529 Savings Accounts: Pros, Cons and Everything In Between

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I. An Overview of Section 529 of the Internal Revenue Code

a. Authorizes tax-favored vehicles to pay for qualified education expenses via state-sponsored Section 529 programs (two types of qualified tuition programs)
   i. Prepaid tuition programs
      1. Programs allow a person to purchase credits on behalf of a designated beneficiary, which entitle the beneficiary to a waiver or payment of tuition at prescribed educational institutions.
      2. Tuition is "locked in" at current rates, thus avoiding the risk of tuition increases above the implicit rate of earnings on the funds.
   ii. Section 529 savings accounts
      1. An investment account program established and maintained by the states, for a named beneficiary, over which an account owner generally can exercise significant powers.
      2. The Section 529 account is invested by the state (or an investment manager selected by the state), generally in a portfolio of mutual fund investments.
         a. NJ has named the New Jersey Higher Education Student Assistance Authority ("HESAA") as the trustee of its program, and as trustee, HESAA has appointed Franklin Templeton as the manager of its current program.
         b. Program currently includes the NJBEST 529 College Savings Plan (owner or beneficiary must be NJ resident) and the Franklin Templeton College Savings Plan (owner or beneficiary need not be NJ resident). The plan terms are similar but have certain differences.

b. Qualified higher education expenses
   i. §529(e)(3)(A):

"(i) tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution,

(ii) expenses for special needs services in the case of a special needs beneficiary which are incurred in connection with such enrollment or attendance, and

(iii) expenses for the purchase of computer or peripheral equipment (as defined in section 168(i)(2)(B)), computer software (as defined in section 197(e)(3)(B)), or Internet access and related services, if such equipment, software, or services are to be used primarily by the beneficiary during any of the years the beneficiary is enrolled at an eligible educational institution.

Clause (iii) shall not include expenses for computer software designed for sports, games, or hobbies unless the software is predominantly educational in nature. The amount of cash distributions from all qualified tuition programs described in subsection (b)(1)(A)(ii) with respect to a beneficiary during any taxable year shall, in the aggregate, include not more than $10,000 in expenses described in subsection (c)(7) incurred during the taxable year."

ii. Room and board can include 1) the amount charged if student is residing in housing owned or operated by the eligible education institutions; or 2) an allowance for room and board that was included in the cost of attendance for federal financial aid purposes, as determined by the eligible education institution.
iii. 2017's Tax Cuts and Jobs Act expanded the definition of "qualified higher education expenses" for purposes of Section 529 to include expenses for tuition in connection with enrollment or attendance at an elementary or secondary public, private or religious school, to the extent that cash distributions for a beneficiary do not exceed $10,000 in a taxable year.
iv. 2019's SECURE Act expands definition of "qualified higher education expenses" to include apprenticeship programs as well (those certified by the U.S. labor secretary under the National Apprenticeship Act).
v. SECURE Act also extends definition of "qualified higher education expenses" to include student-loan repayments (both principal and interest).
    1. There is a <u>lifetime</u> limit of $10,000 which can be used to repay student-loan payments.
    2. Borrowers need to be sure not to double dip. If 529 funds are used to repay student loan interest, the earnings portion

of the distribution used to repay the loan reduces the $2,500 annual limit on student-loan interest deduction.

3. In addition, up to $10,000 per sibling can be withdrawn to repay student loans of a beneficiary's siblings (including step-brothers and step-sisters).

c. Eligible Educational Institutions
   i. Defined by the statute to include accredited post-secondary educational institutions offering credits towards a degree (associate's, bachelor's or graduate/professional degree or another recognized post-secondary credential) plus certain vocational institutions.
   ii. Eligible institutions must qualify to participate in the Department of Education student aid programs.
   iii. Certain foreign institutions may also qualify.

d. Significant difference among state programs
   i. Residency – Some states require in-state residency of the owner or beneficiary (such as with the NJBEST plan).
   ii. Age – Some states require that the beneficiary be less than a certain age (i.e. 18) when the account is opened.
   iii. Owner – Some states do not allow corporations, trusts, guardians, or custodians to serve as account owners (NJ permits trusts or other entities to open accounts).
   iv. Contributions – Some states require mandatory annual contributions and many states have minimum initial investments and some also permit only the owner to contribute to the account.
      1. NJ requires a minimum initial contribution of either $30 or $250 (depending upon the plan).
      2. NJ also requires minimum annual contributions of $300 until the balance reaches at least $1,200.
   v. Some states offer other state specific benefits, such as the NJBEST Scholarship -- a scholarship between $500 and $1,500 is offered for an undergraduate freshman year at certain NJ institutions depending upon total contributions (minimum $1,200) and years NJBEST account open (minimum 4).

e. (Generally) Favorable federal tax consequences
   i. Growth is tax exempt.
   ii. There are no income limitation restrictions on contributions (anyone can contribute).
   iii. Qualifying contributions within the gift tax annual exclusion amount generally are free of the gift tax and the generation-skipping transfer tax.
      1. 5-year front load funding
      2. Gift splitting

iv. Qualified distributions for educational expenses are income tax free to the designated beneficiary.

f. <u>Limitations on contributions</u>

i. Section 529 stipulates that a program qualifies as a qualified tuition program only if it contains adequate safeguards to ensure contributions do not exceed those necessary to provide for the qualified higher education expenses.

1. Prop. Reg. 1.529-2(i)(2) permits contributions of up to five years of undergraduate expenses – indicating that a program satisfies Section 529 if it bars additional contributions to an account as soon as the account reaches a specified account balance limit applicable to **all accounts of designated beneficiaries** within the same expected year of enrollment.
2. Many state programs set limits either on total contributions or the account balance based on the cost of four or five years in state tuition (NJ limit = $305,000), but several states have obtained favorable rulings to allow contribution limits based on a greater number of years of education.

ii. Limitation is per program. What about multiple programs? Example: A is the beneficiary of a NJBEST 529 account with a $305,000 balance; would NY prohibit the same account owner from subsequently opening a NY plan for A?

g. <u>Account owner control</u>

i. The beneficiary generally has no control over or access to the funds in the plan (account owner chooses if and when to distribute to a beneficiary).

ii. The account owner may be able (depending on applicable state law) to direct the distribution of funds from the account, change the beneficiary designation, change investment options (to a prescribed extent) and reclaim the funds (however, income tax may apply to the earnings and a penalty would apply).

1. The account owner is empowered to certify that the beneficiary died or became disabled.
2. The owner may even change the owner (though some states may prohibit a change of ownership during the life of the account owner).

iii. Some states will allow an agent under a durable power of attorney to act on behalf of an incapacitated account owner (the instrument must be drafted to grant specific authority to act on behalf of an incapacitated Section 529 account owner).

h. <u>Death of account owner</u>
   i. The account can continue in existence to a successor account owner and plan will often permit the account owner to designate a successor account owner.
   ii. In absence of such a designation, states approach the death of an account owner in different ways.
      1. Some states allow account owner to designate a contingent account owner or to name a successor account owner by Will (in these states, if no contingent account owner is named, then depending on state and circumstances, successor account owner is: 1) beneficiary; 2) estate of original account owner; or 3) spouse of original account owner).
      2. Some states allow joint account owners (on death of one account owner, other becomes sole owner).
      3. Some states provide only the beneficiary can become the successor account owner.
      4. NJ Plans currently provide that if there is no named successor owner, the beneficiary becomes the owner.
         a. If the beneficiary is less than 18 years of age, the "guardian or trustee" for the beneficiary becomes the owner.
         b. How to determine the identity of guardian or trustee under NJ plans:
            i. Can be named in account owner's Will;
            ii. Can be an individual appointed for such purpose by a court;
            iii. Can be an individual appointed for such purpose by the executor of the account owner's estate; or
            iv. Can be the parent of the beneficiary.
         c. Once a trustee or guardian has assumed ownership over the NJ account, no further contributions to the account are accepted and the guardian or trustee may not change the beneficiary.
      5. If owner becomes estate, does executor have a fiduciary duty to withdraw the funds in a nonqualified distribution to maximize value of the estate for probate beneficiaries?

         Possible solutions: consider naming successor account owner in Will (if permitted by the state program), expressly state in Will that executor has no fiduciary duty to withdraw the funds for the probate beneficiaries, or include a specific bequest with respect to the funds.

i. Applying for federal financial aid
    i. Ownership of a 529 account can affect a student's ability to qualify for financial aid.
    ii. If the parent is the owner of the 529 account, the assets are considered parental assets on the Free Application for Federal Student Aid ("FAFSA").
        1. Approximately $20,000 (depending upon parent's age) will count towards asset protection allowance.
        2. Balance of account will reduce a student's financial aid package.
    iii. If grandparent or other relative is the owner, the assets are not considered parental assets and thus do not reduce a student's financial aid package.
        1. However, distributions from a grandparent owned 529 are treated as student income on the student's applications in future years.
        2. Because FAFSA application considers income from two years prior, consider utilizing grandparent owned 529 funds beginning in a student's junior year of college.

II. Federal and New Jersey Tax Consequences

a. Income Tax
    i. There are no federal income tax deductions for contributions; however, the earnings are generally tax-exempt for federal income tax purposes.
    ii. Some states allow a state income tax deduction to their residents who contribute (many states set a cap on the annual deductions).
        1. Some states will recapture the deduction if the 529 account makes a nonqualified distribution.
        2. A state may not permit a deduction for a rollover from a different state.
        3. Earnings are generally either exempt or deferred for purposes of state income tax.
        4. NJ does not offer its residents a deduction.
    iii. Any distribution other than a qualified distribution is subject to income taxation on the earnings (taxed as ordinary income) at the beneficiary's tax rate.
        1. The account beneficiary can be changed prior to a nonqualified distribution for purposes of changing the tax rate.
        2. If the state program does not allow a nonqualified distribution to any person other than the account owner, the current owner might consider changing the ownership to the intended beneficiary so that the distribution could be

made by the beneficiary to himself or herself, to be taxed at his or her tax rate.

iv. In addition to the income taxation, a nonqualified distribution is subject to a 10% penalty, subject to the following exceptions:
    1. If paid to beneficiary or his or her estate, after his or her death;
    2. If attributable to a disabled designated beneficiary; or
    3. If a designated beneficiary received a qualified scholarship.

v. If the entire 529 account has been distributed and there is a loss, the loss may be claimed as a miscellaneous itemized deduction when all amounts which have been distributed are less than the unrecovered basis.

b. <u>Federal Gift Tax</u>

i. Although an amount paid on behalf of an individual as tuition to a qualifying educational organization for the education or training of the individual is not treated as a gift transfer, qualifying contributions to a 529 account on behalf of a designated beneficiary are treated as completed gifts to the beneficiary that are not future interests in property. Accordingly, the annual exclusion applies to contributions.

ii. 529 accounts can be "front loaded" (5-year allocation if the aggregate amount of contributions during a calendar year by a donor exceeds the annual exclusion).
    1. Prop. Reg. 1.529-5(b)(2) – allocation must be made over the five years, not less; however, any amount in excess of five times the annual exclusion must be treated as a taxable gift in the calendar year of contribution, rather than spread over five years.
    2. Gift splitting between spouses is permitted.

iii. What happens if an account owner transfers the ownership? Does this constitute a gift to the new owner? The statute is silent but it appears no gift is made.

c. <u>Generation-Skipping Transfer ("GST") Tax</u>

i. A transfer to a 529 account within the annual exclusion is exempt from GST tax.

ii. If transfer is in excess of the annual exclusion, GST consequences are not clear.

    Ex: If beneficiary is a skip person, the excess amount might be subject to GST, but it is uncertain because the account owner could change the beneficiary to a person who is not a skip person, or reclaim the property.

d. Federal Estate Tax
    i. No amount is includible in the gross estate of any individual by reason of that individual's interest in a 529 qualified tuition program (owner, donor or beneficiary).
        1. First exception: 5-year front loading gifts are includible if donor dies prior to the expiration of the 5 years (balance of front-loading gift is included on Schedule F of decedent's Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return).
        2. Second exception: distributions occurring as a result of the death of the beneficiary, or to the estate of the beneficiary's estate, would be included in the beneficiary's estate (can be avoided if account owner changes the beneficiary).
    ii. Prop. Reg. 1.529-5(d)(3) – gross estate of a designated beneficiary includes the "value of any interest in" the 529 account.
        1. It is unclear whether the "value of any interest in" includes the entire value of the account.
        2. This is largely a moot point as it would be unusual for a beneficiary to die before the termination of the account and/or for a beneficiary of a 529 account to have an estate subject to federal estate tax.

e. NJ Inheritance Tax
    i. Although the contents of a 529 account are exempt from federal estate tax, NJ levies inheritance tax if a resident decedent is the owner of a 529 account and the named beneficiary is deemed to be "Class C" or "Class D".
    ii. Tax waivers will not be issued by the Division of Taxation until the tax is paid.
    iii. Presumably, if the owner or beneficiary of the 529 account is changed prior to the death of the account owner, the account will no longer be subject to inheritance tax.

III. Change of Beneficiary

a. Changes are permitted by most plans (some charge a fee).

b. There are no federal income tax consequences if the new beneficiary is a "member of the family" of the prior designated beneficiary (if not, change of beneficiary deemed a nonqualified distribution to the account owner).

c. There are no gift and generation-skipping transfer tax consequences if new beneficiary is: 1) "member of the family" of the prior designated beneficiary; and 2) assigned to a generation no lower than the generation of the prior designated beneficiary.

d. §529(e)(3)(A) defines "member of the family" as:
    i. a child or a descendant;
    ii. a brother, sister, stepbrother, or stepsister;
    iii. a father or mother, or an ancestor of either;
    iv. a stepfather or stepmother;
    v. a brother or sister of the father or mother;
    vi. a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law;
    vii. a spouse of any of the above;
    viii. the beneficiary's spouse; or
    ix. a first cousin.

e. If there are gift and generation-skipping consequences, who is the donor?
    i. Prop. Reg. 1.529-5(b)(3)(ii) provides it is the prior designated beneficiary – not the account owner! If assets increase substantially and the transfer is for the benefit a non-member of the family of the prior designated beneficiary and/or assigned to a lower generation, prior beneficiary will be deemed to have made a taxable gift to the new beneficiary.
    ii. The prior beneficiary would make the gift despite typically having no control over the change and may not even be aware the 529 account exists for their benefit.
    iii. 2008 Advance Notice of Proposed Rulemaking proposes treating the account owner as the donor, rather than the prior designated beneficiary.

IV. Roll Overs

a. Many states allow an account owner to switch the 529 account to another state's program by making a rollover; however, if a distribution of a rollover is made, it may cause recapture of deductions in the source state and a rollover distribution may not generate a deduction in the destination state even though the destination state permits deductions.

b. A rollover is permitted only once in a 12-month period per beneficiary, not per account.
    i. Reinvestment must be in another state's 529 plan within 60 days of the distribution.
    ii. What happens if two different account owners with accounts for the benefit of the same beneficiary roll over their accounts in the same 12-month period? Any additional rollover for the same beneficiary within the following 12 months would be a nonqualified distribution.
    iii. Exemption to 12-month rule: 1) beneficiary changed; 2) new beneficiary is a member of the family of old beneficiary; and 3) new beneficiary is not a generation lower than old beneficiary.

c. A beneficiary may be able to qualify for favorable state income tax consequences, such as an exemption with respect to a distribution from the 529. While many states (such as NJ) exempt from state income tax qualified distributions from all 529 plans, some states only permit the exemption if the investment is in that state's sponsored plan.

V. Amount and timing of distributions

a. A qualified distribution must be compared to the adjusted qualified education expenses (total expenses incurred, reduced by any tax-free educational assistance).

b. Amount distributed during a year must not exceed the qualified expenses incurred during the year.

c. A 2008 Advance Notice of Proposed Rulemaking states that a distribution may be a qualified distribution if it occurs either during the same calendar year as the qualified expense OR by March 31 of the following year.

VI. Investment Options

a. Prop. Reg. 1.529-2(g) – Only when funds are *initially* contributed, an account owner may choose between investment options provided by the state's 529 program. The account owner should be able to choose thereafter, and from time to time, different investment options for contributions made after the initial contribution.

b. Most state plan options include:
   i. college savings bank CDs
   ii. single mutual funds
   iii. combination of mutual funds
   iv. static portfolios including all equity, bond, cash equivalent and balanced portfolios
   v. age-based portfolios

c. Changes after the initial contribution – Notice 2001-55 states that pending final regulations, participants can change investments once per calendar year but is unclear whether the limitation is per beneficiary, account owner or account; accordingly, it is generally recommended that all investments in all accounts be changed by an account owner on the same day, and only once per calendar year.

d. The NJ plans however permit an account owner to reallocate existing assets in all accounts for a particular beneficiary to one or more investment options twice per calendar year, or whenever there is a change of beneficiary.

VII. Creditor Claims

a. Varies depending on state plan (check the plan handbook).

b. 529 accounts are protected in federal bankruptcy if:
    i. the amount was contributed at least 365 days prior to the filing of the bankruptcy petition;
    ii. The designated beneficiary of the amount contributed was a child, stepchild, grandchild or step-grandchild of the debtor for the year for which funds were paid or contributed; <u>and</u>
    iii. The amount of the contributions was not in excess of those necessary to provide for the qualified higher education expenses of the beneficiary.

c. If contributions are made between 1 and 2 years prior to the filing of the bankruptcy petition, the protection is limited to $5,000 (indexed for inflation) – currently $6,225.

d. Any transfer deemed to be a fraudulent transfer within two years before the petition date may be brought back into the bankruptcy estate.

VIII. Trust as Owner of 529 Account – acceptable if permitted by the state plan

a. <u>Advantages</u>
    i. The conduct of a trustee owner is subject to the terms of the trust as a matter of fiduciary duty, rather than the judgment of the owner.
    ii. Trust may provide an additional layer of protection in bankruptcy .
    iii. The trust establishes more permanent account ownership.

b. <u>Disadvantages</u>
    i. The donor might not be able to use annual exclusion, as transfer is to a trustee and not to a 529 savings account as required by the Code – will require qualifying in another manner, perhaps by issuing Crummey notices to the trust beneficiaries.
    ii. "Front loading" election is not available to the donor because transfer is to the trustee and not directly to a 529 qualified tuition program.
    iii. The contribution might not qualify for generation-skipping transfer tax annual exclusion unless: 1) the transfer qualifies for gift tax annual exclusion; 2) trust is for a single beneficiary; and 3) trust will be included in the beneficiary's estate.
    iv. If there is a state income tax deduction, it would not be received for a gift to fund a trust.

v. There are also potential negative financial aid consequences to beneficiary (for FAFSA purposes, a beneficiary's interest in the trust is treated as an asset of the beneficiary).

IX. Accounts established under UTMA or UGMA

a. Accounts in the name of a custodian for a minor under UTMA or UGMA can be transferred to a 529 account; however, because a 529 account can only receive cash, all assets must first be liquidated which will require the payment of taxes on any accrued gain.

b. If one was named as beneficiary of an UTMA or UGMA account, he or she must remain the beneficiary on the new 529 account, notwithstanding the account owner's ability to change the beneficiary for other types of 529 accounts.

c. Unlike traditional 529 accounts, when the beneficiary attains the age set forth by state law (in NJ, age 21), the beneficiary becomes owner of the account.