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Unconventional Uses of 529 Plans Should Not Be Ignored by Taxpayers and Their Advisors

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INTRODUCTION

Internal Revenue Code §529 enables taxpayers to establish "529 plans," which may be immune from federal and state income taxes, creditor-protected, and absorbent of losses that have been sustained within them. While most planners understand and recommend the use of 529 plans for gift tax exemption and descendant education planning, the current economic and political environment may occasion the need for a revised perspective of how to best use existing and future 529 plans to maximize personal and family educational and wealth enhancement. The occurrence of losses within 529 plans, a likely increase in future capital gains rates, and a focus on clients' now reduced economic asset base and increased personal needs require a reexamination of 529 plans.

Is it possible to use existing 529 plans to absorb otherwise taxable gains, to act as a tax shelter for the contributor himself or herself, or to use the gift tax annual exclusion to fund 529 plans for certain descendants (such as nephews and nieces) that may be converted free of transfer tax to use for other descendants (such as children) if and when it is appropriate in the future? These, and other questions, are investigated in this article.

Prior to the recent third quarter "recovery,"[1] the Dow had fallen over 50%, which is worse than any other bear market since the Great Depression. Unfortunately, educational savings plans were not immune from this broad market collapse. Indeed, recent statistics indicate that there were 11.2 million 529 plan accounts and that their value fell 12.4% in the fourth quarter of 2008, alone.[2] The result is that many affluent taxpayers hold 529 plans where the amounts invested exceed the present value of the plan assets. Many clients have converted from equities to cash equivalents under 529 plans, and might now reconsider this. Because a taxpayer can close down a "loss position" in a 529 plan and receive all assets tax-free (for any use or reason and without regard to use), clients holding 529 plans with significant losses should consider changing their strategy to have the 529 plan hold more income-producing assets and later withdrawing all assets upon breaking even overall. Also, clients should consider adding more monies to 529 plans with loss positions in order to maximize the ability to have past losses absorb future investment income.

Upon review of the admittedly contrarian ideas set forth below, many taxpayers may (after consulting with their financial advisors) consider abandoning the original plan to use a 529 plan to pay for college expenses when it becomes apparent that "an upside down 529 plan" is an income tax savings vehicle, without regard to where the plan assets are spent to pay for college. Stated another way, why be restricted to using bruised 529 plan assets to pay for college when the income can be withdrawn tax-free and may be better used for other purposes in this uncertain economic environment?

Also, clients may be best served by starting new 529 plans to pay for college expenses, while using existing upside down 529 plans as income savings vehicles. For example, a client who believes a child will need $100,000 for a college education and who has a 529 plan that cost $100,000 but is now worth only $60,000 may fund a new 529 plan to fund college expenses, and use the existing upside down 529 plan to generate tax-free income, which can be withdrawn by the termination and liquidation of the old plan account plan when the total plan assets equal the total cumulative contributions to such plan.

This article will investigate these strategies and questions that arise therefrom after providing a basic background on 529 plan investment rules.

BASIC BACKGROUND INFORMATION

Internal Revenue Code §529 offers generous gift tax and income tax provisions for certain accounts set

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[1] In the third quarter of 2009, the S&P 500 gained 15%.

[2] Investment Company Institute, *529 Plan Program Statistics, December 2008* (May 22, 2009), *available at* http://www.ici.org/research/stats/529s/529s_12-08.

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up for educational purposes. Under this Code Section,[3] earnings on monies contributed to a 529 plan that are used for "qualifying higher education expenses"[4] may be withdrawn income tax-free.

Furthermore, §529(c)(2) allows a donor to front-load his or her gift tax annual exclusion for up to five years. What this means is that an individual may, under current law, contribute up to $65,000 in one year to a 529 plan for the benefit of a "designated beneficiary" and receive the gift tax annual exclusion with respect to such contributions in lieu of having future $13,000 per year annual exclusion allowances with respect to a beneficiary for the next four years. This is a significant benefit that warrants further discussion. Typically, the amount that an individual donor may give without consuming a part of his or her unified credit[5] is limited to $13,000 per donee per year (this amount is indexed). By split-gifting, therefore, married couples may give $130,000 to a 529 plan in 2010 (i.e., $13,000 × 2 × 5) that will be outside of their gross estates, and sheltered in a tax-deferred and potentially tax-free investment for college.[6]

Under §529(c)(3), distributions (or portions thereof) from §529 plans that are not used for "qualifying higher education expenses" are includible in the gross income of the distributee "in the manner as provided in Section 72 to the extent not excluded from gross income under any other provision of [Chapter 1 of the Internal Revenue Code]." Section 529(c)(6) also imposes a 10% income tax penalty on the portion of unqualified withdrawals that are includible in gross income in addition to the federal income tax that is calculated under §72.

Section 72, which addresses the taxation of annuities, provides the general rule that the amount includible in gross income is equal to the amount received by the taxpayer, multiplied by the ratio that the "investment in the contract" bears to the "expected return under the contract." This "exclusion ratio" determines the percentage of the amount received by the taxpayer that is not includible in gross income.[7]

The term "investment in the contract" is defined by §72(c)(1) as the aggregate amount of premiums or other consideration paid for the contract, less the aggregate amount received by the taxpayer before such date, to the extent that such amounts were not includible in the taxpayer's gross income. In the context of 529 plans, therefore, the term "investment in the contract" is straightforward (particularly compared to often times hypertechnical tax code parlance) — namely, it simply refers to the amount of contributions made to the 529 plan, minus the amount of such contributions or portions thereof, that have been previously distributed to the taxpayer and were not includible in the taxpayer's gross income.

The definition of "expected return under the contract" by comparison, is determined under §72(c)(3) by use of actuarial tables of the Treasury Regulations promulgated under §72 (if the expected return depends in whole or in part on the life expectancy of one or more individuals) *or* by the aggregate amounts receivable under the contract as an annuity (if the expected return does not depend upon life expectancy of one or more individuals).

Because distributions from §529 plans generally do not depend on the life expectancy of one or more individuals, the expected return in the context of §529 plans is determined by the amounts distributable under the 529 plan. This amount, in turn, is equal to the value of the account.[8]

MECHANICS OF PLANNING WITH UPSIDE DOWN 529 PLANS

The favorable income tax treatment of 529 plans can be an advantageous planning mechanism for con-

[3] All statutory references in this article are to the Internal Revenue Code of 1986, as amended (the "Code").

[4] Qualifying higher education expenses are defined by §529(e)(3) to include tuition, fees, room and board, books, and other education expenses that are required for the enrollment or attendance of a designated beneficiary at an eligible educational institution.

[5] Under 2009 law, the unified credit against *estate tax* allowed an individual to pass transfer-tax-free $3,500,000 of property (note that this figure is limited to $1,000,000 for *gift taxes*, although there is a distinct possibility of future legislation given that the estate tax has been repealed for individuals who die in 2010). In the latter vein, the prospects for estate tax legislation are properly the topic of a separate article.

[6] The aggregate benefits of multiplying the annual exclusion and of tax deferral are significant and well-known. An important (and overlooked) point, however, is that, in computing the amount that can be front-loaded into a 529 plan, other gifts that have been made to that beneficiary must be fully considered. If the taxpayer intends to fully utilize the five-year amount, then other gifts cannot be made without consuming unified credit. This is potentially a trap for the unwary, or, more aptly, the uninformed. Similarly, unlike present gifts of $13,000, making the five-year election requires filing a gift tax return (Form 709). Subsumed in this previous statement is another point that could be the topic of a separate article, namely that the gift tax exclusion is generally limited to present interests, although like many areas of tax law, there are complicated exceptions to this generalization.

[7] Moreover, paragraph (c)(3)(D) of §529 states that for the purposes of applying §72 to distributions from 529 plans, all distributions made during one taxable year are treated as one distribution, and the value of the contract, income on the contract, and "investment in the contract" are computed as of the close of the calendar year in which the taxable year begins.

[8] This follows as a logical consequence because of the fact that 529 plans allow the distribution of the entire amount of the plan at the contributor's discretion (notwithstanding potentially adverse tax consequences).

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tributors who have suffered losses in value in their 529 plans, which, due to the recent economic downturn, is unfortunately a large universe of plan participants. Because §529 allows a taxpayer to withdraw his or her contributions from the 529 plan on a tax-free basis, any loss in value that occurs subsequent to a contribution may enable the contributor to withdraw income on the contributions and therefore shield investments from income tax. This principle is best illustrated by an example.

Suppose that Client makes contributions totaling $120,000 to a 529 plan to benefit his or her child. Subsequent to the Client's contributions, the value of the 529 plan has decreased so that the account is worth $70,000. Under the §529 and §72 rules for determining amount includible in gross income, the exclusion ratio is equal to the investment in the plan (or $120,000) divided by the value of the plan (or $70,000), which is in excess of 100%. This will always be the case when the value of the 529 plan declines from the time at which assets are contributed to the plan. Therefore, all distributions from the 529 plan that total less than the original investment ($120,000) will be excludible from Client's gross income.

Client can then contribute cash to his or her 529 plan, which can be used to purchase assets that may appreciate in subsequent years. Client will be able to shield $50,000, plus the value of the new contribution, from income taxes.

Continuing with our example, suppose Client contributes $30,000 of additional cash to the 529 plan, which amount is used to purchase a mutual fund within the plan that is subsequently sold for $50,000. Suppose that Client takes a distribution of the $20,000 of the gain earned on the subsequent contribution. This $20,000 is excluded from Client's gross income because, under the exclusion ratio method as applied in the context of §529, his or her investment in the plan at the close of the calendar year (i.e., $120,000 + $30,000 – $20,000 = *$130,000*) exceeds the value of the contract at the close of the calendar year.

Furthermore, the 10% penalty tax applies only to amounts that are included in gross income. Because the $20,000 distribution is not includible in gross income, the penalty tax does not apply.

The bottom line is that the hypothetical Client can effectively shield $20,000 of gain from income taxation and still have $30,000 of a "hidden tax deduction" remaining within the 529 plan.[9]

This planning opportunity will enable individuals to contribute money to 529 plans and have future growth under the plan investments shielded from income tax to the extent of past economic losses.

Further, as discussed above, many taxpayers may consider abandoning the original plan to use a now upside down 529 plan to pay for college expenses when income earned going forward can be withdrawn tax-free as long as this occurs before the total value of plan assets exceeds the total cost thereof. Well-to-do clients may therefore consider starting new 529 plans to pay for college expenses, and using existing upside down 529 plans as income tax savings vehicles.

COSTS ASSOCIATED WITH SUCH PLANNING

There is admittedly a cost to qualify for this "planning opportunity." [10] The first (and more obvious) is that the 529 plan must have suffered investment losses. Assuming that this is the starting point for most Americans in 2010, planners must discover how to recover some of these losses (either directly, or, indirectly, by factoring in the tax benefits).[11]

The second "cost" is the use of the gift tax annual exclusion and/or lifetime unified credit amount that must be used in order for the contributor to contribute assets to the 529 plan. However, provided that the contributor has not otherwise used his or her annual exclusion with respect to such beneficiaries, funding the 529 plan should not be a problem. For most taxpayers, this "cost" is therefore more theoretical than real.

Additionally, having assets under 529 plans can be more expensive and much less flexible than holding stock and bond portfolios and low-cost mutual funds. Sales charges and annual administrative expenses are imposed by many 529 plan sponsors.[12]

Clients should also be aware that only limited "qualified higher education expenses" can be paid tax-free from an appreciated 529 plan. These expenses

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[9] Note that if Client instead closed the account and withdrew the money, then it would generate a loss that would qualify as a miscellaneous itemized deduction (subject to the 2% floor on miscellaneous itemized deductions). The allowance of a miscellaneous itemized deduction in this situation has been blessed by the IRS in IRS Publication 970.

[10] Admittedly, "planning opportunity" is something of an overstatement given that the starting point is a loss position in a 529 plan that was not anticipated or welcomed. However, the authors properly assume that the starting point for the analysis herein is a 529 plan that has suffered significant losses such that this tax "break" may help Client recover his or her losses.

[11] Put another way, recovering 35% (currently the highest tax bracket) does not restore lost money, but it at least reduces the pain of the investment loss (to the tune of Client's applicable tax bracket).

[12] Like any investment vehicle, all 529 plans have fees and expenses. Not only do these charges vary among 529 plans, but also they can vary within a single 529 plan. The following is a nonexhaustive list of some of the most common fees, charges and expenses found in college savings plans: (i) enrollment fees, (ii) annual maintenance fee, (iii) sales charges, (iv) administration/management fees, and (v) underlying fund expenses.

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consist of tuition, fees, books, supplies and equipment required for the enrollment or the attendance at an eligible institution, expenses for special needs services, and room and board expenses. Transportation costs are not included, and room and board expenses can be paid from the 529 plan tax-free only if the beneficiary carries at least half of the normal full-time course load. Under §529(e)(3)(B)(ii), the cost of room and board paid for by tax-free 529 plan distributions cannot exceed the actual amount charged if the student resides in housing owned or operated by the school, or up to the amount that the school would charge for such items if a more-than-half-time student does not reside in school-provided housing.

Contributions to a 529 plan may be made only in cash. Furthermore, neither the contributor nor a designated beneficiary of the plan may directly or indirectly direct the investment of any contributions to the plan. However, the contributor is permitted to change the investment option or plan administrators each year if he or she is unhappy with the investment approach of his or her current plan.

Another restriction is that a 529 plan must have adequate safeguards to prevent contributions to the plan in excess of those necessary to provide for the qualified higher education expenses of the beneficiaries. Thus it may not be advisable to employ the strategy that is discussed herein without addressing these restrictions. However, with the rising costs of education, the uncertainty of future education expenses, and the advanced levels of education that may be obtained by plan beneficiaries, it is difficult to determine what would be "necessary" to provide for the qualified higher education expenses of beneficiaries who may not attend college until some years in the future. The authors take the view that contributions to the plan should not be egregiously in excess of reasonable future education expenses. Planners and financial advisors should help clients determine what are "reasonable" contributions on an individual basis, as such amounts may vary based on clients' particular circumstances.

USE OF GIFTING ALLOWANCES

Contributions to a 529 plan are generally considered to be gifts for gift tax purposes under §529(c)(2)(A)(i), although certain transfers of money into 529 plans will not be considered new gifts. An example of where gift treatment should not apply, despite statutory language that seems to make this automatic, would be where monies from a Transfers to Minors Act account are transferred to a 529 plan for the same minor. By the same rationale a 529 plan funded by an individual for himself or herself would not be considered to be a taxable gift. Likewise, the funding of a 529 plan by an irrevocable trust for one or more descendants of the client, where the funding of the trust itself was a taxable or tax-exempt gift for the beneficiaries thereof, should not be considered a taxable gift. Some advisors have caused family limited partnerships that are owned in large part by parents, and to some extent by irrevocable trusts for descendants, to invest in 529 plans so that the investment into the 529 plan is not considered to be a taxable gift by the taxpayer. This should allow income tax savings if the plan assets are used directly for college expenses, and at that time considered distributions to partners and/or trust beneficiaries. Such distributions may be characterized as redemptions of the partnership interest that is owned by the children or trust for their benefit at the time of expenditure, causing a reduction in their percentages of partnership ownership.

ANTI-ABUSE RULES

Investment Vehicle Prohibitions Expected

On January 18, 2008, the Service issued an Advance Notice of Proposed Rulemaking,[13] which provides that anti-abuse rules will be issued to prevent 529 plans from being used solely as investment vehicles, as opposed to being used to provide for college expenses. These regulations have not yet been proposed, but it would be expected that the IRS may challenge 529 plans that are established solely for investment purposes or converted to be used solely for investment purposes, despite the lack of any statutory or regulatory language that disallows the use of 529 plans for investment purposes.

Switching Intended Beneficiaries

Taxpayers may establish 529 plans for one individual, and later switch the plan to be used for another individual. Under §529(c)(3)(C), the identity of the beneficiary under a 529 plan can be changed once a year without causing a change to be considered a distribution from the 529 plan, and the individual funding and maintaining the plan can decide that he or she wishes to use the plan assets for his or her individual benefit. Even where 529 plan growth causes income to be recognized by the account owner on withdrawal, an individual having significant health costs may have deductions to offset such income, except for the 10% income tax penalty on the portion of unqualified withdrawals that are includible in gross income.

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[13] REG-127127-05, 73 Fed. Reg. 3441.

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Section 529(c)(5)(B) provides that the change of the designated beneficiary of a 529 plan does not cause the imposition of federal gift tax or generation-skipping transfer tax if the new beneficiary is assigned to the same generation as (or a higher generation than) the old beneficiary under §2651, and if the new beneficiary is a "member of the family" of the old beneficiary. The term "member of the family" is defined in §529(e)(2) to include the following individuals (and the spouses thereof) with respect to any designated beneficiary: his or her spouse, children or descendants thereof, siblings or step-siblings, parents or ancestors thereof, stepparents, nieces or nephews, aunts or uncles, father-in-law, mother-in-law, sister-in-law, brother-in-law, son-in law, daughter-in-law, and first cousins.

An example of a change in the designated beneficiary that would not cause the imposition of federal gift or generation-skipping transfer tax would be where a taxpayer establishes a 529 plan to provide benefits for a particular nephew or niece, but later determines that the benefits are really needed for a child of the individual, or for the individual himself. Conversely, as indicated in regulations that were proposed in 1998 [14] but never finalized, and as implied by §529(c)(5)(B), a change in the designated beneficiary of a 529 plan from a child of the taxpayer to a grandchild of the taxpayer would result in a taxable gift from the child to the grandchild, notwithstanding that the child had no knowledge of the change in designated beneficiary. The IRS stated in the 2008 Advance Notice of Proposed Rulemaking that it intends to issue proposed regulations providing that a change in the identity of a designated beneficiary resulting in the imposition of any tax will be considered to be a distribution to the account owner, and a subsequent gift by the account owner to the new beneficiary so that the account owner would be liable for any transfer tax resulting from the change in beneficiary.[15]

Further, the IRS indicated and announced in the January 18, 2008 Advance Notice of Proposed Rulemaking [16] that an additional anti-abuse rule will be issued to prevent 529 plans from being opened for one beneficiary with an intention to actually have the plan benefit another beneficiary. An example would be to open a 529 plan and to use the $13,000 per year annual gifting allowance on a nephew, when the real plan is to spend nominal amounts on the nephew and to convert the 529 plan to be used for a child. Nevertheless, the tax law applicable to 529 plans clearly contemplates that plan benefits can be transferred to a new beneficiary on an annual basis, and it is clear that this flexibility is needed as circumstances change with respect to the beneficiaries who actually attend college and their expenses, needs and scholarship prospects.

Many affluent clients have nephews, nieces, grandchildren, grandnephews and grandnieces, as well as friends and more distant relatives and expected future-born relatives who may be significantly benefitted by 529 plans in the future. Current 529 plan law clearly anticipates that not all 529 plan assets will be used for education, and this is illustrated by the very fact that 529 plan distributions will be subject to income tax, and a penalty tax, when they are made for non-educational purposes to the extent that the value of the plan has grown since contribution (total excess of plan values over plan basis (cost minus prior withdrawals)) upon distribution.

CONCLUSION

While the conventional use of 529 plans is to save for college expenses, funded with the $13,000 per individual annual gift tax exclusion, the existence of upside down 529 plans calls for taxpayers to determine whether it is best for them to leave those plans as tax-free savings vehicles and to fund new 529 plans so that the first dollar of future appreciation thereon is income-tax-free when such funds are used for educational purposes. In addition, clients should consider having monies that are already set aside under family limited partnerships or irrevocable trusts used to fund 529 plans, because such contributions to 529 plans may not be considered gifts at the time of funding. Clients may also consider establishing 529 plans for more distant relatives, which can be used as "backup college savings plans" for other relatives where annual exclusion gifting for other purposes makes future transfers to college savings plans for such relatives a challenge.

The strategies that are discussed in this article are examples of creative thinking that can be used to mitigate the damage that has been done to 529 plans that were initially designed to provide for college expenses. By using loss positions in 529 plans to effectively shield future income from taxes, clients may creatively be able to use losses that were caused by the recent economic downturn to their advantage, and find a silver lining in the economic storm.

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[14] Prop. Regs. §1.529-5(b)(3)(ii).

[15] REG-127127-05, 73 Fed. Reg. 3441.

[16] REG-127127-05, 73 Fed. Reg. 3441.

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