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Learning Center

Never Too Affluent for 529 Plans: 529 Gifting and Estate Planning Strategies

High-net-worth individuals are in a unique position when it comes to financing their children's college education. Not only do they want to provide the best education money can buy for their children, but they also may be seeking ways to reduce their taxable estate, while creating an education legacy for future generations. Despite being able to cover the cost of their children's college education with their current income and assets, these affluent individuals may be pleasantly surprised to learn that no one is too affluent to benefit from a 529 college savings plan. 529 plans are not only effective college savings vehicles; they also have unique gift and estate tax benefits not found anywhere else in the federal tax code. These benefits have great appeal for affluent clients concerned with optimizing their estate planning. This white paper will explore 529 plan strategies for affluent families.

Overview of 529 Plans

A 529 plan — named for the section of the Internal Revenue Code that authorizes them — is a tax-favored savings plan that is designed to help families save for college costs. 529 plans may be operated by either a state or higher education institution. States may operate both prepaid or savings plans (most states offer only savings plans), and higher education institutions may offer only prepaid plans (about 225 institutions offer prepaid plans). A prepaid plan allows a saver to purchase credits at today's tuition costs. A 529 savings plan, on the other hand, allows contributions to accumulate a value that can be used to pay for college education expenses at some time in the future.

529 College Savings Plan Contributions and Limits

529 college savings plans can only accept contributions made in cash. The annual contribution limit is plan specific, and may vary widely. For example, the maximum contribution per beneficiary for Georgia's 529 plan is $235,000, whereas the maximum contribution for New York's 529 plan is $375,000. 529 plan contributions are made on an after-tax basis (that is, the donor does not receive a federal tax deduction for contributions). Earnings are tax-deferred, and distributions are federal-tax-free if used for qualified educational expenses. State tax treatment varies by state. Qualified expenditures are tuition, room and board (subject to certain conditions), books, and supplies and equipment required for the course of study at an eligible institution. An eligible institution is any higher education institution, either U.S. or foreign, eligible to distribute federal financial aid.[1] For distributions taken for reasons other than to pay for qualified educational expenses, the earnings portion of these nonqualified distributions may be subject to income taxation and an additional 10% penalty.

The Unique Gift and Estate Tax Characteristics of 529 Plans

Beyond education savings benefits, 529 college savings plans have unique gift and estate tax benefits not found anywhere else in the federal tax code. While the gift tax still applies for 2010, as the law currently stands, estate and generation-skipping transfer taxes are repealed for 2010, and will be reinstated on January 1, 2011, with a $1 million exemption and a 55% tax rate, unless the president enacts new legislation with alternative provisions.

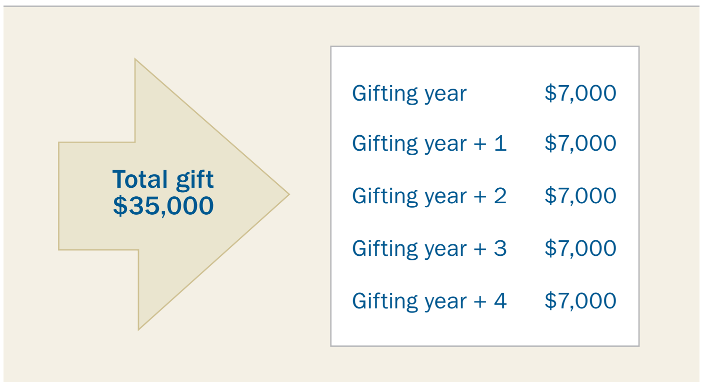
Benefit #1: A 529 donor's gift is complete for federal gift tax purposes

Each person has an annual federal gift tax exclusion of $13,000, or $26,000 for a married couple, for 2009 and 2010. Consequently, a person generally can give up to $13,000 each to any number of people, and none of the gifts will be taxable. Contributions to a 529 plan qualify for the gift tax exclusion. A separate annual exclusion applies to each person to whom a gift is given. 529 plans also have a special accelerated gifting rule that allows a donor to gift up to five times the annual gift tax exclusion amount (that is, $65,000 for a single person and $130,000 for a married couple for 2009 and 2010) without incurring gift tax, provided the donor does not make any further gifts to that beneficiary over the ensuing five years (beginning with the year of the initial contribution). This is known as the five-year accelerated or front-loaded gifting option, which is unique to 529 plans.

[1] IRS Publication 970

This option enables a donor to make a larger initial gift (thereby allowing for a greater time period of tax-deferred growth), without having to pay gift tax (and without reducing the unified credit, which could be used to offset estate taxes at death). Normally, the total amount of gifts from one individual to another individual in a single year must be equal to or less than the annual gift tax exclusion in order to avoid gift tax. Any amount contributed to a 529 plan over the annual gift tax exclusion can be treated as five separate, equal gifts to avoid gift tax, up to a limit of five times the annual gift tax exclusion. So, for example, if a donor wished to contribute $35,000 to a 529 plan for a child or grandchild, it can be treated as five separate, equal gifts of $7,000, as illustrated below.

Accelerated gifting



The accelerated gifting option may be particularly attractive to donors who expect to leave a sizeable estate and would like to make a large gift, but do not want to reduce their unified credit (because they would prefer to use it to offset estate taxes). For grandparents, it has the added value of not getting involved with the generation-skipping transfer tax.

Accelerated gifting also removes the future growth from estate tax. Donors elect the accelerated gifting option on federal gift tax Form 709. If a donor elects to treat a donation as five separate, equal gifts to avoid gift tax, then the donation will be excludable from his or her estate on a pro rata basis. To fully avoid estate tax, the donor must survive to January 1 of the fifth calendar year.

Many high-net-worth individuals use a two-calendar-year giving strategy to maximize gifts, obtain state tax deductions (if available), avoid gift tax and reach investment breakpoints. Breakpoints are reductions in sales charges obtained by exceeding certain investment amounts. An example would be if a married couple with two beneficiaries contributed $26,000 to each beneficiary in one year, and then contributed $130,000 to each beneficiary the next year.

Example

Year	Actual Contribution Amount	Federal Gift Tax Exclusion	Amount Donated for Federal Gift Tax Purposes
2010	$13k per parent ($26k in total)	$13k ind./ $26k couple filing jointly	$26k couple filing jointly
2011	$65k per parent ($130k in total)	$13k ind./ $26k couple filing jointly	$26k couple filing jointly
2012		$13k ind./ $26k couple filing jointly	$26k couple filing jointly
2013		$13k ind./ $26k couple filing jointly	$26k couple filing jointly
2014		$13k ind./ $26k couple filing jointly	$26k couple filing jointly
2015		$13k ind./ $26k couple filing jointly	$26k couple filing jointly

In this case, the married couple contributes a total of $156,000 per beneficiary ($312,000 in total) in two calendar years, but never exceeds the annual gift tax exclusion by electing to treat the second gift as pro rata over a five-year period. At the same time, by using Rights of Accumulation between each beneficiary account, and a Letter of Intent, the couple receives a sales charge reduction or breakpoint applicable to a one-time investment of $312,000 on every dollar invested, even though the amounts were invested in two different accounts and at two different points in time.[2] Of course, the contributions must be made within the time specified in the letter in order to receive reduced charges.

[2] Letter of Intent is a commitment to contribute a certain dollar amount over a 13-month period. Rights of Accumulation allows an investor to combine the current value of qualified units already owned with the value of a future purchase to reach a breakpoint level that qualifies for a reduced sales charge.

Benefit #2: The 529 account owner maintains rights of property

529 plans allow the account owner, not the beneficiary, to retain control of the account assets (some conditions apply). This is a significant advantage that 529 plans have over other gifting and estate planning vehicles. Consequently, the account owner has the freedom to decide — for any reason — to change beneficiaries on the 529 plan, or to recall the gift. If the assets are not used for qualified higher education expenses, the earnings portion of the nonqualified distribution will be treated as ordinary income for federal and state income tax purposes, and in most instances is subject to a 10% penalty tax.

Benefit #3: 529 assets are excluded from the donor's or owner's estate

Although the account owner retains control of the assets in a 529 plan, those assets are excluded from the donor's or owner's taxable estate (subject to the limited exception explained previously, i.e., if the donor dies during the five-year period associated with the accelerated gifting option).

Benefit #4: 529 plans are flexible

529 plans are flexible because the account owner can:

- Roll over money between beneficiaries who are family members, without tax ramifications
- Change beneficiaries within the family (to a qualified family member) and still preserve tax benefits
- Change the beneficiary to future heirs and still avoid gift tax by managing the gift process as outlined later in this text
- Name a successor account owner who will assume control of the account upon death of the account owner while avoiding probate (the successor owner can be an individual or it can be a trust)

Managing the Gift Process

If the account owner names a new beneficiary who is one or more generations below the former beneficiary, there is a gift tax event, and the former beneficiary is the donor for gift tax purposes.[3] When gifts are made down a generation, the accelerated gifting option can be used to avoid gift tax.

Another consideration is the generation-skipping transfer (GST) tax. Gifts during life or bequests from the estate can also be subject to the GST tax if the gifts or bequests are to a person who is more than one generation younger (for example, a grandchild). As the law currently stands, the GST tax is repealed for 2010, but is scheduled for reinstatement on January 1, 2011.

Conclusion

Based on current income and assets alone, some affluent parents may plan on paying higher education costs out-of-pocket. This may lead them to forego college savings vehicles such as 529 plans. While that may be a sensible short-term strategy, it should not prevent them from considering 529 plans for longer term estate and legacy planning strategies. Getting a head start on funding the next generation's education through a 529 could lead to decades of tax-deferred growth outside of one's gross taxable estate. Considering all this, it is safe to say that a person is never too affluent to benefit from a 529 plan.

Please remember there's always the potential of losing money when you invest in securities.

[3] Internal Revenue Code Section 529(c)(5)(B)

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