Schiff Hardin

529 Planning: Happy 25th Birthday

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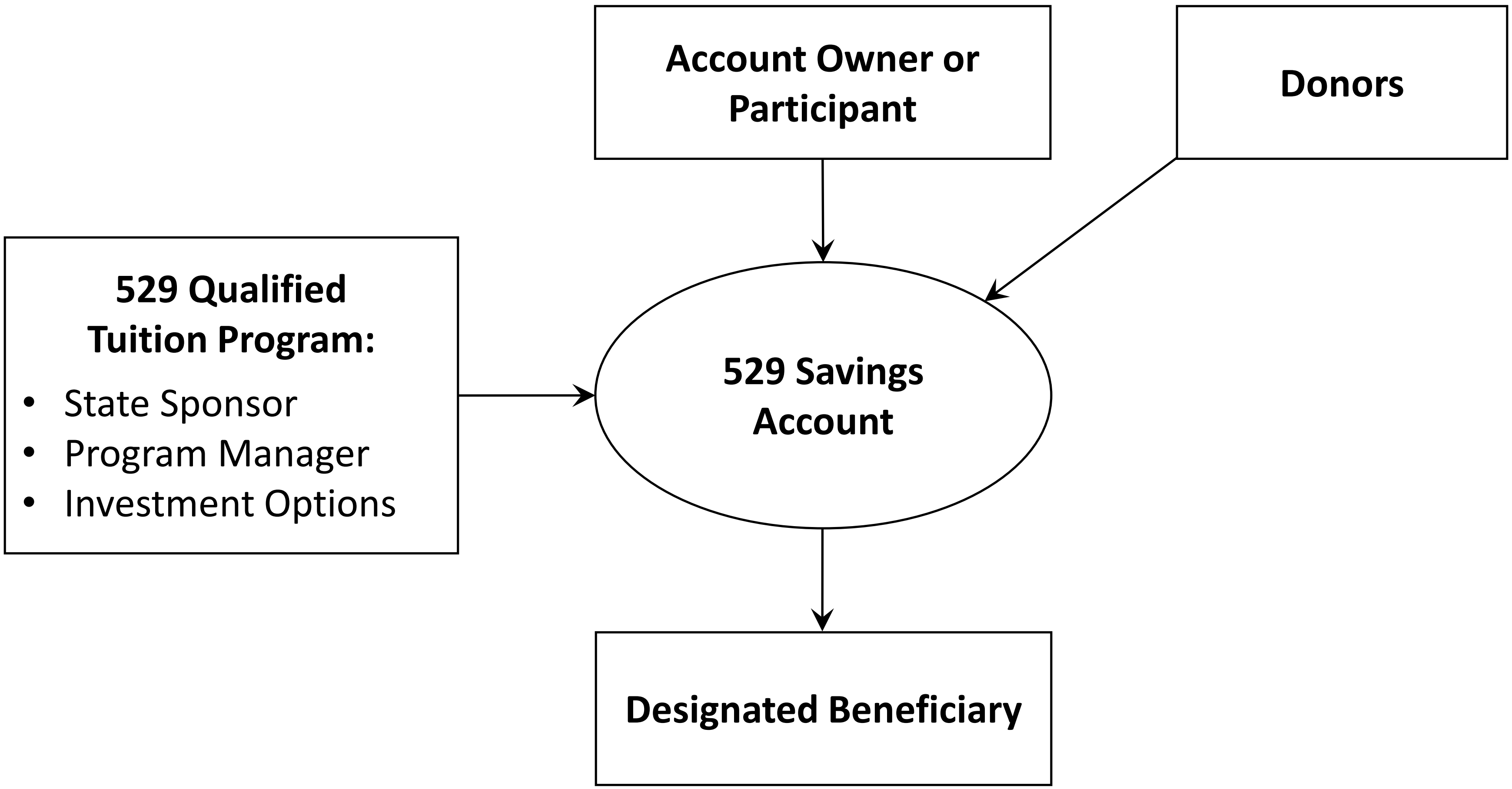
HOW CAN . . . .

- I make a completed gift that
  - could use my existing estate tax exclusion
  - could, if to grandchildren, use my current GST exemption
- Retaining the right to get the funds back if I need them
- Retaining the right to change the beneficiaries
- Keeping the funds out of my estate
- And perhaps obtaining some creditor protection

PARTIES


Account Owner or Participant
Donors
529 Qualified Tuition Program:
• State Sponsor
• Program Manager
• Investment Options
529 Savings Account
Designated Beneficiary

529 TAX ADVANTAGES

- No income limits
- Income tax exemption
- Completed gift
- Annual exclusions (gift and GST)
- Front-loading gifts of five times annual exclusion
- No estate tax inclusion
- In some states, state income tax deduction

529 OTHER ADVANTAGES

- Account Owner
  - Can be donor
  - Controls distributions
  - Can change beneficiary
  - Can take funds back
- Designated Beneficiary
  - Does not control (unless UTMA)
  - Can be account owner
  - Can be adult (check the program)
- Creditor Protection (with limits)

QUALIFIED DISTRIBUTIONS

- Qualified Higher Education Expenses
  - Tuition, fees, books and equipment required for attendance at an eligible educational institution
  - Expenses for special need services
  - Room and board if in program for educational credential and enrolled at least half time (amount school includes in cost of attendance)
  - Expenses for purchase of computer, equipment, software, and Internet (no games)

QUALIFIED DISTRIBUTIONS EXPANDED

- Up to $10,000 per beneficiary each year for tuition at an elementary or secondary public, private or religious school (in the aggregate from all accounts for the beneficiary).
- Expenses for a registered apprenticeship program.
- Repayment of qualified education loans of the beneficiary and beneficiary's siblings, up to a lifetime total of $10,000 per individual.
- State law may not be as broad as federal law.

TEN BIGGEST MISTAKES

1. 5-Year Election: Not following the rules.
2. Not understanding the state and program rules.
3. Not matching distributions with expenses.
4. Changing the beneficiary without understanding the rules.
5. Rolling over without understanding the rules.
6. Not planning for the account owner's death and disability.
7. Not considering the impact on financial aid.
8. Not thinking about divorce and Medicaid qualification.
9. Making a trust an account owner without careful drafting.
10. Overfunding 529 accounts.

MISTAKE 1: FIVE-YEAR AVERAGING

- Election must affirmatively be made on gift tax return.
  - Check box
  - Attach statement
- Gift splitting occurs first, then each spouse decides whether to make an election.
- Pro rata over five years up to annual exclusion amount.
- Excess is a gift in year one.
- Advance Notice permits late election on first gift tax return filed after due date if no timely return was filed.
- Portion allocated to years after donor's death included in estate.

MISTAKE 2: NOT UNDERSTANDING THE STATE AND PROGRAM RULES

- State definition of qualifying expenses or eligible educational institutions may be narrower than federal definition
- State rules about beneficiaries or requiring investments to age
- State income tax deductions
  - Available?
  - Limit
  - Possible clawback if account moved out of state
  - Possible clawback if nonqualified distribution
- State creditor protection
- State Medicaid rules
- Program issues
  - Can third parties contribute?
  - When can account owner be changed?
  - What happens if account owner becomes disabled?

MISTAKE 3: NOT MATCHING DISTRIBUTIONS

- Best practice is for distribution and expense to be in same year
- Advance Notice would permit distribution in Year 1 to be used as late as March 31, Year 2 (but not the reverse).
- Documenting expenditures
  - Saving receipts
  - Saving lists of required books, supplies and equipment.

MISTAKE 4: CHANGING THE BENEFICIARY WITHOUT UNDERSTANDING THE RULES

- New beneficiary must be a “member of the family” of the old beneficiary to avoid the change being a nonqualified distribution (and probably a gift).
- If new beneficiary is one or more generations below old beneficiary there is a gift.
  - Can use gift tax annual exclusion
  - Presumably can use 5-year election
  - Who is making the gift?
- If new beneficiary is two or more generations below the old beneficiary, GST tax consequences.

MISTAKE 5: THOUGHTLESS ROLLOVER

- Rollover from one program to another is permitted once in any given 12-month period for the same beneficiary.
  - Move from one program to another within the same state may be viewed as an investment change, not a rollover.
- Safe harbor: roll over with beneficiary change.
- If a state income tax deduction was taken, is there recapture?
- Are there other adverse state income tax consequences?

MISTAKE 6: NOT PLANNING FOR ACCOUNT OWNER'S DEATH AND DISABILITY

- Who can manage the account if the account owner becomes disabled?
  - Can the successor account owner step in?
  - If not, what does the Program Description say?
  - Can the agent under a power of attorney act? Do you need special language in the power of attorney?

MISTAKE 6: NOT PLANNING FOR ACCOUNT OWNER'S DEATH AND DISABILITY

- Who becomes the successor account owner when the account owner dies?
  - Name a successor on the program form
  - If there is no designated successor, what does the Program Description say?
    - May be the beneficiary if of a particular age
    - May be a parent of the beneficiary
    - May be the account owner's estate. Where would the estate pass the account? May want special backup Will provision.
- Be helpful to the Program's attorney in these situations.

MISTAKE 7: NOT CONSIDERING FINANCIAL AID IMPACT

- Asset tests for financial aid are affected by who is the account owner (student/UTMA, parent, grandparent or other)
  - Do the student/parent even know about the 529 account for the initial FAFSA?
  - Inclusion in Expected Family Contribution
- Income tests for financial aid are affected by who is the account owner
  - Distributions from 529 accounts owned by someone other than parent or student count as untaxed income.
- Timing of distributions is important

MISTAKE 8: DIVORCE AND MEDICAID CONSIDERATIONS

- Parent funded 529 accounts
  - Settlement should address who will be account owner and successor, what expenses will be funded from account and disposition of excess funds.
- Third party contributions to parent owned account
  - Will they be used to discharge both parents' obligation?
- 529 accounts owned by grandparents or others
  - In theory, settlement agreement should not be able to reach funds
  - Will distributions count towards one or both parent's obligations?
- Medicaid treatment varies

MISTAKE 9: IGNORING COMPLICATIONS OF TRUSTS

- Why not make a revocable trust the (successor) account owner?
  - During the grantor's life:
    - Does the trust permit gifts to the beneficiary?
    - Does the trustee have directions about when to make distributions and when to change the beneficiary?
  - At the grantor's death:
    - Which trust will own the account?
    - If no provision is made, does trustee have a duty to use funds for debts, expenses and taxes or to pay to residuary beneficiaries?
    - What are trust provisions for distributions and changing beneficiaries
- Intentionally using 529 accounts in irrevocable trusts can define the intended uses for the account and impose fiduciary duties, but poses challenging tax issues

MISTAKE 10: OVERFUNDING

- Overfunding and then making a nonqualified distribution is unlikely to be financially successful
  - Earnings portion taxed as ordinary income
  - 10% penalty tax
- Consider whether excess will be transferred to beneficiary or moved to accounts for other beneficiaries
- Consider whether funding is for college only, or also vocational school and apprenticeship, or also for grad school
- Consider whether grandparents or parents may directly pay tuition

QUESTIONS?

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