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529 Plans and Estate Planning

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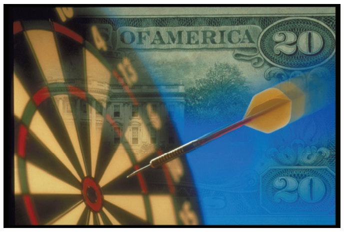

Since their creation in 1996, 529 plans have become to college savings what 401 (k) plans are to retirement savings --an indispensable tool for helping you amass money for your child's or grandchild's college education. That's because 529 plans offer a unique combination of benefits unmatched in the college savings world: availability to people of all income levels, professional money management, high maximum contribution limits, and generous tax advantages.

Yet 529 plans are increasingly being used for another purpose--estate planning. This estate planning use has emerged thanks to special tax rules surrounding lump-sum contributions to 529 plans, combined with the convergence of two powerful trends--boomer grandparents and soaring college tuition.

Estate planning framework

To fully appreciate how the gift and estate tax laws favor 529 plans, it's helpful to first understand how these laws apply to other assets. For 2011, the gift tax is reunited with the estate tax, and every individual has a $5 million lifetime basic exclusion amount from federal gift and estate tax. This means that if the total amount of your lifetime gifts and the value of your estate is less than $5 million at the time of your death, no federal gift or estate tax will be owed.

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In addition to the $5 million lifetime basic exclusion amount, individuals get an annual exclusion from the federal gift tax, which is currently $13,000. This means you can gift up to $13,000 per recipient per year gift tax free. And, a married couple who elects to "split" gifts can give up to $26,000 per recipient per year gift tax free.

Finally, gifts made to grandchildren (or anyone who is more than one generation below you) have special tax rules. These gifts are subject to both federal gift tax and an additional tax known as the federal generation-skipping transfer tax (GSTT). However, there are exceptions for this tax too: a lifetime exemption of $5 million in 2011 and an annual exclusion that's the same as for federal gift tax--$13,000 or $26,000 for married couples. (See the section "Estate tax--a moving target" for more information.)

Special gifting feature of 529 plans

Under special rules unique to 529 plans, you can make a lump-sum contribution to a 529 plan in an amount equal to five times the federal annual gift tax exclusion (i.e., $65,000 per individual or $130,000 for a married couple) per recipient, as long as you make a special election on your federal gift tax return that effectively spreads the lump-sum gift evenly over five years, and provided you do not make any other gifts to the same recipient during the five-year period.

Example: *Mr. and Mrs. Brady make a lump-sum contribution of $130,000 to their grandchild's 529 plan in Year 1, electing to spread the gift over five years. The result is they are considered to have made annual gifts of $26,000 ($13,000 each) in Years 1 through 5 ($130,000/5 years). Because the amount gifted by each spouse is within the annual gift tax exclusion, the Bradys won't owe any gift tax (assuming they don't make any other gifts to their grandchild during the five-year period). In Year 6, they can make another lump-sum contribution and repeat the process. In Year 11, they can do so again.*

Thus, 529 plans offer an opportunity for wealthy parents and grandparents to put hundreds of thousands of dollars away gift tax free to help their children and grandchildren with college costs, while paring down their estates and reducing potential estate tax liabilities.

There is a caveat, however. If the donor were to die during the five-year period, then a prorated portion of the contribution would be "recaptured" into the estate for estate tax purposes.

Example: *In the previous example, assume Mr. Brady dies in Year 2. The result is that his total Year 1 and 2 contributions ($26,000) are not included in his estate. But the remaining portion attributed to him in Years 3, 4, and 5 ($39,000) would be included in his estate. However, the contributions attributed to Mrs. Brady ($13,000 per year) would not be recaptured into the estate.*

Section 529 plan basics

Section 529 plans are governed by federal law (section 529 of the Internal Revenue Code, hence the name) but are sponsored by states and, less commonly, colleges. Each plan may have slightly different features, but each must conform to the federal framework. There are two types of 529 plans--college savings plans and prepaid tuition plans.

College savings plans are the more popular type; nearly all states offer one or more of these plans. A college savings plan functions like an individual investment-type account. You select one or more of a plan's investment portfolios, and you either gain or lose money, depending on how those portfolios perform (similar to a 401(k) plan). College savings plans typically accept over $300,000 in maximum lifetime contributions, and these funds can be used for tuition, fees, room and board, books, and equipment at any accredited college in the United States or abroad.

By contrast, a prepaid tuition plan pools your contributions with the contributions of others, and in return you get a predetermined number of units or credits that are guaranteed to be worth a certain percentage of college tuition in the future (in effect, you are paying future tuition with today's dollars). Funds in a prepaid tuition plan can only be used to cover tuition and fees at the limited group of colleges (typically in-state public colleges) that participate in the plan. Prepaid tuition plans are generally limited to state residents, whereas college savings plans are open to residents of any state.

Each type of 529 plan has an account owner, who is the person who opens the account, and a beneficiary, who is the person for whom contributions are being made. The account owner has the flexibility to make contributions to the account, request withdrawals from the account, change the investment selections for the account (for college savings plans only), and change the beneficiary of the account.

Grandparents can open a 529 account and name their grandchild as beneficiary (only one person can be listed as account owner), or they can contribute to an already established 529 account.

Note: *Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.*

Grandparent as 529 account owner

A grandparent isn't required to be the account owner of his or her grandchild's 529 plan to make contributions to the account. But if the grandparent is the account owner, there are two additional benefits.

First, as account owner, a grandparent can retain some measure of control over his or her contributions by changing investment selections, authorizing account withdrawals for both education and non-education purposes, or even closing the account. A grandparent will have this control over these contributions even though they generally aren't considered part of his or her estate for tax purposes--a rare advantage in the estate planning world. However, funds in a grandparent-owned 529 plan can still be factored in when determining Medicaid eligibility, unless these funds are specifically exempted by state law.

Second, a grandparent-owned 529 plan is not counted for purposes of federal financial aid, meaning that the value of the account won't have any impact on the beneficiary's ability to qualify for federal aid. Compare this to a parent-owned 529 plan, which is counted as a parental asset by the federal aid formula and may reduce the amount of federal aid a student is eligible to receive.

Did you know...

- *If your grandchild doesn't go to college or gets a scholarship, you can name another grandchild as beneficiary with no penalty*
- *Many states offer income tax deductions for contributions to their 529 plan*
- *A grandparent-owned 529 plan isn't counted as an asset for federal financial aid purposes*
- *According to the College Board, as of June 30, 2010, assets in 529 college savings plans totaled $135.2 billion. There were 8.8 million 529 college savings plan accounts with an average value of $13,300, and 1.2 million 529 prepaid tuition plan accounts with an average value of $14,300.*

Tax consequences of 529 plans

The following chart summarizes the federal tax consequences of gifting to a 529 plan, and highlights the income tax ramifications.

Gift Tax	All contributions to a 529 plan qualify for the annual federal gift tax exclusion--$13,000 ($26,000 for joint gifts). A special election for gifts up to $65,000 ($130,000 for joint gifts) can be made where the gift is spread evenly over a five-year period and no gift tax will be owed. Grandparents are subject to the generation-skipping transfer tax (GSTT) in addition to federal gift tax. Gifts of $13,000 or less ($26,000 for joint gifts) are excluded for purposes of the GSTT. Only the portion of the gift that results in federal gift tax will also result in GSTT. State laws may vary.
Estate Tax	Contributions made to a 529 plan generally aren't considered part of your estate for federal estate tax purposes when you die, even though you might retain control of the funds in the account (as 529 plan account owner) during your lifetime. Instead, the value of the account will be included in the beneficiary's estate. The exception to this general rule occurs when you elect to spread a gift over five years and you die during this five-year period. In this case, the portion of the contribution allocated to the years after your death would be included in your gross estate for tax purposes. State laws may vary.
Income Tax	Contributions grow tax deferred. Withdrawals from a 529 plan used to pay the beneficiary's qualified education expenses are completely tax free at the federal level. Withdrawals from a 529 plan that aren't used to pay the beneficiary's qualified education expenses (called a nonqualified distribution) face a double consequence--the earnings portion is subject to a 10% penalty and is taxed at the recipient's rate (in other words, the person who receives the distribution--either the account owner or the beneficiary--is taxed on it). State laws may vary.

Estate tax--a moving target

If you're interested in using a 529 plan for estate planning purposes, make sure you are familiar with the current federal gift and estate tax rules.

The following table shows what the tax rate and exemption amount will be through 2012.

	2011	2012
Top gift and estate tax rate	35%	35%
Gift and estate tax exemption amount	$5 million	$5 million (indexed for inflation)

Note: *If there is no further legislation, the tax rate and exemption amount above will sunset after 2012, and the transfer tax rules that were in effect in 2000 will apply for 2013 and beyond. That means a gift and estate tax exemption equivalent amount of $1 million and a top tax rate of 55%.*

A trend that's here to stay

As the cost of a college education continues to climb out of reach for many parents, grand-parents are stepping in to help. This trend is expected to accelerate in the coming years as the baby boomers, most of whom went to college and want the same opportunities for their grandchildren, start gifting what is expected to be trillions of dollars over the next few decades. The benefit of using a 529 plan is twofold--grandparents can enjoy great personal satisfaction in helping their grandchildren with college costs, and they can do so in a way that pares down their estate and minimizes potential gift and estate taxes.

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