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SECTION 529 EDUCATIONAL SAVINGS ACCOUNTS

Many of our clients wish to establish pools of funds that can be used for the education of their families. As a result of favorable federal tax legislation, educational savings accounts, which are a type of qualified state tuition plan authorized by Section 529 of the Internal Revenue Code of 1986, as amended ("Section 529"), can be established on a tax-favorable basis to provide income-tax free monies to pay for "qualified higher education expenses" of the *designated beneficiary* and, potentially, one or more *members of the family* of the initial designated beneficiary.

Although another type of qualified state tuition programs, known as prepaid tuition plans, are also authorized pursuant to the provisions of Section 529, this *White Paper* will focus solely on educational savings accounts.

Educational savings accounts are created by transferring funds into an investment account managed by a professional investment advisory firm which has contracted with a state, an agency or instrumentality of a state or an eligible educational institution. Only cash contributions, including checks, money orders, credit cards and similar methods of payments, are permitted to be made to an educational savings account. Note that not all programs currently accept credit cards.

Unlike prepaid tuition plans, the investor relies on the expectation that the market will outpace both inflation and increases in college costs. Moreover, there is risk associated with any equity-oriented educational savings account which is not present with prepaid tuition plans. As discussed later, monies in educational savings accounts can be used for a wide variety of *qualified higher education expenses*; thus, not limited just to tuition, board and local fees.

Although Section 529 and the regulations promulgated pursuant to that section set forth the federal law requirements and limitations pertaining to educational savings accounts, each state which creates an educational savings account-type qualified state tuition program is able to impose greater restrictions and limitations than those contained in Section 529. Therefore, it is imperative that you carefully review the terms and conditions of the particular educational savings account-type qualified state tuition program which you are considering. There are several websites, such as www.savingforcollege.com, www.scholarshare.org, and www.collegesavings.com which contain additional information, including links to each of the qualified state tuition programs, to enable you to obtain more specific information with which to make a decision.

What makes educational savings accounts established pursuant to Section 529 so unique, revolves around the special income, gift, estate and generation-skipping transfer tax provisions pertaining to the establishment and maintenance of, and modifications to, educational savings accounts.

Federal Income Tax Aspects:

Contributions made to an educational savings account are not deductible for federal income tax purposes. In other words, contributions are made entirely with after-tax dollars. During the period that funds are held in an educational savings account, the income earned from the investments of the fund, such as dividends, interest and gains on sales, is not taxed for federal income tax purposes.

If a distribution is made from an educational savings account to or for the benefit of the beneficiary of such account, the general rule is that such distribution is includable in the gross income of the distributee (beneficiary) under the annuity rules contained in Section 72 of the Internal Revenue Code of 1986, as amended. Those rules include the following:

1. All educational savings accounts of which an individual is a designated beneficiary are treated as one account;
2. All distributions made during a taxable year shall be treated as one distribution; and
3. The value of the educational savings account(s), income on the educational savings account(s), and the investment in the educational savings account(s) are computed as of the close of the calendar year in which the taxable year begins.

The potential non-taxable portion of any distribution is determined by multiplying the amount of the distribution by a fraction, the numerator of which is the amount of the total contributions made to the educational savings account(s) and the denominator of which is the value of the educational savings account(s).

Effective with respect to distributions made on or after January 1, 2002, distributions used to pay *qualified higher education expenses* are excluded from the gross income of the beneficiary. For distributions made after December 31, 2018, the term “*qualified higher education expenses*” means tuition, fees, books, supplies and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution or participation in a qualified apprenticeship program. Room and board are also qualified higher education expenses to the extent they do not exceed certain limits contained in Section 529.

For qualified education loan repayments under Section 529, there are tax-free distributions allowed, not to exceed \$10,000.00, for amounts paid as principal or interest on any qualified education loan of the designated beneficiary or a sibling of the designated beneficiary.

Section 529 provides for special rules for accounting of distributions made to the sibling of a designated beneficiary. The amount distributed shall be taken into account with respect to the sibling and not with respect to the designated beneficiary.

Section 529 also provides certain rules which enable you to transfer funds from one educational savings account maintained for a beneficiary to another educational savings account for the same designated beneficiary. Note that specific educational savings account qualified state tuition programs may place limitations on the ability to rollover funds from one educational savings account to another, even though not otherwise prohibited by Section 529.

Section 529 also allows you to rollover funds from a educational savings account maintained for one designated beneficiary to a new educational savings account established for a different (new) designated beneficiary, if the new designated beneficiary is a *member of the family* of the initial designated beneficiary. The term “*member of the family*” is defined in Section 529 as any one of the following:

1. Son or daughter, or a descendant of either;
2. Stepson or stepdaughter;
3. Brother, sister, stepbrother or stepsister;
4. Father, mother, or ancestor of either;
5. Stepfather or stepmother;
6. Son or daughter of a brother or sister;
7. Brother or sister of a mother or father;
8. Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law;
9. Cousin;
10. Spouse of anyone listed above, including the spouse of the new beneficiary.

Note that a cousin will only be a *member of the family* with respect to distributions made after December 31, 2001, insofar as cousins were added to the definition of a *member of the family* as a part of the Economic Growth and Tax Relief Reconciliation Act of 2001.

Any change in the designated beneficiary of an educational savings account is **not** treated as a distribution if **the new beneficiary is a member of the family of the initial designated beneficiary.** If the new beneficiary is not a *member of the family* of the initial designated beneficiary, the distribution is treated as a distribution to the account owner. Note that the educational savings account qualified state tuition programs of some states prohibit distributions from being made to anyone other than the initial designated beneficiary or the account owner, even though this is more restrictive than the rules contained in Section 529.

Section 529 also allows an account owner to transfer **ownership** of an educational savings account to another person, but not all states, with respect to their education savings account qualified state tuition program, allow the ownership of an educational savings account to be transferred.

An additional ten percent federal income tax is imposed on certain distributions from an educational savings account pursuant to the provisions of Section 529. Payments and distributions which are not subject to the additional ten percent federal income tax include each of the following:

1. Distributions used to pay qualified higher education expenses;

2. Payments or distributions made to a beneficiary (or to the estate of the designated beneficiary) on or after the death of the designated beneficiary;
3. Payments or distributions attributable to the disability of the designated beneficiary (the beneficiary 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 a long-continued and indefinite duration);
4. Payments or distributions made on account of a scholarship, allowance or payment described in Section 25A(g)(2) of the Internal Revenue Code of 1986, as amended, 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.

Federal Gift and Generation-Skipping Tax Aspects:

A contribution made to an educational savings account is a completed gift for federal gift tax purposes and is considered a gift of a present interest, rather than a future interest. This means that the contribution qualifies for the federal gift tax annual exclusion pursuant to Section 2503(b) of the Internal Revenue Code of 1986, as amended. Currently, the amount of the annual exclusion per individual recipient (within a calendar year period) is \$18,000.00. A special rule contained in Section 529 allows a donor (person making the contribution) to aggregate his or her annual exclusions that could otherwise be made over a five-year period, beginning with the year of the contribution. For example, you could contribute \$90,000.00 in 2024 to an educational savings account for the benefit of a specific individual, and you would be allowed to *amortize* that gift over the years 2024, 2025, 2026, 2027 and 2028 for purposes of the federal gift tax annual exclusion. In other words, if you contribute \$90,000.00 to an educational savings account in 2024 for the benefit of Sally, you make no other gift to Sally in calendar years 2024 through 2028, and you do not die prior to January 1, 2028, the \$90,000.00 contribution would not be deemed as a taxable gift which would otherwise reduce your applicable credit amount for federal gift and estate tax purposes.

The annual exclusion that exists for federal generation-skipping transfer tax purposes also applies to contributions to educational savings accounts in the same manner as described above relative to the federal gift tax.

Federal gift and generation-skipping transfer tax may apply when a designated beneficiary of an educational savings account is changed to a new beneficiary who is a generation or more below the generation of the old beneficiary. Note, however, that Section 529 treats such change as a transfer by the old beneficiary rather than the account owner. This rule may not, however, withstand a challenge under the provisions of the Constitution of the United States of America because the old beneficiary is not making a *transfer to* the new beneficiary. The current provisions of Section 529 would not cause the account owner to incur any federal gift or generation-skipping transfer tax consequences resulting from the change of a designated beneficiary, although the Internal Revenue Service recently announced that it is targeting abusive situations in which taxpayers are using education savings accounts for purposes for which they were not intended.

Federal Estate Tax Aspects:

The fact that a person who contributes money to an educational savings account and names himself or herself as the account owner does not cause the value of the educational savings account to

be included in the estate of the contributor/account owner upon his or her death. The only exception to this rule occurs if a person contributes more than \$18,000.00 in a calendar year and dies before amortization of his or her annual exclusion for federal gift tax purposes over future calendar years.

Restrictions and Limitations:

Section 529 restricts an owner of, contributor to, or designated beneficiary under, an educational savings account, from directly or indirectly controlling the investment of any contribution to an educational savings account, or directly or indirectly controlling the investment of any earnings attributable to contributions. Note, however, that a qualified state tuition program does not violate this requirement if a person who establishes an account pursuant to which the program is permitted to select among different investment strategies designed exclusively by the program at the time that the initial contribution is made establishing the account. Moreover, the Internal Revenue Service recently announced that owners of educational savings accounts will now be allowed to change the investment strategy once every year.

Note that there are limits on the amount of contributions that can be made to an educational savings account for a designated beneficiary. Section 529 does not contain a specific dollar limitation; rather, the limitation imposed by Section 529 requires that the educational savings account qualified state tuition program provide adequate safeguards to prevent a contribution on behalf of a designated beneficiary which is in excess of those amounts necessary to provide for the qualified higher education expenses of the beneficiary. You will find that there are limitations imposed by the state under the terms of the program it establishes and that the maximum contribution will vary from program to program. The ceiling in some states is in excess of \$200,000.00.

Summary:

In summary, other than the inability to manage the investment of the funds comprising the educational savings account, Section 529 provides strong incentives, including significant tax advantages, to establish educational savings accounts. Remember, the particulars of qualified state tuition programs vary from state to state, and are modified from time to time to attract contributors.

Should you wish to obtain additional information pertaining to education savings accounts, please contact an attorney in our trust and estates practice group.

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