A Primer: Section 529 Plans, Coverdell Education Savings Accounts (Education IRAs), and Other Tax-Smart Ways to Save for College[1]

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Introduction

Benjamin Franklin once observed, "An investment in knowledge always pays the best interest."[2] As legal assistance attorneys, clients frequently ask: What is the best way to save or pay for education, especially college education for children and grandchildren? There really is no one "best" answer or resolution to this question. Many more options are available today than ever before. Traditionally, we have counseled clients on the use of custodial accounts such as the Uniform Gifts to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA).[3] These standby methods are quite appealing now that Congress has lowered the capital-gains tax rate that effectively reduces the tax rate most children will pay on any gains in their stock portfolio to between eight and ten percent.[4]

We have also counseled clients on the use of U.S. Savings Bonds, such as Series EE bonds issued after 1989 and all Series I (inflation adjusted) bonds.[5] For married taxpayers with adjusted incomes of $117,750 or less ($73,500 for single tax return filers), some or all of the interest earned on these bonds is tax-free if used for higher education expenses.[6] Consumers' main complaint about them is their low interest rate.

In addition to the traditional savings techniques discussed above, Congress has recently introduced tax incentives to promote education savings, including prepaid tuition and education investment plans commonly referred to as 529 Plans (after Section 529 of the Internal Revenue Code which governs them), Coverdell Education Savings Accounts (formerly called Education IRAs), Hope Scholarships, and Lifetime Learning Credits.[7] This article focuses on 529 Plans and Coverdell Education Savings Accounts. The appendices provide supplemental statutory guidance.

Background

Increasing Cost of Higher Education

The College Board compiled data from 2001-2002, which shows an increase of 9.6% in college tuition and fees at four-year public institutions, and 5.8% at four-year private institutions, as compared with a 1.2% annual increase in the Consumer Price Index.[8] The increase in tuition and fees from 2000-2001 was 4.4% and 5.2%, respectively.[9] College costs increased an average of 7.7% per year during the period 1971-

1. *See* Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001) (2001 Act). Unless otherwise noted, all references to "section" or "§" are to the Internal Revenue Code of 1986, as amended, and the regulations and proposed regulations thereunder.

2. Saving for Education: A Long-Term Investment, A Guide to Understanding 529 Plans 1, Investment Co. Instit. (2002) [hereinafter 529 Plans].

3. *See* Uniform Transfers to Minors Act § 2 (2000); Uniform Gifts to Minors Act § 2 (2000). The National Conference of the Commissioners on Uniform State Laws promulgated the UGMA in 1956. All fifty states and the District of Columbia have adopted some version of the UGMA. Henry J. Lisher, Jr., 846 T.M., Gifts to Minors 16(2) (1997). The UGMA has been revised several times and renamed as the UTMA in 1993. *Id.* at 18. Forty eight states and the District of Columbia have adopted a version of the UTMA. *Id*.

4. I.R.C. § 1(h) (2000).

5. *See* Bureau of the Public Debt, *Series EE/E Savings Bonds*, *available at* http://www.publicdebt.treas.gov/sav/savinvst.htm (last visited Apr. 20, 2004) ("EE Bonds are low-risk savings products that pay interest based on current market rates on Treasury securities. EE Bonds are a safe and secure way to save for the future, whether it's to finance education, supplement retirement income, or give as a gift."); Savingsbonds.com, *Home*, *available at* www.savingsbonds.com (last visited Apr. 21, 2004); U.S. Dep't of the Treasury, *Treasury Direct*, *available at* www.treasurydirect.gov (last visited Apr. 21, 2004).

6. I.R.C. § 135(a), (b), (c)(1).

7. *See* 529 Plans, *supra* note 2.

8. *See 2002 Trends in College Pricing*, *available at* www.collegeboard.org (last visited Apr. 23, 2004) [hereinafter *2002 Trends in College Pricing*]; *News 2000-2001*, *available at* www.collegeboard.org (last visited Apr. 23, 2004) [hereinafter *News 2000-2001*].

2001, in comparison to an average 5.1% annual increase in the Consumer Price Index over the same period.[10] From 1989 to 1999, college costs increased at more than twice the rate of the Consumer Price Index (5.6% versus 2.3%).[11]

The economic importance of higher education has also increased. United States Census Bureau statistics show the annual income for a person with a college degree is more than eighty percent higher than for a high school graduate.[12]

In 2020, the College Board projects average college costs for four years of tuition and fees, books and supplies, room and board, transportation and other expenses, as $271,698 for private institutions, and $123,487 for public institutions.[13] Using present costs of actual institutions and projecting to 2020 (assuming five percent inflation rate in college costs), the "in-state" cost for four years of attendance at SUNY-Albany (a four-year public college) will be $130,272, the "out-of-state" costs for Michigan State University (a four-year public college) will be $204,676, and the cost for Columbia University (a four-year private college) will be $358,547.[14]

Predominant Financial Concern

According to the College Savings Plans Network, a non-profit affiliate of the National Association of State Treasurers, public opinion polls indicate the greatest financial concern of most American families has shifted from the ability to save sufficient retirement assets to the ability to pay for children's college education.[15]

In August 1995, the United States General Accounting Office (GAO) published a report on state tuition programs in existence at that time.[16] According to the GAO report:

> When asked on Alabama's program application how they would save for college costs without the tuition prepayment program, about 52% of purchasers in 1991-1994 checked "savings account," about 17% checked "savings bonds," about 15% checked "life insurance," and only about 6% checked "stocks." With passbook savings accounts currently offering less than 3%, it appears that a large percentage of Alabama's participants would be putting their money in investments that would be expected to provide a lower return than the anticipated rate of tuition inflation, about 7-8% per year.[17]

According to an Alliance/Harris College Savings Poll (August 2001), families expect to save only $20,000 for college costs, but expect to pay more than $80,000.[18]

Traditional Education Savings Techniques

Traditional education savings techniques include gifts to a student or for the student's benefit, and tuition payments made directly to the educational organization. Gifts of up to $11,000 per year or $22,000 if the donor is married[19] to a beneficiary outright, a custodial account for a beneficiary, or certain types of trusts for a beneficiary, qualify for an annual exclusion from gift tax.[20] They are treated as nontaxable gifts" for purposes of generation-skipping transfer (GST) tax.[21]

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9. *2002 Trends in College Pricing*, *supra* note 8; *News 2000-2001*, *supra* note 8.

10. *2002 Trends in College Pricing*, *supra* note 8; *News 2000-2001*, *supra* note 8.

11. *See* The College Board, Independent College 500 Index (1999), *available at* www.benico.com (last visited Apr. 21, 2004).

12. *See 2002 Trends in College Pricing*, *supra* note 8.

13. *See id.* (assuming five percent inflation rate in college costs).

14. U.S. News Online, *What Will College Cost for Your Child?*, *available at* www.benico.com (last visited Apr. 12, 2004).

15. *See* College Savings Plans Network (CSPN), *About CSPN*, *available at* http://www.collegesavings.org/ (last visited Apr. 21, 2004).

16. U.S. General Accounting Office, *College Savings: Information on State Tuition Prepayment Programs*, Aug.1995, *available at* www.gao.gov/archive/1995/he95131.pdf (last visited Mar. 9, 2004).

17. *Id.*

18. Alliance/Harris College Savings Poll (Aug. 2001), *available at* www.benico.com (last visited Apr. 12, 2004) [hereinafter Alliance/Harris College Savings Poll].

19. The married couple may elect to "split gifts" with his or her spouse for gift tax purposes under Internal Revenue Code (IRC or Code) Section 2513. I.R.C. § 2513 (2000).

20. *Id.* §§ 2503(b), 2642(c).

21. *Id.*

Qualified Transfers for Educational Expenses

In addition to the gift tax and GST tax annual exclusions, certain qualified transfers for educational expenses are exempt from gift tax and GST tax.[22] A qualified transfer is a tuition payment made directly to a qualified educational institution for the education and training of an individual, but does not include amounts paid for books, supplies, dormitory fees, board, or other expenses which do not constitute direct tuition costs.[23]

There is no limit on the amount of a qualified transfer, and qualified transfers may be made in conjunction with other education savings techniques (e.g., annual exclusion gifts and contributions to 529 Plans and Coverdell Education Savings Accounts).[24] A qualified transfer is exempt from gift tax and GST tax without regard to the relationship between the payor and the student.[25]

The Internal Revenue Service (IRS) has ruled that a donor may make qualified transfers to prepay multiple years of a student's tuition.[26] Such prepayment allows a donor who may not live to make future tuition payments to confer substantial tax-free benefits on a beneficiary currently, while reducing the donor's taxable estate.

Current Status

Currently, all fifty states and the District of Columbia have 529 Plans in operation or development.[27] Over 1.5 million students have been enrolled in 529 Plans, with contributions representing more than $9.5 billion dedicated for future college costs.[28] Cerulli Associates, a financial consulting firm, has predicted that assets in 529 Plans will grow to more than $50 billion by 2006.[29] According to Salomon Smith Barney's research on public awareness of college savings vehicles, eighty-five percent of investors know about U.S. Savings Bonds, fifty-two percent know of Education IRAs (now Coverdell Education Savings Accounts), but just thirty percent know about 529 Plans.[30]

Prepaid Tuition Plans and Education Investment Plans

Code Section 529 authorizes two types of qualified tuition programs (QTPs): prepaid tuition plans and education investment plans.[31] Under the prepaid tuition plan, a contributor purchases tuition credits or certificates on behalf of a designated beneficiary, which entitles the beneficiary to the waiver or payment of qualified higher education expenses.[32] Prepaid tuition plans are designed to hedge against inflation, and enable a contributor to lock-in tomorrow's tuition at today's prices.

Under the education investment plan, a contributor deposits amounts in a separate investment account established for the purpose of meeting the qualified higher education expenses of the designated beneficiary.[33] Once deposited in the account, the contributions are invested in the market (typically, in mutual funds). Investments within these plans are subject to market fluctuations, and do not offer a guaranteed return.

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22. *Id.* §§ 2503(e), 2611(b)(1).

23. Treas. Reg. § 25.2503-6(b)(2) (2000).

24. *See id.*

25. *Id.* § 25.2503-6(a).

26. Tech. Adv. Mem. 199941013 (July 9, 1999). In this Technical Advice Memorandum, the IRS ruled that a grandmother's non-refundable payments made directly to a preparatory school for several years of her grandchildren's tuition qualified for exclusion from gift tax treatment. *Id.*; *see* Treas. Reg. § 25.2503.

27. Savingforcollege.com, *Internet Guide to Coverdell ESA*, *available at* http://www.savingforcollege.com/ (last visited Apr. 21, 2004) [hereinafter *Internet Guide to Coverdell ESA*].

28. Jane J. Kim, *Choosing a College-Savings Plan*, WALL ST. J., Sept. 24, 2003, at D2.

29. *College Savings Plans: The Race Is On*, N.Y. TIMES, Jan. 13, 2002, at B6.

30. John Waggoner, *529 Adds Up to College Savings*, USA TODAY, Sept. 6, 2000, at B1. According to an Alliance/Harris College Savings Poll (Aug. 2001), only twenty-five percent of families polled were aware of 529 Plans. *See* Alliance/Harris College Savings Poll, *supra* note 18. Sixty-two percent, however, said they would invest in a 529 Plan once they understood the features and benefits. *Id*.

31. I.R.C. § 529 (2000).

32. *Id.* § 529(b)(1)(A)(i).

33. *Id.* § 529(b)(1)(A)(ii).

QTP Requirements

To receive tax-favored treatment, a QTP must meet the following criteria: (1) cash contributions only; (2) separate accounting; (3) no investment direction permitted; (4) no pledging of interest as security; (5) prohibition on excess contributions; (6) prepaid tuition plan sponsors no longer limited to states; and (7) reporting.[34]

First, tuition purchases and investment account contributions may be made in cash only.[35] A QTP may not accept stock or other property. Consequently, a contributor (including the custodian of an UTMA or UGMA account) may need to liquidate investments and pay capital gains tax before making a QTP contribution. Second, the program must maintain a separate accounting for each designated beneficiary.[36] Third, no contributor or designated beneficiary may directly or indirectly direct the investment of any contribution to the program or the earnings thereon.[37] For education investment plans, contributors typically may select among different investment strategies designed by the plan on creation of the account. This limited, initial "direction" is specifically permitted under the proposed regulations.[38]

Fourth, no interest in the program or portion thereof may be pledged as collateral or otherwise used as security for a loan.[39] Fifth, a program must contain adequate safeguards to prevent contributions on behalf of a beneficiary in excess of those reasonably necessary to provide for the qualified higher education expenses of the beneficiary.[40] The Proposed Regulations pro vide a safe harbor whereby a QTP will satisfy this requirement if it bars any additional contributions to an account once the account reaches a specified account balance limit applicable to all accounts of designated beneficiaries with the same expected year of enrollment. The total contributions may not exceed the amount determined by actuarial estimates that is necessary to pay the beneficiary's tuition, required fees, and room and board expenses for five years of undergraduate enrollment at the highest cost institution allowed by the QTP.[41]

Lastly, each QTP or its designee must submit reports to the IRS and designated beneficiaries with respect to contributions, distributions, and such other matters as the IRS may require.[42]

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34. *See id.*

35. *Id.* § 529(b)(2).

36. *Id.* § 529(b)(3).

37. *Id.* § 529(b)(4).

38. Prop. Treas. Reg. § 1.529-2(g), 63 Fed. Reg. 45,019 (Aug. 24, 1998). In Notice 2001-55, issued 7 September 2001, the IRS recognized that there are a number of situations that might warrant a change in the investment strategy with respect to a 529 Plan account. I.R.S. Notice 2001-55, 2001-2 C.B. 299. Notice 2001-55 provides that the IRS expects that final regulations under Section 529 will provide that a 529 Plan does not violate Code Section 529(b)(4) if it permits a change in the investment strategy selected for a 529 Plan account once per calendar year and upon a change in the designated beneficiary of the account. *Id.* The IRS expects that final regulations will also provide that, to qualify under this special rule, a Plan must (1) allow participants to select only from among broad-based investment strategies designed exclusively by the Plan; and (2) establish procedures and maintain appropriate records to prevent a change in investment options from occurring more frequently than under the foregoing circumstances. *Id.*

In response to the rapid growth and sophistication of 529 Plans, in Notice 2001-55, the IRS recognized that there are a number of situations that might warrant a change in the investment strategy with respect to a 529 Plan account. I.R.S. Notice 2001-55, 2001-2 C.B. 299. According to Notice 2001-55, the IRS expects that final regulations under Section 529 will provide that a 529 Plan does not violate Section 529(b)(4) if it permits a change in the investment strategy selected for a 529 Plan account once per calendar year and upon a change in the designated beneficiary of the account. *Id.*

Notice 2001-55 further states that the IRS expects final regulations will provide that, to qualify under this special rule, a Plan must (1) allow participants to select only from among broad-based investment strategies designed exclusively by the Plan; and (2) establish procedures and maintain appropriate records to prevent a change in investment options from occurring more frequently than under the foregoing circumstances. *Id.*

39. I.R.C. § 529(b)(5).

40. *Id.* § 529(b)(6).

41. § 1.529-2(i)(2), 63 Fed. Reg. at 45,024. In practice, most QTPs impose a cap on contributions between $100,000 and $250,000. Before the 2001 Act, QTPs could be established and maintained only by a state or a state agency or instrumentality. The 2001 Act authorizes private institutions to establish and maintain prepaid tuition plans, but retains the "state only" limitation on education investment plans. To qualify its program as a QTP, a private institution must hold program contributions in a qualified trust and receive an IRS ruling or determination that the program meets the applicable requirements of a QTP. I.R.C. § 529(b)(1).

Qualified Tuition Plans Exempt from Federal Income Tax

A QTP is exempt from federal income tax, but is subject to the same rules as charitable organizations regarding taxation of unrelated business income.[43] As a result, earnings on QTP contributions compound income tax-free within the plans.

Qualified Distributions Exempt from Federal Income Tax

Qualified Distributions Excluded from Gross Income

In-Kind Distributions

In-kind distributions which, if paid for by the distributee, would constitute payment of a qualified higher education expense, are excluded from gross income.[44] Consequently, a beneficiary will not be subject to income tax upon the eventual use of purchased credit hours under a prepaid tuition program.

Cash Distributions

If aggregate cash distributions in a given year do not exceed the beneficiary's qualified higher education expenses in such year, no amount is included in the beneficiary's gross income.[45] If aggregate cash distributions exceed qualified higher education expenses, the amount includible in gross income is equal to the aggregate distribution amount reduced by an amount bearing the same ratio to such amount as the beneficiary's qualified higher education expenses bear to the aggregate distribution amount.[46]

Benefits Treated as Distributions

Any benefit furnished to a designated beneficiary under a QTP is treated as a distribution to the beneficiary for purposes of determining income tax liability.[47]

Coordination with HOPE and Lifetime Learning Credits

The amount of qualified higher education expenses to which QTP distributions may be applied is reduced by the amount of such expenses that were taken into account in determining the HOPE and Lifetime Learning credits allowed under section 25A of the Code.[48]

Coordination with Coverdell Education Savings Accounts

If in any year aggregate distributions on behalf of a beneficiary from any QTP and Coverdell Education Savings Account exceed the beneficiary's total qualified higher education expenses, expenses will be allocated between such distributions for purposes of determining the income tax treatment of the distributions.[49]

Nonqualified Distributions Taxed under Annuity Rules

Nonqualified distributions (those not used to pay qualified higher education expenses) are included in the distributee's income and taxed under the annuity rules of Code Section 72.[50]

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42. *Id.* § 529(d). *See* § 1.529-4, 63 Fed. Reg. at 45,025. Proposed Regulations require a 529 Plan to report on Form 1099-G, Certain Government Payments, the earnings portion of any distribution made during the year, together with other information such as the name, address and tax identification number of the distributee. *Id.* The 529 Plan must furnish a statement to the distributee on or before 31 January of the year following the calendar year in which the distribution is made. In addition, a 529 Plan must file Form 1099-G on or before 28 February of the year following the calendar year in which the distribution is made. Notice 2001-81, 2 C.B. 617. Notice 2001-81 provides that these reporting requirements continue in effect for distributions made in 2001. Notice 2001-81 further provides that in light of the expansion of Code Section 529 under the 2001 Act to include prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions), the IRS will issue a new form, Form 1099-Q, for taxable years beginning after 31 December 2001. *Id.* A copy of Form 1099-Q is available for downloading from the IRS website. Dep't. of the Treasury, *Internal Revue Service*, *available at* www.irs.gov (last visited Apr. 21, 2004).

43. I.R.C. § 529(a).

44. *Id.* § 529(c)(3)(B)(i).

45. *Id.* § 529(c)(3)(B).

46. *Id.* § 529(c)(3)(B)(ii).

47. *Id.* § 529(c)(3)(B)(iv).

48. *Id.* § 529(c)(3)(B)(v).

49. *Id.* § 529(c)(3)(B)(vi).

Change in Beneficiaries

Rollovers

A QTP distribution is not included in taxable income to the extent it is transferred within sixty days of distribution to:

(1) another QTP for the same beneficiary; [51] or

(2) a QTP for another designated beneficiary who is a member of the family of the original designated beneficiary.[52]

Limit on Same Beneficiary Rollovers

A tax-free rollover may be made to an account for the same beneficiary only once within a twelve-month period.[53] If a rollover occurs within twelve months of a prior rollover for the same beneficiary, the rollover will be taxed to the beneficiary as a nonqualified distribution.

Change in Designated Beneficiaries

A change in the designated beneficiary of a QTP is not treated as a nonqualified distribution if the new beneficiary is a member of the family of the original beneficiary.[54]

Aggregation of Accounts

For purposes of calculating taxable income for nonqualified distributions, all QTPs of which an individual is the designated beneficiary are aggregated and treated as a single QTP and all distributions are treated as single distribution.[55]

Valuation Date

For purposes of calculating taxable income for nonqualified distributions, the value of a QTP account, income earned on the account, and investment in the account are computed as of the close of the calendar year in which the taxable year begins.[56]

Illustration of Tax Savings

529 Plan Accounts versus Taxable Accounts

Assuming a one-time lump sum investment of $50,000, an eight percent annual return and a combined federal and state tax rate of thirty-five percent, after eighteen years a taxable account will grow to $124,524. A 529 Plan account which is not subject to federal or state tax will grow to $199,801, a difference of $75,277.[57]

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50. *Id.* § 529(c)(3).

(1) Applying the annuity rules, distributions are divided into two portions: (1) contributions (return of investment), and (2) earnings. *Id.* § 7 (2)(e)(2)(B), (9). Earnings allocable to an account are determined by subtracting the investment in the account (total contributions) from the balance of the account. Prop. Treas. Reg. § 1.529-3(b), 63 Fed. Reg. 45,019 (Aug. 24, 1998).

(2) The earnings portion of the distribution is included in the gross income of the distributee. *Id.* § 1.529-3(a). The portion of the distribution that consists of original contributions is not subject to tax.

(3) The earnings portion is taxed as ordinary income, irrespective of whether part or all of the earnings are attributable to capital gains.

(4) There is some uncertainty as to whether earnings on a nonqualified distribution are included in the income of the designated beneficiary or the account owner (e.g., who is deemed to be the "distributee"). The Proposed Regulations provide that "*Distributee* means the designated beneficiary or the account owner who receives or is treated as receiving a distribution from a [QTP]." *Id.* § 1.529-1(c). An example included in the proposed regulations indicates that nonqualified distributions made to the designated beneficiary will be taxed to such beneficiary. *Id.* § 1.529-3(b)(3), example 2(ii). In practice, however, certain QTPs may prohibit nonqualified distributions to anyone other than the account owner.

51. I.R.C. § 529(c)(3)(C)(i)(I).

52. *Id.* § 529(c)(3)(C)(i)(II).

53. *Id.* § 529(c)(3)(C)(iii).

54. *Id.* § 529(c)(3)(C)(ii).

55. *Id.* § 529(c)(3)(D)(i)-(ii).

56. *Id.* § 529(c)(3)(D)(iii).

57. This figure is based on the authors' computation.

Effect of 2001 Act on 529 Plan Savings

Assume grandparents contribute $100,000 to an education investment QTP for a newborn grandchild, and the assets grow at an annual rate of ten percent. When the grandchild reaches age eighteen, the account balance is $555,991. Assuming the average 7.7% annual inflation rate for college costs, the account balance would greatly exceed the approximately $82,500 per year for tuition, fees, books, room and board at a four-year private college. Assuming the account earnings would have been subject to tax on distribution at the grandchild's rate of fifteen percent under the 529 Plan rules before the 2001 Act, the 2001 Act exemption from federal income tax represents a savings of $83,200. Any QTP assets not used to pay the grandchild's education expenses could be withdrawn (subject to income tax on the earnings and a ten percent penalty), or rolled over to a QTP account for another grandchild or other family member.[58]

State Income Taxation

Most states' tax treatment of income parallels federal tax treatment.[59] Consequently, in most states, qualified distributions from 529 Plans are exempt from state income tax. Even before the 2001 Act, certain states (e.g., Virginia) exempted from state income tax qualified distributions from their state's QTPs.[60] Certain states allow an up-front income tax deduction for contributions to their state's QTPs. For example, Virginia allows an income tax deduction of $2,000 per QTP account per year, with an unlimited carry forward until the full amount has been deducted. If a contributor is age seventy or above, the $2,000 annual deduction cap does not apply and the contributor may deduct the entire contribution amount in the year made.[61]

Gift Tax Treatment of 529 Plans

Contributions Treated as Completed, Present Interest Gifts

For gift and generation-skipping transfer tax purposes, any contribution to a QTP on behalf of a designated beneficiary is treated as a completed gift to such beneficiary which is not a future interest in property.[62]

Treatment of Excess Contributions: Five-Year Averaging Election

If a contributor's aggregate contributions during a calendar year exceed the annual exclusion amount for gift tax purposes under Code Section 2503(b), the contributor may elect to take the aggregate amount into account ratably over the five-year period beginning with such calendar year.[63] Thus, in 2004, an individual may contribute up to $55,000, and a married couple who elect to split gifts for gift tax purposes under Code Section 2513 may contribute up to $110,000, per QTP beneficiary in one year free of gift tax or GST tax.

The following is a list of practical examples:

Example 1:

In 2004, grandmother, a widow, contributes $25,000 to a QTP account for grandchild. Because grandmother's 2004 contribution exceeds the $11,000 annual exclusion amount, she elects to take the $25,000 into account ratably from 2004 to 2008. As a result, grandmother is treated as having made completed gifts of $5,000 in each of 2004, 2005, 2006, 2007, and 2008. Note that grandmother cannot elect to treat her 2004 excess contribution as a completed gift of $11,000 in each of 2004 and 2005, and a completed gift of $3,000 in 2006.

Example 2:

In 2004, grandmother contributes $75,000 to a QTP account for grandchild. Grandmother is treated as having made a completed gift of $31,000 in 2004 ($11,000 of which qualifies for the annual exclusion from gift tax and GST tax, and $20,000 of which does not), and completed gifts of $11,000 in each of 2005, 2006, 2007, and 2008.

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58. *See* I.R.C. § 529(c); § 1.529-3, 63 Fed. Reg. at 45,025.

59. *See* RIA, All States Tax Guide para.15-110 (2003) (referring to chart).

60. *See, e.g.*, Va. Code. Ann. § 58.1-322 (LEXIS 2004).

61. *Id.* § 58.1-322D7.

62. I.R.C. § 529(c)(2)(A)(i). A QTP contribution is treated as a completed gift even though the contributor retains the right to revoke the gift and revest the contribution in himself or change the beneficiary of the account to a new beneficiary by direct change or rollover. *Id.* Because the contribution is treated as a "present interest" gift, it qualifies for the annual exclusion from gift tax under Code Section 2503(b) and exclusion from generation-skipping transfer tax under Code Section 2642(c)(2). Treas. Reg. §§ 25.2503(b), 2642(c)(2) (2000).

Whereas Code Section 529, as originally enacted, excluded QTP contributions from gift tax and GST tax treatment as Code Section 2503(e) qualified transfers for educational expenses, in 1998, the statute was amended to provide that contributions do not constitute Code Section 2503(e) qualified transfers, but rather, constitute completed gifts of present interests qualifying for the annual exclusion from gift tax and exclusion from generation-skipping transfer tax. I.R.C. § 529(c)(2)(A)(ii).

63. *Id.* § 529(c)(2)(B).

Example 3:

Assume the same facts set forth in Example 1, except that in 2005, grandmother makes an additional contribution to the QTP account of $11,000 (the amount of the annual exclusion in 2005). Grandmother is treated as having made an additional completed gift of $11,000 in 2005, $6,000 of which qualifies for the annual exclusion ($11,000 - $5,000 from 2004 contribution treated as completed gift for 2003), and $5,000 of which constitutes a taxable gift (to which unified credit and GST exemption may be applied, or if none is available, upon which gift tax and GST tax must be paid).

Example 4:

Assume grandmother contributed $50,000 to a 529 Plan in 2001, when the annual exclusion amount was $10,000. Grandmother elected to take the $50,000 in account ratably from 2001 to 2005, so that grandmother is treated as having made completed gifts of $10,000 in each of years 2001-2005. In 2002, the annual exclusion amount was adjusted for inflation to $11,000. Can grandmother contribute an additional $4,000 in 2002 to take advantage of the additional $1,000 of annual exclusion in 2002-2005? No, according to the Proposed Regulations. The proposed regulations indicate that beginning in 2002, grandmother can contribute an additional $1,000 per year each 1 January.[64]

Treatment of Distributions

General Rule

In general, a distribution from a QTP is not treated as a taxable gift for gift tax or generation-skipping transfer tax purposes.[65]

Special Rules for Rollovers or Change of Beneficiaries

If New Beneficiary Is in Same or Older Generation as Original Beneficiary

A change in the designated beneficiary of a QTP (or a rollover to a QTP account of a new beneficiary) is not treated as a transfer for gift tax or GST tax purposes if the new beneficiary is in the same generation or a generation above the old beneficiary (as determined in accordance with the GST tax rules).[66]

If New Beneficiary Is in Younger Generation Than Original Beneficiary

A change in the designated beneficiary of a QTP (or a rollover to a QTP account of a new beneficiary) is treated as a transfer for gift tax and GST tax purposes if the new beneficiary is in a generation below the old beneficiary (as determined in accordance with the GST tax rules).[67]

Gift by Original Beneficiary

If upon a rollover or change in account beneficiary the new beneficiary is in a generation below the old beneficiary, the transfer is treated as a taxable gift from the original beneficiary to the new beneficiary. The transfer is also subject to GST tax if the new beneficiary is two or more generations below the generation of the original beneficiary.[68]

Original Beneficiary May Apply Own Annual Exclusion

The original beneficiary may apply his or her annual exclusion for gift tax purposes, including the five-year averaging election, to shield the deemed gift from gift tax.[69]

Phantom Gift

These rules effectively allow a beneficiary to be subject to gift tax and GST tax based on the independent act of the account owner, of which act the beneficiary may have no knowledge.

Estate Tax Treatment of 529 Plans

Contributor's Estate

General Rule: No Inclusion in Estate

In general, no amount is includible in the gross estate of a contributor by reason of an interest in a QTP.[70] This is so even though the contributor retains the right to revoke the gift and

64. *See* Prop. Treas. Reg. § 1.529-5(b)(2), 63 Fed. Reg. 45,019 (Aug. 24, 1998).

65. I.R.C. § 529(c)(5)(A).

66. Prop. Treas. Reg. § 1.529-5(b)(3)(i), 63 Fed. Reg. 45,019 (Aug. 24, 1998).

67. I.R.C. § 529(c)(5)(B).

68. § 1.529-5(b)(3)(ii), 63 Fed. Reg. at 45,025.

69. *Id.* § 1.529-5(b)(3)(ii).

revest the account in the contributor and the right to change the beneficiary to a new beneficiary selected by the contributor.[71]

Exception When Contributor Elects Five-Year Averaging for Excess Contributions

When a contributor elects to take excess contributions into account ratably over a five-year period and dies before the close of the five-year period, the contributor's gross estate will include the portion of such contributions allocable to the periods after the contributor's date of death.[72]

Beneficiary's Estate

The statute provides that amounts distributed on account of the death of the designated beneficiary are included in the beneficiary's gross estate.[73] The Proposed Regulations provide "[t]he gross estate of the designated beneficiary of a [QTP] includes the value of any interest in the [QTP]."[74] Although the Proposed Regulations do not define a designated beneficiary's "interest" in a QTP, IRS personnel have indicated that the likely interpretation would be that the entire QTP balance would be included in the designated beneficiary's estate at death.[75]

Planning Considerations

Advantages of 529 Plans

Qualified Distributions Fully Exempt from Income Tax

Before the 2001 Act, 529 Plans offered a significant tax benefit by deferring income tax on contribution earnings (which benefit was offset in part by conversion of capital gains to ordinary income). The 2001 Act, however, exempts 529 Plan earnings from federal income tax altogether if funds are used for qualified higher education expenses.[76] This full exemption will generally provide a superior return to traditional, taxable education savings techniques such as gifts to the student outright or to a custodial account or trust for the student. Further, a contributor may donate up to five times the annual exclusion amount in the year of contribution without incurring gift tax or generation-skipping tax, thereby increasing tax-free compounding. This election is not available for traditional education savings techniques.[77]

Account Owner May Reacquire Funds

Another benefit is that the account owner may reacquire the 529 Plan funds at any time for any reason, subject to income tax and an additional ten percent tax on the earnings portion of nonqualified distributions. Unlike traditional gifts, this retained control by the donor does not cause inclusion of the 529 Plan account in the donor's estate at death.[78]

Beneficiary Does Not Control Funds

Unlike traditional gifts outright or to custodial accounts, the beneficiary of a 529 Plan account generally has no control over accounts for his or her benefit. Rather, the account owner has control over distributions and may reacquire the funds or change the beneficiary at any time (e.g., if the beneficiary chooses to join the circus rather than attend college).[79]

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70. I.R.C. § 529(c)(4)(A).

71. § 1.529 cmt., para. [29], 63 Fed. Reg. at 45,024.

72. I.R.C. § 529(c)(4)(B); § 1.529-5(d)(2), 63 Fed. Reg. at 45,025.

Example:

In 2003, grandmother, a widow, contributes $20,000 to a QTP account for grandchild, and elects to take the $20,000 into account ratably from 2003 to 2007. As a result, grandmother is treated as having made completed gifts of $4,000 in each of 2003, 2004, 2005, 2006, and 2007. Grandmother dies on 1 January 2005. $8,000 (the amount attributable to 2006 and 2007) is includible in grandmother's gross estate. Note, however, that none of the post-contribution earnings or appreciation attributable to the $8,000 is included in grandmother's gross estate.

73. I.R.C. § 529(c)(4)(B).

74. § 1.529-5(d)(3), 63 Fed. Reg. at 45,025.

75. *See* Susan T. Bart & Peter S. Gordon, Planning for College: Tax and Other Considerations D-26 (Mar. 2001) (noting this was written material for the ACTEC Seminar (citing Telephone Interview with Susan Hurwitz, Internal Revenue Service (16 Aug. 1999))).

76. *Id.* § 529(c)(1).

77. *Id.* § 529(c)(2).

78. *Id.* § 529(c)(3); § 1.529, cmt. [29], 63 Fed. Reg. at 45,024.

79. *See* I.R.C. §§ 529(b)(4), (c)(3)(C); § 1.529-2(g), 63 Fed. Reg. at 45,024.

No Income Restrictions and High Contribution Limits

Unlike Coverdell ESAs, which will be discussed in the following section, there are no restrictions on a contributor's ability to participate in 529 Plans based on the contributor's adjusted gross income. In addition, contribution limits are substantially higher than Coverdell ESAs.[80]

May Be Used in Conjunction with Other Education Savings Techniques

A contributor may take advantage of 529 Plans in conjunction with qualified transfers of tuition payments under Code Section 2503(e), contributions to Coverdell ESAs, and other education credits.[81]

Disadvantages of 529 Plans

Lack of Investment Control

The account owner and beneficiary are prohibited from exerting investment control over 529 Plan accounts.[82] However, because an account owner may select an investment strategy upon creation of the account, and because most 529 Plan sponsors allow contributions irrespective of residency, a contributor may "shop" among the various 529 Plans and investment options offered nationwide.

Most QTP sponsors retain professional money managers or offer popular mutual funds.[83] Current QTP investment managers include TIAA-CREF, Merrill Lynch, Fidelity, Vanguard, T. Rowe Price, Salomon Smith Barney, and Morgan Stanley Dean Witter.[84]

Each QTP generally offers multiple investment products and portfolios. For example: (1) Arizona's education investment program offers a "high tech" portfolio;[85] (2) California's education investment program offers a "socially responsible" portfolio;[86] and (3) many QTPs offer "age-based portfolios," with accounts for younger beneficiaries invested largely in equities, shifting to fixed income as the beneficiary approaches college-age.[87]

Contributors may hedge their bets by investing in multiple accounts (either with the same sponsor or different sponsors) with different investment strategies. To the extent a contributor is dissatisfied with investment performance after a contribution has been made, the contributor may make a tax-free qualified rollover to a new QTP account offering a different investment strategy. This "escape hatch" was made easier by the 2001 Act's authorization of a "same beneficiary rollover" once per twelve-month period.[88]

Importantly, in Notice 2001-55,[89] issued 7 September 2001, the IRS recognized that there are a number of situations that might warrant a change in the investment strategy with respect to a 529 Plan account. Notice 2001-55 provides that the IRS expects that final regulations under Code Section 529 will provide that a 529 Plan does not violate Code Section 529(b)(4) if it permits a change in the investment strategy selected for a 529 Plan account once per calendar year and upon a change in the designated beneficiary of the account. The IRS expects that final regulations will also provide that, to qualify under this special rule, a Plan must (1) allow participants to select only from among broad-based investment strategies designed exclusively by the Plan; and (2) establish procedures and maintain appropriate records to prevent a change in investment options from occurring more frequently than under the foregoing circumstances.[90]

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80. *See* I.R.C. § 529.

81. *See* I.R.C. §§ 529(c)(2), 529(c)(3)(B)(v), 529(c)(3)(B)(vi).

82. I.R.C. § 529(b)(4).

83. 529 PLANS, *supra* note 2, at 5.

84. *Id.*

85. *See* Arizona Family College Savings Program, *Frequently Asked Questions About the College Savings Bank Arizona Family College Savings Program*, *available at* http://arizona.collegesavings.com/azfaqs.shtml (last visited Apr. 21, 2004).

86. *See* Golden State Scholar Share, *College Savings Trust*, *available at* www.scholarshare.com (last visited Apr. 21, 2004) ("California has created The Golden State ScholarShare College Savings Trust. ScholarShare, a new '529' college savings program based on the Internal Revenue Code section that created qualified tuition programs, is designed to help California families and others save in order to meet the increasing costs of higher education.").

87. *See* Virginia College Savings Plan, *available at* www.529Virginia.com (last visited Apr. 21, 2004) (under construction) (outlining Virginia's VEST program regarding age-based evolving portfolios) [hereinafter Virginia College Savings Plan].

88. I.R.C. § 529(c)(3)(c)(iii).

89. 2 C.B. 299 (2001).

90. *Id.*

Excess Funds

To the extent a beneficiary does not use all of the 529 Plan account funds for qualified higher education expenses, the earnings portion of the excess funds will be subject to income tax and an additional ten percent federal tax. The account owner may avoid these consequences, however, by changing the 529 Plan beneficiary or making a qualified rollover to another 529 Plan.[91]

Tax Consequences to Beneficiary

If a beneficiary dies while funds are held in any 529 Plan for his or her benefit, the account balance will be included in the beneficiary's taxable estate, even though the beneficiary had no control over the funds or may have no knowledge of the account's existence. Moreover, a beneficiary may be subject to adverse gift tax and GST tax consequences based upon the account owner's independent acts (such as a rollover to a new account for a beneficiary unrelated to or in a generation below the original beneficiary).[92]

Considerations in Selecting a 529 Plan

Importantly, although the federal statute provides generally applicable guidelines and requirements, individual QTPs may contain additional and varied restrictions. In fact, existing QTPs differ significantly. *It is essential to compare and confirm the terms of a particular QTP before investing. Located at Appendix B is a 529 Plan "checklist" that may serve as a good due diligence tool for the Legal Assistance Officer who is counseling a client on the legal and tax aspects of selecting a QTP or comparing alternative QTPs so the client will understand the terms and options afforded by a QTP before making any investment into a QTP.*

Coverdell Education Savings Accounts (Formerly, "Education IRAs")

In 1997, Congress introduced the Education IRA, governed by new Code Section 530 of the Internal Revenue Code, effective for tax years beginning 1 January 1998.[93] On 26 July 2001, President Bush signed a bill formally renaming Education IRAs "Coverdell Education Savings Accounts" (Coverdell ESAs).[94] As with 529 Plans, a Coverdell ESA is exempt from federal income tax, but is subject to the same rules as a charitable organization regarding taxation of unrelated business income.[95] A Coverdell ESA is a trust created or organized in the United States (and designated as a Coverdell ESA at the time created or organized) exclusively for the purpose of paying the qualified education expenses of an individual who is the designated beneficiary of the trust.[96]

The written instrument creating the trust must meet the following requirements. Contributions to a Coverdell ESA must be in cash; accepted before the date on which the designated beneficiary reaches age 18; and when added to other contributions for the taxable year (except in the case of rollover contributions), limited to $2,000.[97] The trustee must be a bank or other person who satisfactorily demonstrates to the IRS that it will administer the trust consistent with the requirements of Code Section 530 or who has demonstrated the same with respect to a retirement IRA.[98] No part of the trust assets may be invested in life insurance contracts.[99] The trust assets may not be commingled with other property except in a common trust fund or common investment fund.[100] Any account balance must be distributed to the designated beneficiary within thirty days of the earlier of the beneficiary's death, or the beneficiary's thirtieth birthday. There are no age limitations, however, with respect to any designated beneficiary with special needs.[101] The trustee of a Coverdell ESA (or custodian of a qualified custodial account) must make such reports to the Internal Revenue

91. I.R.C. § 529(c)(3)(A), (B), (C).

92. *Id.* § 529(c)(4), (5).

93. Pub. L. No. 107-16, 115 Stat. 38 (1997).

94. Pub. L. No. 107-22, 115 Stat. 196 (2001) (renaming the Education IRAs in memory of the late Senator Paul Coverdell (R-Ga.), a backer of Education IRAs, who died in 2000 as a result of an intracerebral hemorrhage).

95. I.R.C. § 530(a).

96. *Id.* § 530. A custodial account may be treated as a Coverdell ESA trust if the assets of the account are held by a bank or another person who meets the definition of a qualified trustee under Code Section 530(b)(1)(B), and if the custodial account would otherwise qualify as a Coverdell ESA. *Id.*

97. *Id.* § 530(b)(1)(A), (iii).

98. *Id.* § 530(b)(1)(B).

99. *Id.* § 530(b)(1)(C).

100. *Id.* § 530(b)(1)(D).

101. *Id.* § 530(b)(1)(E).

Service and the designated beneficiary as are required by regulations with respect to contributions and distributions.[102]

Income Phase-Out

When the contributor's "modified adjusted gross income" (e.g., adjusted gross income adding back certain foreign income) exceeds $95,000, the amount he or she may contribute to a Coverdell ESA is progressively reduced, and no contribution may be made by a single filer whose modified adjusted gross income exceeds $110,000.[103] The contribution limit for a married contributor filing jointly is reduced when modified adjusted gross income exceeds $190,000 and is fully phased out when modified adjusted gross income exceeds $220,000 (exactly two times the limits for a single filer).[104]

Income Tax Treatment of Coverdell ESA Earnings and Distributions

As with 529 Plans, a Coverdell ESA is exempt from federal income tax, but is subject to the same rules as a charitable organization regarding taxation of unrelated business income.[105] If the aggregate distributions from a Coverdell ESA during a tax year do not exceed the designated beneficiary's qualified education expenses for such year, no amount of the distributions shall be included in the beneficiary's gross income.[106] If the aggregate distributions from a Coverdell ESA during a tax year exceed the designated beneficiary's qualified education expenses for such year, a proportionate amount of the distribution shall be included in the beneficiary's gross income and taxed under the annuity rules under Code Section 72.[107]

Income Tax Treatment of Coverdell ESA Earnings and Distributions

Coordination with Hope and Lifetime Learning Credits

The total amount of qualified education expenses with respect to an individual will be reduced by the amount of such expenses taken into account in determining the Hope or Lifetime Learning credit allowed to the individual.[108] An individual taxpayer may claim the Hope Scholarship credit for payments made to an eligible education institution (e.g., college or vocational school tuition and fees) for qualified tuition and related expenses of an eligible student during the first two years of that student's post-secondary education.[109] The Hope Scholarship credit equals 100 percent of the first $1,000 of tuition and related expenses and fifty percent of the next $1,000 for a maximum annual credit of $1,500 per student.[110]

An individual taxpayer may claim the Lifetime Learning credit for qualified tuition and related expenses paid. The credit amount is equal to twenty percent of the first $10,000 of qualifying tuition and related expenses for a maximum credit of $2,000.[111] Unlike the Hope Scholarship credit, the Lifetime Learning credit is calculated per taxpayer (not per student).[112] However, if a taxpayer elects for a taxable year the Hope Scholarship credit with respect to a student's tuition or related expenses, the Lifetime Learning credit is not available with respect to that same student.[113] The taxpayer may, however, claim the Lifetime Learning credit in the same taxable year with respect to other students. In other words, qualified tuition and related expenses with respect to one student's education cannot be allocated between the two tax credits. Both credits are subject to Phase-Out rules. The allowable amount of the credits is phased out ratably for taxpayers with modified adjusted gross income between $41,000 and $51,000 ($82,000 and $102,000 for joint tax returns).[114] These income ranges are indexed for inflation.[115]

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102. *Id.* § 530(h).

103. *Id.* § 530(c)(1) (noting the 2001 Act revised the modified adjusted gross income rules to remove the marriage penalty).

104. *Id.*

105. *Id.* § 530(a).

106. *Id.* § 530(d)(2)(A).

107. *Id.* § 530(d)(2)(B).

108. *Id.* § 530(d)(2)(C)(i).

109. *Id.* § 25A(b)(2)(C).

110. *Id.* §§ 25A(b)(1)(A), (B), 25A(h)(1)(A) (inflation adjustment).

111. *Id.* § 25A(c)(1); Treas. Reg. § 1.25A-4(a)(1) (2002).

112. I.R.C. § 25A(c)(1).

113. *Id.* § 25A(c)(2)(A); § 1.25A-4(a)(3).

Coordination with Qualified Tuition Programs

If aggregate distributions to a beneficiary for which the Coverdell ESA provision and the 529 Plan provisions both apply exceed the beneficiary's total qualified education expenses for the tax year, the taxpayer must allocate such expenses among such distributions for purposes of determining taxable income.[116]

Additional Tax on Nonqualified Distributions

General Rule

When a beneficiary receives a Coverdell ESA distribution that is not used for qualified education expenses (and the earnings portion thereof is thus included in the beneficiary's gross income), an additional tax of ten percent is imposed on such amount.[117]

Exceptions

The ten percent additional tax on earnings does not apply if the distribution is made on account of: (1) the beneficiary's death; (2) the beneficiary's disability; (3) the beneficiary's receipt of a scholarship (to the extent of such scholarship)[118] or (4) the distribution of an excess contribution (and earnings thereon), if the distribution is made before the prescribed date (before the 2001 Act, the deadline was April 15 of the following tax year; the 2001 Act extended this date to sixth months after the end of the tax year).[119]

Rollover Contributions

A distribution from a Coverdell ESA will not be included in the designated beneficiary's gross income to the extent such distribution is paid, within sixty days of the distribution, into another Coverdell ESA for the benefit of the same beneficiary or a member of the family of such beneficiary who has not reached age thirty.[120]

Change in Beneficiary

A change in beneficiary of a Coverdell ESA is not treated as a nonqualified distribution if the new beneficiary is a member of the family of the old beneficiary and has not reached age thirty.[121]

Estate and Gift Tax Treatment of Coverdell ESAs

The same gift tax and estate tax rules applicable to 529 Plans apply to Coverdell ESAs.[122]

Considerations in Selecting a 529 Plan

First, although most states allow nonresidents to participate in their QTPs, states may offer certain tax benefits (such as income tax deductions for contributions, matching contributions or scholarships, exemption from state financial aid consideration, or guaranteed returns) to residents only.[123] Some state-sponsored QTPs may require the contributor or beneficiary to be a resident of their state. Residency requirements are more often associated with state-sponsored prepaid tuition plans than state-sponsored education investment plans.[124] Each QTP is managed and invested differently and has its own costs and fees. Investments are typically managed by the program

114. I.R.C. § 25A(d)(1), (2); § 1.25A-1(c)(1).

115. I.R.C. § 25A(h)(2); *see* Rev. Proc. 2002-70, 2002-2 C.B. 845.

116. I.R.C. § 530(d)(2)(C)(ii).

117. *Id.* § 530(d)(4)(A).

118. *Id.* § 530(4)(B).

119. *Id.* § 530(d)(4)(C).

120. *Id.* § 530(d)(5). For purposes of a Coverdell ESA, the phrase "member of the family" of the designated beneficiary has the same definition as in Code Section 529(e)(2). *Id.* § 530(d)(5). A tax-free rollover of a Coverdell ESA may only be made if no rollover has been made within the prior twelve months. *Id.*

121. *Id.* § 530(d)(6).

122. *Id.* § 530(4).

123. *See, e.g.*, VA. CODE ANN. § 58.1-322(D)(7) (LEXIS 2004). This section enables a contribution to be deducted from Virginia taxable income in the amount of the contribution up to $2,000. If age seventy or older, there is no ceiling on the amount of the contribution that can be deducted. *Id*.

124. *See Internet Guide to Coverdell ESA*, *supra* note 27 (containing a state-by-state listing of 529 plan requirements).

sponsor or a professional money manager. Most programs offer the contributor numerous investment options or portfolios upon creation of an account. Contributors should review portfolios offered, past investment performance, and fees.[125] Different QTPs have set different minimum and maximum contribution amounts. As of 1 January 2002, the maximum contribution limit for a Virginia QTP is $250,000.[126] Some QTPs may allow contributions to an account by an account owner only. Certain plans may impose additional restrictions on an account owner's ability to obtain qualified or nonqualified withdrawals and/or subject nonqualified distributions to penalties in addition to the ten percent federal tax.[127] Next, certain plans may restrict the number of times an account owner may change designated beneficiaries or rollover accounts, or restrict an account owner's ability to rollover an account to a different QTP. Also, certain plans may restrict transfers of account ownership during the account owner's lifetime and at death, and have different default provisions in the event a successor account is not designated on a plan form. Some plans may guarantee a fixed (often conservative) rate of return.

Advantages of Coverdell ESAs

Qualified Distributions Exempt from Income Tax

As with 529 Plans, earnings within a Coverdell ESA compound income-tax free, and distributions used for qualified education expenses are exempt from income tax.[128]

Covers Elementary and Secondary School Expenses

The 2001 Act expanded the scope of education expenses to which Coverdell ESA funds may be applied to include elementary and secondary school (kindergarten through grade 12) expenses, as well as higher education expenses. 529 Plans cover higher education expenses only.[129]

Contributor Retains Investment Control

A contributor to a Coverdell ESA may select as custodian any bank, mutual fund company, or other financial institution that can serve as custodian of a traditional IRA, and may invest in any qualifying investments available through the sponsoring institution (e.g., stocks, bonds, mutual funds, certificates of deposit). This allows greater investment control than 529 Plans.

Disadvantages of Coverdell ESAs

Low Contribution Limit

The $2,000 contribution amount still offers limited relief against education costs.[130] In addition, annual maintenance fees affect the investment return on a smaller account balance more significantly.

Contributor Income Phase-out

When the contributor's adjusted gross income exceeds a certain amount ($95,000 for contributors filing singly, $190,000 for a married contributor filing jointly), the maximum contribution amount is reduced, and no contribution may be made by a contributor whose adjusted gross income exceeds a certain amount ($110,000 for contributors filing singly, $220,000 for married contributors filing jointly).[131] Thus, this option is not available to certain individuals.

Beneficiary Age Restrictions

Except with respect to special needs beneficiaries, contributions may only be made for beneficiaries under the age of eighteen.[132]

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125. Fees for managing the account range from 0.5% to 2% a year, depending on the QTP. Investment performance varies among the programs and portfolios offered. According to a survey conducted by the *Business Week* magazine, Arizona's technology fund, launched in September 2000, lost 48.2% of its value by 31 December 2000, while Louisiana's lone bond fund reported a steady 6.51% gain for 2000, and the 2000 return for Kansas's age-based portfolios ranged from 2.2% to 11.9%. Almost all other programs gained or lost between 8%. *See* Business Week Online, *College Savings Plans Come of Age*, *available at* www.businessweek.com (last visited Mar. 12, 2001).

126. *See* Virginia College Savings Plan, *supra* note 82 (providing Virginia's official program description, including the maximum contribution level of $250,000 per beneficiary).

127. *See Internet Guide to Coverdell ESA*, *supra* note 27 (containing a state-by-state listing of any restrictions, penalties, and other requirements for each state's college savings plan).

128. I.R.C. § 530(a) (2000).

129. I.R.C. § 529(e)(3).

130. I.R.C. § 530(b)(1).

131. I.R.C. § 530(c).

132. I.R.C. § 530(b)(1)(A)(ii).

Irrevocable Gift

Unlike 529 Plans, where the contributor retains the power to reacquire the account funds, a contribution to a Coverdell ESA is treated as an irrevocable gift, and will pass to the beneficiary if not used for educational expenses.[133]

Planning Opportunities

Parents (or Grandparents) with Modest Wealth

For parents with modest wealth, contributions to 529 Plans for their children will provide: (1) tax-free compounding of earnings and superior investment performance as compared with other taxable investment vehicles (such as parents' savings accounts or custodial accounts for children); (2) retained control over when and to whom distributions will be made; (3) retained ability to reacquire funds if desired; and (4) a disciplined savings approach for college costs. Parents whose income falls below the statutory limits may also wish to contribute to Coverdell ESAs to cover primary and secondary school expenses, such as tutoring or purchase of a family computer.

Grandparents with Substantial Wealth

For grandparents with substantial wealth who are comfortable making irrevocable gifts, paying (or prepaying) grandchildren's tuition directly to educational institutions—which payments are excluded from gift tax and GST tax treatment under Code Section 2503(e) and Code Section 2611(b)(1)—will provide tax-free benefits to the grandchildren and reduce the grandparent's estate.[134] In addition to these tuition payments, the grandparent could use his or her annual exclusion amount either to establish a 529 Plan (to pay higher educational expenses other than tuition) or to make other "tax-leveraged" gifts to grandchildren.

Transfer of Funds from Custodial Account

Many QTPs allow transfers of funds from a UGMA or UTMA custodial account to a QTP account for the same beneficiary.[135] Because all contributions must be in cash, any securities or other non-cash property held in the custodial account must first be sold, which may incur taxable income or gain. The transfer of assets from a custodial account to a 529 Plan account should be treated as an investment by the custodian (no gift tax or GST tax consequences). The 529 Plan account remains subject to applicable UGMA/UTMA statute. Any assets refunded from the 529 Plan account are held subject to the UGMA/UTMA statute. The custodian, as account owner of the QTP account, will not have the usual power to change the designated beneficiary, and the designated beneficiary will become the owner of the QTP account when the beneficiary reaches 18 (or 21, depending on the terms of the custodial account).[136]

Trusts as 529 Plan Account Owners

Many 529 Plans now permit trusts to open accounts.[137] In this situation, the Trustee is the account owner, and the trust beneficiary designated by the Trustee is the account beneficiary. Whether a trustee may transfer trust assets to a 529 Plan account will depend on the terms of the trust agreement and applicable fiduciary state law.

Trusts permitting distributions for the beneficiary's education should allow consideration of investment in a 529 Plan account. With respect to existing trusts, the trustee must determine whether the fiduciary investment powers permit investment in a 529 Plan account. Newly drafted trusts could specifically authorize investment in 529 Plan accounts. The trustee must assess the income tax cost of liquidating trust assets to make a 529 Plan contribution versus the income tax benefits of a 529 Plan account.

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133. I.R.C. § 530(d)(3), (6).

134. I.R.C. §§ 529(d)(4), (5); Prop. Treas. Reg. § 1.529-5, 63 Fed. Reg. 45,019 (Aug. 24, 1998).

135. Prop. Treas. Reg. § 1.529-2(d)(iv) authorizes QTPs to accept rollovers. Legal assistance attorneys will need to review the actual state QTP to see if such a state sponsored QTP permits a transfer from an existing UGMA or UTMA account. *See* § 1.529-1(c), 63 Fed. Reg. at 45,024 (defining a person to include a trust).

136. Legal assistance attorneys should review the applicable state's implementation of the applicable UGMA/UTMA statute and such state's QTP requirements.

137. *See* I.R.C. § 529(b)(1); § 1.529-1(c), 63 Fed. Reg. at 45,024 (including a trust within the meaning of a "person"). Additionally, attorneys should consult the actual requirements of the particular state QTP under consideration.

The transfer of assets from a trust account to a 529 Plan account should be treated as an investment by the custodian (no gift tax or GST tax consequences). Whether the trustee (as account owner) may change account beneficiary will depend on the terms of the trust agreement (for example, whether the trust has multiple beneficiaries).[138]

If the donor makes gifts to the trust (rather than directly to the 529 Plan account), the gifts may not qualify for the annual exclusion (absent withdrawal rights in the trust), and the gifts will not qualify for the special five-year averaging election.[139]

If trust beneficiary dies while assets remain in 529 Plan account, assets will be included in beneficiary's estate. Use of a trustee as account owner avoids problems related to succession of account ownership in the event of a donor's incapacity or death.[140]

Spendthrift provisions in the trust agreement may provide additional creditor protection.[141]

If the donor is the account owner, a nonqualified withdrawal returns the account assets to the donor's estate (unless the Plan allows a distribution to the beneficiary). If a trustee is the account owner, a nonqualified withdrawal returns the account assets to the trust, outside of the donor's estate, to be administered under the terms of the trust.[142]

Remember to Aggregate Gifts

Although an individual may take advantage of multiple education savings techniques, he or she must remember to aggregate contributions for gift tax purposes.[143]

Plan for Successor Account Ownership in Event of Incapacity or Death

Estate planning questionnaires should now include the question: "Are you the Account Owner under a qualified tuition program (529 Plan) or other education savings account?," and provisions should be made for the designation of one or more contingent account owners in the event the client becomes incapacitated or dies before all funds are distributed from the account.[144]

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138. I.R.C. § 529.

139. *Id.*

140. *Id.*

141. *Id.*

142. *Id.* § 529(c)(4).

143. *Id.* § 529(c)(2); Prop. Treas. Reg. § 1.529-2(i), 63 Fed. Reg. 45,019 (Aug. 24, 1998). For instance, if in 2002, a parent contributes $10,000 to a 529 Plan account for a child, contributes $2,000 to a Coverdell ESA for a child, and makes an additional $5,000 outright gift (or deemed gift, for example, through a premium payment on insurance held by a *Crummey* trust) to a child, the parent will be deemed to have made a gift of $17,000 to the child, $11,000 of which qualifies for the annual exclusion, and $7,000 of which is taxable (or against which the unified credit must be applied).

144. Note the following in planning for successor account ownership in the event of incapacity or death:

a. Some 529 Plans specifically authorize an account owner's attorney-in-fact under a durable power of attorney to act on the account owner's behalf.

b. Durable powers of attorney may be drafted to expressly authorize actions with regard to 529 Plan accounts (including power to make or revoke gifts), as well as any desired limitations on such actions.

c. Many 529 Plans allow or require the original account owner to list a contingent successor account owner in the event of the original account owner's death. The designation of a successor account owner is made either on a plan document or in the account owner's will.

d. If the 529 Plan account does not provide for the designation of a successor account owner, or if no successor account owner is named or able to act, the terms of the plan will determine who becomes the account owner at the original account owner's death (e.g., the original account owner's estate or spouse, or the beneficiary (or beneficiary's guardian)).

e. If the original account owner's estate becomes the successor account owner, potential problems arise:

(i) Absent a contrary direction in the account owner's will, does the personal representative have a fiduciary duty to withdraw the account assets and maximize the estate assets for the probate beneficiaries?

(ii) If the account assets are withdrawn, to whom do they pass?

(iii) May the personal representative designate a successor account owner?

Conclusion

As the foregoing materials and references suggest, there are a variety of programs available for parents, grandparents, and other contributors to establish a plan which will monetarily enable a child to attend an institution of higher learning.[145] The qualified tuition plans authorized under Internal Revenue Code section 529 are extremely expansive and complex. The legal assistance attorney will be required to become intimately familiar with the terms of the various state-and-private-institution sponsored 529 plans to properly advise his clients. There are many resources available to help the legal assistance attorney to accomplish this undertaking.

145. For example, the Virginia College Savings Plan website provides information on Virginia sponsored QTPs. Virginia is regarded by many tax and financial industry experts as offering the most flexible and sophisticated 529 Plans to the general public. Virginia College Savings Plan, *available at* www.529Virginia.com (under construction) (last visited Apr. 21, 2004).

The College Savings Plan Network, an affiliate of the National Association of State Treasurers, serves as "a clearinghouse for information among college savings programs." Its website includes Frequently Asked Questions, links to each established college savings program, and a summary of the tax advantages (e.g., availability of a state income tax deduction for contributions and state income tax exemption for earnings), age restrictions and portability (e.g., whether certain benefits may be applied to out-of-state schools and whether rollovers permitted) of each program. College Savings Plans Network (CSPN), *About CSPN*, *available at* http://www.collegesavings.org/ (last visited Apr. 21, 2004) ("In 1991, the College Savings Plans Network formed as an affiliate to the National Association of State Treasurers . . . to make higher education more attainable . . . .").

The website, http://www.savingforcollege.com/, founded by college savings plan expert and certified public accountant Joseph F. Hurley, provides legislative updates, links to current articles and college savings programs, and comparisons of programs and investment returns. *Internet Guide to Coverdell ESA*, *supra* note 27.

The College Board website, http://www.collegeboard.com/splash offers calculators, scholarship searches, and other useful facts. The College Board, *Connect to College Success*, *available at* http://www.collegeboard.com/splash (last visited Apr. 21, 2004).

Appendix A

529 Plan Definitions and Special Rules

Designated Beneficiary[146]

> The term "designated beneficiary" means -
>
> (A) the individual designated at the commencement of participation in the QTP as the beneficiary of amounts paid (or to be paid) to the QTP,[147]
>
> (B) in the case of a change of beneficiaries. . . the individual who is the new beneficiary [of the QTP],[148] and
>
> (C) in the case of an interest in a [QTP] purchased by a State or local government . . . [or a Code Section 501(c)(3) charitable organization] as part of a scholarship program operated by such government or organization, the individual receiving such interest as a scholarship.[149]

The designated beneficiary need not be related to the contributor, and under most QTPs the designated beneficiary may be the contributor.[150] Unlike Coverdell Education Savings Accounts, there are no statutory age restrictions on the designated beneficiary of a QTP.[151]

Member of the Family

To qualify for a tax-free change of beneficiary or account rollover, the new beneficiary must be a "member of the family" of the original beneficiary.[152] The term "member of the family" includes:

(1) A son or daughter, or a descendant of either;

(2) A stepson or daughter;

(3) A brother, sister, stepbrother or stepsister;

(4) The father or mother, or an ancestor of either;

(5) A stepfather or stepmother;

(6) A son or daughter of a brother or sister;

(7) A brother or sister of the father or mother;

(8) A son-in-law, daughter-in-law, mother-in-law, father-in-law, brother-in-law, or sister-in-law;

146. I.R.C. § 529(e)(1).

147. *Id.* § 529(e)(1)(B).

148. *Id.* § 529(e)(1)(C).

149. *Id.* § 529(e)(1).

150. *See id.*

151. *See id.*

152. *Id.* § 529(e)(2); Prop. Treas. Reg. § 1.529-1(c), 63 Fed. Reg. 45,019 (Aug. 24, 1998).

(9) The spouse of the designated beneficiary or the spouse of any individual described in clauses (1) through (8).[153]

(10) My first cousin of an individual described in clauses (1) through (8) above.[154]

Qualified Higher Education Expenses

The term "qualified higher education expenses" includes:

(1) "[T]uition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution."[155]

(2) Room and board for students who attend school at least half-time, subject to certain dollar limitations for students living at home or off-campus.[156]

(3) Expenses incurred by a special needs beneficiary for certain services.[157]

(4) There are no dollar limitations on room and board expenses. Room and board expenses are limited by (i) the allowance for room and board included in the student's cost of attendance as established by the educational institution, or (ii) the actual invoice amount charged to the student residing in on-campus housing, if greater.[158]

Eligible Educational Institution

The term "eligible educational institution" is defined as "an institution which is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. § 1088) . . . and which is eligible to participate in a program under title IV of such Act."[159] This definition includes any accredited college, university, vocational school, or other postsecondary educational institution eligible to participate in student aid programs administered by the Department of Education.

When Contributions Deemed Made

A contribution will be deemed made on the last day of a donor's tax year if the contribution is made before the due date of the donor's income tax return (not including extensions).[160]

Account Owner

The Proposed Regulations define "account owner" as the individual "entitled to select or change the designated beneficiary of an account, to designate any person other than the designated beneficiary to whom funds may be paid from the account, or to receive distributions from the account if no such other person is designated."[161] Many QTPs permit persons other than the account owner to make contributions to an account.

153. Pub. L. No. 105-206, § 6004(c)(3), 112 Stat. 685 (1998).

154. I.R.C. § 529(e)(2)(D).

155. *Id.* § 529(e)(3)(A).

156. *Id.* § 529(e)(3)(B).

157. *Id.* § 529(e)(3)(A)(ii).

158. *Id.* § 529(e)(3)(B)(ii).

159. *Id.* § 529(e)(5).

160. *Id.* § 530(b)(5).

Some QTPs allow the account owner to transfer ownership of the QTP during the account owner's lifetime, and many allow a transfer of ownership at the account owner's death by operation of law (under a successor account owner designation on the QTP application) or under the account owner's will.

Neither Code Section 529 nor the proposed regulations address the gift tax or generation-skipping transfer tax consequences of a change in account ownership.[162]

Certain QTPs permit an agent designated under the account owner's durable power of attorney to act if the account owner is incapacitated. If a particular plan expressly permits an attorney-in-fact to act or does not specifically address the issue, an account owner may wish to include language in the account owner's power of attorney specifically authorizing his or her attorney-in-fact to take actions with respect to a QTP.[163]

An account owner must examine the terms of the particular QTP carefully to determine successor ownership at the account owner's death. For example, under certain QTPs, if no successor account owner is designated on the QTP forms, the beneficiary may become the account owner at the age of majority notwithstanding a contrary direction in the original account owner's will.

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161. Prop. Treas. Reg. § 1.529-1(c), 63 Fed. Reg. 45,019 (Aug. 24, 1998).

162. *See id.*; I.R.C. § 529.

163. *See* Timothy Guare, *To What Extent May An Attorney-in-Fact Deal with a Qualified State Tuition Program Account Created by a Principal?*, 139 TRUSTS & ESTATES 33 (Sept. 2000).

Appendix B[164]

Selecting a 529 Plan: "Checklist"

Use this checklist to compare the features of different 529 plans. All of this information is readily available from the offering documents each plan provides.

__Who may open the account?

__Is there any limit on who qualifies as an eligible beneficiary?

__Are there any age requirements for the account owner or beneficiary?

__Can I change the account beneficiary? If so, are there any fees assessed by the plan for the change?

__Is the plan available to residents in my state?

__At which colleges, universities, or vocational schools may withdrawals be used? For example, if the 529 plan is a prepaid tuition plan there may be limits on the institutions whose tuition is covered in full.

__Do I have to name a specific school when buying a prepaid tuition plan? If the plan is school-specific, what happens if the student decides to attend a different school or isn't admitted by the school?

__Are prepaid tuition benefits guaranteed by the state?

__How are prepaid plan benefits indexed to tuition inflation? Are they guaranteed to equal actual tuition increases, the state average increase, or a projected increase?

__Does the plan impose any minimum contribution requirements?

__What has been the performance of the various investment options offered by the plan?

__Does my state offer any tax advantages for either contributions made to the account or withdrawals from the account?

__Is there a limit on how often I can invest in the account or on how much I can annually invest in the account?

__What is the maximum amount that I can invest in the account over the life of the account?

__What expenses are covered by plan withdrawals?

__What is the plan's refund policy?

__Are there any special incentives for state residents?

__What fees are associated with my account?

__Is there an account minimum I must maintain to avoid certain fees?

__Can I buy the plan directly from the state or plan sponsor, or must it be purchased through a broker-dealer?

__If I purchase the plan through a broker-dealer, will the broker-dealer impose any additional fees in connection with opening the account?

__Can I change how my money is invested?

__If I consult with a financial advisor, what relationship, if any, does that adviser have with the plan he or she is recommending?

__What investment options are offered by the plan?

__What are the risks associated with each of the investment options?

__Are any of the investment options "age-based" such that the portfolio will be automatically adjusted as the beneficiary gets older?

__Does the plan limit how soon I can begin taking withdrawals from the account?

__Does the plan impose any penalties for withdrawals from the account or impose any account termination fees?

__What customer service does the plan provide (toll-free phone numbers, online account information, regular bulletins or mailings)?

__What happens to existing investments and future investments if the investment manager is changed by the state?

__What if my child does not pursue a post-secondary education?

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164. This checklist was compiled from a guide book published in 2002 by The Investment Company Institute, *Saving for Education; A Long-Term Investment, A Guide to Understanding 529 Plans*. You may download a free edition of this guide at the CSPN's website, an affiliate of the National Association of State Treasurers. *See* 529 PLANS, *supra* note 2, at 1.