



Planning Pointers

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529 Plans

THE TAX ACT OF 2001 EXPANDED THE TAX BENEFITS OF THE EDUCATIONAL SAVINGS PLANS UNDER INTERNAL REVENUE CODE SECTION 529 ("529 PLANS"), MAKING THEM EXTREMELY POPULAR. VARIOUS FINANCIAL INSTITUTIONS HAVE HELPED EACH STATE ESTABLISH ITS UNIQUE 529 PLANS, THUS PROVIDING THE CONSUMER WITH MANY CHOICES AND FACTORS TO CONSIDER BEFORE INVESTING IN ANY 529 PLAN.

What are 529 plans?

- There are two types of 529 plans. One is a prepaid tuition plan, and the other is a college savings account plan.

What are the requirements of a 529 plan?

- The plan must be established and maintained by a state (or state agency) or by one or more eligible educational institutions.
- All contributions to the plan must be in cash.
- Neither the plan owner nor the beneficiary may self-direct the investment of the plan funds.

[Note: Most plans allow a somewhat limited choice of investment strategies at the time the plan is established.]

- The funds cannot be used as security or collateral for a loan.
- There must be separate accounting for each beneficiary's account.
- Penalties are incurred when plan funds are used for other than qualified higher educational expenses.
- There must be adequate safeguards to prevent funding in excess of the beneficiary's expected qualified higher educational expenses.

What expenses are considered "qualified higher educational expenses"?

- "Qualified higher educational expenses" include tuition, fees, books, supplies and equipment required for your beneficiary's enrollment at an eligible educational institution (i.e., an accredited post-secondary educational institution). They also may include room and board if your beneficiary is enrolled on at least a half-time basis.

What control do you have after establishing a 529 plan?

- Usually a plan owner can (i) change the beneficiary, (ii) approve or disapprove withdrawals from the plan, including closing the account, (iii) move the account to

another 529 plan ("rollover") and (iv) designate a successor owner. Most plans are subject to the plan owner's creditors.

Who can be the owner of the plan, and who can be the plan beneficiary?

- Under most 529 plans, there are no restrictions or limits on the income or the ages of the plan owner or beneficiary, and no required relationship between the plan owner and beneficiary.

What are the tax benefits and consequences of 529 plans?

INCOME TAX

- If the plan funds are used solely for your beneficiary's qualified higher educational expenses ("qualified withdrawals"), the income earned by the funds held in the 529 plan is not subject to federal (and most states') income tax. For non-qualified withdrawals from the plan, the plan owner must report as taxable income the earnings portion of any such withdrawal. In addition, the plan owner will incur a 10% federal penalty on the earnings portion of non-qualified withdrawals, except when the non-qualified withdrawal is made on account of the beneficiary's death or disability, or is made because a scholarship is awarded to the beneficiary.

[Note: Changing the beneficiary will be a non-qualified withdrawal if the new beneficiary is not a member of the prior beneficiary's family, meaning that prior beneficiary's descendant, stepchild, sibling, step-sibling, ancestor, step parent, niece, nephew, aunt, uncle or first cousin, or the spouse of any such relative of the prior beneficiary.]

GIFT TAX

- Your contributions to a 529 plan can qualify as annual exclusion gifts for federal gift tax purposes. In addition, you may frontload a 529 plan by making up to five years of annual exclusion gifts in a single year. For example, in 2002 you may contribute to a beneficiary's account five times your annual exclusion amount (5 x \$11,000). Of

course, any other gifts to that beneficiary over the next four years will not qualify for the annual exclusion. If you die during that five-year period, the annual exclusion amounts previously applied for any years after your death are treated as taxable in your estate. If you change your beneficiary to one who belongs to a generation below the generation of the original beneficiary, then the transfer is deemed a taxable gift made by the original beneficiary. (Also, see below concerning possible federal generation-skipping transfer tax on a change of beneficiary.)

ESTATE TAX

- If you contribute to a 529 plan and die before the funds are fully withdrawn, the value of the 529 plan will not be included in your taxable estate (except as mentioned above concerning advanced use of your annual exclusion amounts). Thus, contributions to a 529 plan reduce your taxable estate. If your beneficiary of the 529 plan dies before the funds are fully withdrawn, it appears that the value of the 529 plan will be included in the beneficiary's taxable estate for federal estate tax purposes.

GENERATION-SKIPPING TRANSFER ("GST") TAX

- Your contributions to a 529 plan for a beneficiary who is more than one generation below you (e.g., a grandchild) will not be subject to the federal GST tax to the extent you apply your gift tax annual exclusion to those contributions. (Contributions to which annual exclusions are not applied are subject to the federal GST tax.) If, however, you change your beneficiary to one who is more than one generation below the original beneficiary, a GST transfer will be deemed to have been made by the original beneficiary.

What factors should you consider when investing in a 529 plan?

The programs of each state are different. In reviewing a prospective plan, you should pose several questions, including the following:

- Are there any residency and/or age requirements for the plan owner and/or the beneficiary?
- Are only certain schools covered?
- Are there any minimum or maximum contribution levels?
- Are there limits on the amount which can be used for room and board?
- Are there penalties (in addition to the 10% imposed by the federal government) for non-qualified withdrawals?
- What investment strategies are offered?
- What are the costs incurred in establishing and maintaining the plan (e.g., initial fee, annual fees, etc.)?
- Are there state income tax benefits?
- What impact, if any, will the plan have on the beneficiary's chances of obtaining financial aid?

[Note: For purposes of financial aid applications, prepaid tuition plans are usually considered the beneficiary's available assets, while the college savings account plans are deemed to belong to the plan owner.]

For more information check the following websites:
www.savingforcollege.com; and www.collegesavings.org

This bulletin, which has been prepared by the attorneys of the Individual Clients Group of Robinson & Cole, is intended to provide only general information on the topics presented. If you wish to examine how this information may impact your estate plan, please contact Robinson & Cole and ask for an attorney in the Individual Clients Group.



ROBINSON & COLE^{LLP}

INDIVIDUAL CLIENTS GROUP

J.C. David Hadden, Christopher J. Hug, Judith M. Keppelman, Linda J. McDowell,
David Thomas Ryan, George L. Smith, Robert H. Smith, Jr., John O. Tannenbaum, William C. Ely,
Elizabeth M. Grant, Deirdre A. Devaney, Meredith A. Leff, Jeanmarie B. Shea

For more information, call 1-800-826-3579.

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