 Account” is a tuition savings account or prepaid tuition plan as defined under section 529 of the Code.

APPENDIX II

CREDITOR PROTECTION FOR 529 SAVINGS ACCOUNTS
Updated October 1, 2025

Any comments on this table or new developments that should be reflected on the table should be sent to susan.bart@afslaw.com.

			Statute Expressly Specifies Protection from Creditors of			Exemption Inapplicable			
State	**Statutory Exemption**	**Limited to State's Own Program**	**Donor**	**Account Owner**	**Beneficiary**	**Child Support**	**Divorce**	**Other Limitations**	**Comments**
Alaska	Alaska Stat. §§ 14.40.802; 34.40.110(b)(4)	Y		√	√	√			
Arizona	Ariz. Rev. Stat. § 33-1126(A)(10)	N		√	√			Exemption does not include contributions within two years of bankruptcy.	
Arkansas	A.C.A. § 6-84-110(b)(2)	Y		√	√				
California	CA Civ Pro Code § 704.105	Y		√				Exemption limited to amount of gift tax annual exclusion for contributions during 365-day period prior to filing bankruptcy; same limit applies to contributions made 366-730 days prior to filing bankruptcy.	
Colorado	C.R.S. 23-3.1-307.4	Y	√	√	√				
Florida	Fla. Stat. § 222.22	N	√	√	√				
Idaho[2]	Idaho Code § 11-604A	Y				√	√		
Illinois[3]	15 ILCS 505/16.5 735 ILCS 5/12-1001(j)	Y	√	√	√			Exemption limited to amount of gift tax annual exclusion for contributions during 365-day period prior to filing bankruptcy; same limit applies to	

[2] *In re McFarland*, No. 04-01623, 2004 WL 4960367 (Bankr. D. Idaho, Sept. 3, 2004) (holding that the statutory exemption for employee benefit plans expressly includes the state's 529 college savings accounts).

[3] *PNC Bank, N.A. v. Dubin*, 2013 U.S. Dist. Lexis 48070 (2013) (permitting non-bankruptcy creditor to enforce judgment against 529 accounts).

State	Statutory Exemption	Limited to State's Own Program	Statute Expressly Specifies Protection from Creditors of: Donor	Account Owner	Beneficiary	Exemption Inapplicable: Child Support	Divorce	Other Limitations	Comments
								contributions made 366-730 days prior to filing bankruptcy.	
Kansas[4]	K.S.A. § 60-2308(f)(2)-(4)	Y		√	√			Beneficiary must be lineal descendant of account owner. No protection for contributions made within one year before bankruptcy petition or judgment for claims. Contributions made between one year and two years prior to bankruptcy petition or judgment for claims only protected up to $5,000 per account owner.	
Kentucky	Ky. Rev. Stat. § 164A.350	Y		√	√				
Louisiana	La. R.S. 17: 3096G	N	√	√	√			Protection of beneficiary's right to account assets applies only to accounts established under the state's own program.	
Maine	Me. Rev. Stat. Ann. Title 20-A, § 11478	Y		√	√				
Maryland	Md. Education Code Ann. § 18-1913	Y						No protection from the State as a creditor.	
Michigan	M.C.L. § 600.6023(1)(l)	N							
Nebraska	R.R.S. Neb. § 85-1809	Y		√	√				
Nevada[5]	N.R.S. § 21.090	Y						Exemption amount may not exceed $500,000. Exemption is inapplicable	

[4] *In re Werth*, 468 B.R. 412 (Bankr. D. Kan. 2012) (holding that contributions to 529 accounts made within the year preceding the filing of a bankruptcy petition are not exempt).

[5] *VFS Financing, Inc. v. Specialty Financing Corp*., 2014 U.S. Dist. Lexis 100341 (2014) (permitting enforcement of judgment against all funds deposited in 529 account owned by debtor after entry of judgment, including funds contributed by third parties).

State	Statutory Exemption	Limited to State's Own Program	Statute Expressly Specifies Protection from Creditors of: Donor	Account Owner	Beneficiary	Exemption Inapplicable: Child Support	Divorce	Other Limitations	Comments
								if "the money will not be used by any beneficiary to attend a college or university" or the money was deposited after entry of a judgment against the owner.	
New Jersey	N.J. Stat. § 18A:71B-41.1	Y	√		√			Provides exemption for moneys paid into or out of an account for qualified higher education expenses.	
New Mexico	NM Stat. § 42-10-1(A)(12)	N							
New York	NY CLS CPLR § 5205	Y						Exemption is very limited. See the statute.	
North Carolina	N.C. Gen. Stat. § 1C-1601	N				√	√	Exemption limited to $25,000. Excludes funds contributed during prior 12 months unless contributions were made in the ordinary course of the debtor's financial affairs and were consistent with the debtor's past pattern of contributions. Exemption is also limited to the extent that the funds are used to fund college for a child of the debtor.	
North Dakota	N.D. Admin. Code 12.5-02-01-06	Y		√	√				
Ohio	ORC 2329.66(A)(10)(c),(e)	N		√	√	√		Exemption does not apply to amounts "deposited for the purpose of evading the payment of any debt."	See ORC 3334.15(A) re Ohio prepaid 529 accounts.
Oklahoma	31 Okl. St. § 1. A. 24	Y							
Oregon	ORS § 348.863(2)	Y		√	√				
Pennsylvania	24 P.S. § 6901.309.2	Y		√	√				
Rhode Island	R.I. Gen. Laws § 9-26-4(15)	Y				√	√		

			Statute Expressly Specifies Protection from Creditors of			**Exemption Inapplicable**			
State	**Statutory Exemption**	**Limited to State's Own Program**	**Donor**	**Account Owner**	**Beneficiary**	**Child Support**	**Divorce**	**Other Limitations**	**Comments**
South Carolina	S.C. Code Ann. § 59-2-140	Y							Protects "contributions," the "right of a person to a refund of contributions" and "any other right."
South Dakota	S.D. Codified Laws § 13-63-20	Y	√	√	√			No exemption for funds contributed by account owner or contributor within one year of filing bankruptcy petition.	
Tennessee	Tenn. Code Ann. § 49-7-822	N							
Texas	Tex. Prop. Code § 42.0022	N							Protects "a person's right to the assets held in or to receive payments or benefits under."
Virginia	Va. Code Ann. § 23.1-707(G) and § 23-38.81(E).	Y	√	√	√				
Washington	RCW 28B.95.125	Y						Limited to deposits made more than 2 years before filing or judgment	
West Virginia	W.Va. Code § 18-30-7(i)	Y		√	√				
Wisconsin[6]	Wis. Stat. § 16.641	Y			√				

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[6] *Cirilli v. Bronk* (*In re Bronk*), 444 B.R. 902 (Bankr. W.D. Wis. 2011) (holding that Wisconsin's exemption statute protects only the beneficiary's right to qualified withdrawals from a college savings account).