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MAKING THE MOST OF SECTION 529 SAVINGS ACCOUNTS

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Established under the Qualified Tuition Program (QTP) in a particular state, section 529 savings accounts have become a valuable estate planning tool for individuals with higher estate values. Once established, earnings on the section 529 savings accounts are not federally taxable income when used for qualified higher education expenses. Some states also allow for income tax exemption on earnings from such accounts.

Requirements

Section 529 savings accounts must be "established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account." I.R.C. § 529(b)(1)(A)(ii). Contributions must be in cash, not other asset forms. The account may not be used as collateral for a loan.

Each state establishes its own contribution limits. Most states limit contributions based on four or five years of in-state tuition per beneficiary. Additionally, a QTP must provide separate accounting for each beneficiary.

Advantages

The I.R.C. § 529 regulatory scheme allows individuals to contribute to section 529 accounts regardless of their income. Although contributions are not tax deductible at the federal level, advantages of section 529 savings accounts include tax exemption and continued control by the grantor. Beneficiaries of section 529 savings accounts have no direct access to, or control over, the account funds. Instead, the account owner can direct the distribution of account funds, even changing the beneficiaries.

Specifically related to tax exemption, the following tax advantages exist in properly funded and managed section 529 accounts:

- Earnings are exempt from federal income tax.
- Earnings qualify for either state tax exemption or deferral, depending on state regulations.
- Up to five times of the annual gift exclusion amount (currently $15,000 in 2021) can be contributed to the section 529 savings account (per individual) without incurring a gift tax.
- Contributions that qualify for the annual gift tax exclusion also qualify for the annual Generation-Skipping Tax (GST) exclusion. Thus, grandparents can make large contributions to these accounts without allocating any of their GST exemptions (currently $11.58 Million in 2021).

In addition to tax advantages and owner control over section 529 savings account funds, the accounts also have the following advantages:

- The account owner can reacquire (withdraw) the funds from the account, allowing a donor to set funds aside for a beneficiary's college education, but also to withdraw the funds for any reason.

- Funds held in section 529 savings accounts will not disqualify beneficiaries from financial aid or education credits, including the American Opportunity Credit and the Lifetime Learning Credit.
- The allowable education costs for which funds can be used is more expansive than previously enacted programs. Funds can be used for room and board and other necessary educational expenses, not strictly tuition and fees. Further, up to $10,000 per year can be spent on elementary or secondary education for a beneficiary.
- Funds in section 529 savings accounts receive special protection in bankruptcy.

Disadvantages

However, individuals must be aware of potential drawbacks of section 529 savings accounts. Namely, although the account owner can reacquire funds from the account, any distributions to beneficiaries must be made only for Qualified Higher Education Expenses (QHEEs). If funds are not distributed for QHEEs, a ten percent penalty tax is applied to the earnings. Further, if the beneficiary does not use all of the funds for QHEEs, undesirable tax consequences may result from distributing the remaining funds.

Another disadvantage of section 529 savings accounts is the limited investment options due to regulation by state programs. State program regulations also result in lack of complete investment control for the account owner, including the limited ability to change investment strategies. Specifically, the account owner may only change the investment in the account twice each calendar year. I.R.C. § 592(b)(4).

Finally, due to uncertainties regarding how the programs and state law will develop and change, predictive investing is more difficult. Unlike other investment accounts, investment managers for state programs change frequently. Frequent management changes also contribute to uncertainties surrounding investment management.

Conclusion

Section 529 savings accounts can be an effective way for wealthy taxpayers to find their heirs' education without having to use their annual gift tax exclusion or lifetime estate tax exclusion. The freedom to reclaim account funds provides security that the funds will still be available to the taxpayers in the event of unforeseen circumstances. However, taxpayers might be aware of not only restrictions on penalty-free use of the funds by the beneficiaries, but also the limited investment options available to these accounts.