SCHENKMAN JENNINGS LLC
ATTORNEYS AT LAW

February 2009

Estate Planning Series

USING 529 PLANS TO INVEST FOR COLLEGE AND MANAGE WEALTH

In recent years, Section 529 plans have become a popular tool to set money aside for future college expenses. What many people do not realize is that Section 529 plans can also serve as an effective wealth transfer and asset protection tool.

The 529 plan, which derives its name from a section in the Internal Revenue Code is a tax-advantaged investment vehicle generally available to families regardless of their income level to pay for a child's or grandchild's college education. It allows investment earnings to grow sheltered from federal income taxes, provided withdrawals are used to pay for "qualified education expenses". For parents or grandparents concerned about estate taxes, 529 plans have another benefit. They support a long-term gifting strategy, while still providing the grantor significant control over assets that have been removed from his/her taxable estate.

The Basics

Before you consider the potential role of a 529 plan in your estate plan, it is important to understand a few basics. There are two types of 529 plans -- **prepaid tuition plans**, which let you lock in tomorrow's tuition at today's rates, and **college savings plans**, which let you choose from a menu of investments and offer more return potential, as well as risk. Both types of plans are generally sponsored by a state government (although tax law permits certain educational institutions to sponsor prepaid tuition plans) and administered by one or more investment companies. This article focuses on the **529 college savings plan.**

With a **529 college savings plan**, the underlying investment options are typically managed by mutual fund companies. Many plans offer age-based asset allocation portfolios that become more conservative as the beneficiary grows older. Others let account owners choose from individual investment options to create a customized portfolio. Originally, 529 plans only offered the benefit of tax-deferral -- taxes on earnings were not due until withdrawal and then only at the beneficiary's rate, however, in 2001 Congress passed legislation that made qualified withdrawals federally tax free. This remains in effect today.

Eligibility to contribute to a 529 plan is not limited by age or income. Withdrawals can be used to pay for "qualified education expenses", which can include a child's or grandchild's tuition, supplies, room and board, etc. in connection with an eligible institution, which generally are colleges, universities, community colleges and technical/vocational schools. Withdrawals for purposes not related to paying qualified education expenses are subject to ordinary income taxes and a 10% penalty tax.

In establishing a 529 plan, you are not limited to participating in your home state's 529 plan. You can participate in national plans sponsored by other states as well. Since there are many options, it is recommended that you consult with your accountant or a qualified financial advisor to assist you in selecting the best plan for your needs before investing in a particular plan.

A Valuable Estate Planning Tool

The IRS clearly had college planning in mind when it drafted Section 529 of the Internal Revenue Code. However, it also left the door open to use 529 plans as an **estate planning tool**. That is because a contribution to a 529 plan is considered a completed gift for Federal tax purposes from the donor to the beneficiary named on the account, even though the account owner, not the beneficiary, maintains control over the money while it is in the account. In 2009, tax rules permit you to give up to $13,000 (which is indexed to inflation in future years) to as many individuals as you choose each year, free from federal gift taxes. A couple can therefore give $26,000 per beneficiary per year without incurring taxes.

Under a 529 plan, you can also accelerate your gifting schedule by electing to make a lump-sum contribution of $65,000 to a 529 plan in the first year of a five-year period ($130,000 for a couple) for a single beneficiary. With multiple children or grandchildren, the wealth transfer potential can be substantial. If you have five grandchildren, you could immediately remove up to $325,000 ($650,000 for a couple) from your taxable estate by contributing the money to five separate 529 plan accounts. Then, after five years, you could do it again. Of course, you would not then be able to make additional taxable gifts to that beneficiary during the five-year period. However, if you use the five-year averaging election and die before the five years are up, a prorated portion of the contribution may be considered part of your taxable estate.

You Stay in Control

It's worth emphasizing that although the assets contributed to a 529 plan are no longer considered part of your taxable estate, you still exercise control over the money. You decide how it will be invested -- within the confines of the plan's available investment options -- and when it will be withdrawn. You also have the **right to change beneficiaries** for any reason, in the event that the original beneficiary decides not to attend college, or his/her college tuition and other payments are less than the value of his/her 529 plan. In doing so, you will not trigger tax consequences provided you choose a beneficiary who is a member of the original beneficiary's family (under Section 529, qualified family members include the beneficiary's brothers or sisters, mother or father, sons or daughters, and nieces or nephews, among others). If there is not another suitable beneficiary, you also have the option of closing the account and taking the money back. If you take this route, earnings will be subject to income taxes, you will be subject to a 10% penalty, and the asset will become part of your estate.

SUMMARY

A 529 plan can be an important part of your estate plan as contributions will be removed from your estate and gains will be income tax free. Once it is decided that a 529 plan will be part of your estate plan, we recommend that you consult with your accountant or a qualified financial advisor to help choose the best state sponsored plan to satisfy your investment needs.

SCHENKMAN JENNINGS LLC
ATTORNEYS AT LAW
13 Roszel Road Princeton, NJ 08540 (609) 452-0110