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529 Plans and Estate Planning





529 plans and estate planning

The use of 529 plans for estate planning purposes 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.



529 Plans and Estate Planning

Many grandparents want to establish a college fund for their grandchildren. One way to do this is with a 529 plan.

529 plans have become to college savings what 401(k) plans are to retirement savings — an indispensable tool for helping amass money for college. 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. Funds in a 529 plan can also be used to pay K-12 expenses, up to \$10,000 per year.

Yet 529 plans are increasingly being used for another purpose — estate planning. That's because the special tax rules that govern 529 plans allow grandparents to save for their grandchild's college education in a way that simultaneously pares down their estate and minimizes potential gift and estate taxes.

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 2021, every individual has an \$11,700,000 basic exclusion amount (plus any unused exclusion amount of a deceased spouse) 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 \$11,700,000 at the time of your death, no federal gift or estate tax will be owed.

In addition to this basic exclusion amount, individuals get an annual exclusion from the federal gift tax, which is currently \$15,000. This means you can gift up to \$15,000 per recipient per year gift tax free. And, a married couple who elects to "split" gifts can give up to \$30,000 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 \$11,700,000 in 2021 (same as the basic exclusion amount) and an annual

exclusion that's the same as for federal gift tax — \$15,000 for individuals or \$30,000 for married couples.

Accelerated gifting feature of 529 plans

Under special rules unique to 529 plans, you can make a lump-sum contribution to a 529 plan and avoid federal gift tax if the contribution in 2021 is less than \$75,000 for individual gifts or \$150,000 for joint gifts (five times the annual gift tax exclusion), and you don't make any other gifts to the same recipient in the five-year period. Essentially, you are spreading the gift over five years. You need to make a special election on your federal tax return to do this.

Example: Mr. and Mrs. Brady make a lump-sum contribution of \$150,000 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 \$30,000 (\$15,000 per grandparent) in Years 1 through 5 (\$150,000/5 years). Because the amount gifted by each grandparent 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 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 dies 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 (\$30,000) are not included in his estate. But the remaining portion attributed to him in Years 3, 4, and 5 (\$45,000) would be included in his estate. However, the contributions attributed to Mrs. Brady (\$15,000 per year) would not be recaptured into the estate.



Did you know ...

- If your grandchild doesn't go to college or gets a full scholarship, you can name another grandchild as beneficiary of your 529 account with no penalty
- Many states offer income tax deductions for contributions to their 529 plan
- Funds in a 529 college savings plan can be used for graduate school

Note

Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing; specific plan information is available in each issuer's official statement. There is the risk that investments may not perform well enough to cover college costs as anticipated. Also, before investing, consider whether your state offers any favorable state tax benefits for 529 plan participation, and whether these benefits are contingent on joining the in-state 529 plan. Other state benefits may include financial aid, scholarship funds, and protection from creditors.

529 Plan Basics

Section 529 plans are governed by federal law (section 529 of the Internal Revenue Code) 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 — savings plans and prepaid tuition plans.

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 savings plans only), and change the beneficiary of the account. People of all income levels are eligible to open an 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.

529 savings plans

529 savings plans are the more popular type of 529 plan; nearly all states offer one or more of these plans. A 529 savings plan functions like an individual investment-type account, similar to a 401(k) plan. You select one or more of a plan's investment portfolios, and you either gain or lose money, depending on how those portfolios perform. Funds in the account can be used to pay the full cost of tuition, fees, room and board, books, and supplies at any accredited college or graduate school in the United States or abroad. Funds can also be used to pay K-12 tuition expenses, up to \$10,000 per year. Most 529 savings plans have lifetime contribution limits of \$350,000 and up (limits vary by state).

529 prepaid tuition plans

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 that participate in the plan, which are typically in-state public colleges. Prepaid tuition plans are generally limited to state residents,

whereas savings plans are open to residents of any state.

Grandparent as 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 some additional considerations.

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, regarding financial aid, a grandparent-owned 529 account does not need to be listed as an asset on the federal government's aid application, the FAFSA. However, distributions (withdrawals) from a grandparent-owned 529 plan are reported as untaxed income to the beneficiary (grandchild), and this income is assessed at 50% by the FAFSA. By contrast, a parent-owned 529 plan is reported as a parent asset on the FAFSA (parent assets are assessed at 5.6%) but distributions from a parent-owned 529 plan aren't counted as student income.

To avoid having a distribution from a grandparent-owned 529 account count as student income in a way that could negatively affect financial aid, one option is for the grandparent to delay taking a distribution from the 529 account until anytime after January 1 of the grandchild's junior year of college (because the FAFSA won't need to be submitted again). Another option is for the grandparent to change the owner of the 529 plan account to the parent.

Colleges have their own rules when distributing their own financial aid. Most colleges require a student to list any 529 plan for which he or she is the named beneficiary, so grandparent-owned 529 accounts would be treated the same as parent-owned accounts.



Accelerated gifting

In 2021, gifts of up to \$75,000 (or \$150,000 for joint gifts) can be made to a 529 plan and no gift tax will be owed if a special election is made to spread the gift evenly over a five-year period.



Tax Consequences of 529 Plans

| | |
|-------------------|---|
| Gift Tax | <p>All contributions to a 529 plan qualify for the annual federal gift tax exclusion — \$15,000 for individuals or \$30,000 for joint gifts in 2021.</p> <p>A special election for gifts up to \$75,000 (\$150,000 for joint gifts) can be made where the gift is spread evenly over a five-year period and no gift tax will be owed.</p> <p>Grandparents are subject to the generation-skipping transfer tax (GSTT) in addition to federal gift tax. Gifts of \$15,000 or less (\$30,000 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.</p> |
| Estate Tax | <p>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.</p> <p>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.</p> |
| Income Tax | <p>Contributions grow tax deferred.</p> <p>Withdrawals from a 529 plan used to pay the beneficiary's qualified education expenses are completely tax free at the federal level.</p> <p>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).</p> |

Estate Tax Rates

The following chart summarizes federal estate tax rates and exemptions for 2021 and 2020.

| | 2021 | 2020 |
|---|-----------------------------------|-----------------------------------|
| Annual gift exclusion | \$15,000 | \$15,000 |
| Gift and estate tax applicable exclusion amount | \$11,700,000 + DSUEA ¹ | \$11,580,000 + DSUEA ¹ |
| Generation-skipping transfer (GST) tax exemption | \$11,700,000 ² | \$11,580,000 ² |

¹ Basic exclusion amount plus deceased spousal unused exclusion amount (DSUEA)

² The GST tax exemption is not portable

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