Attorney Timothy P. Crawford, CPA, CELA*, CAP**
wanted to share this information with you.

SECTION 529 PLANS

College Savings Plans

Tax Free Savings for College. Use in place of a Minor's Trust (2503(c) Trust), Uniform Gift to Minors Act (UGMA), or Uniform Transfer to Minors Act (UTMA)

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A. INTRODUCTION

A primary reason to give to children, grandchildren and other loved ones is to financially prepare for the payment of their college education. The cost of a college education continues to rise faster than inflation. A newborn may face annual costs at some private colleges of $60,000 per year. Without proper planing, this cost can really hurt the family budget when Junior reaches 18 years of age. Thanks to the Tax Relief Act of 1997 and the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Relief Act"), tax-smart planning opportunities have dramatically improved. The strategy of choice is the Section 529 education savings plan.

Planning for college is not the only reason for making gifts to the younger generation. Two primary additional reasons include: (1) reducing your *income* taxes and (2) reducing your *estate* tax risk.

B. KEY OBJECTIVES IN GIFTING

In developing a plan of gifting, the following objectives should be considered:

1. Retaining control. It is often undesirable to give a child or grandchild under the age of 21 (or possibly older) the unlimited access to large sums of money. In fact, minor children cannot legally own or transfer assets without a parent's consent. The donor should attempt to maintain control as long as possible.

2. Avoiding the Kiddie Tax. The Kiddie Tax was designed by Congress to prevent parents from reducing their income tax by transferring income-producing

assets to minor children having lower tax brackets (called income splitting). The Kiddie Tax taxes a portion of *unearned* investment income of any child under 14 years of age at the top rate of the parent. The advantage associated with shifting income from a high-bracket parent to a low-bracket child is limited by the Kiddie Tax.

Kiddie Tax rules provide that if the child has unearned income, basically dividends, interest, and rents, exceeding $1,500 in 2001, the first $750 is offset by the child's standard deduction. The second $750 is taxed at the child's rate. Any unearned income exceeding $1,500 is taxed to the child at the parents' tax rate. It should be noted that *earned* income is not subject to the Kiddie Tax and is always taxed at the child's own rate.

Tax Return Preparer Compliance Note: Once the child's income exceeds his or her standard deduction ($4,400 in 2000), he or she must file an individual tax return and attach Form 8615 to calculate the Kiddie Tax. Alternatively, the child's parents can include their child's income on their tax return and pay the tax. In such a case, a Form 8814 is attached to the parents' return. Any income tax the parents pay on the child's unearned income is considered a gift from parent to child when computing the $11,000 annual exclusion for the parent.

To minimize the adverse impact of the Kiddie Tax, consider investments in tax-deferred vehicles, such as, Section 529 plans, Education IRAs, Series EE U.S. savings bonds, growth stocks, tax-free municipal bonds and life insurance policies.

3. **Income Tax Advantages.** It is desirable, in addition to avoiding the Kiddie Tax, that the earnings on dollars contributed, when used for college, be *tax-deferred* or even better, *tax-free.*

4. **Estate Tax Reductions.** It is desirable to place the gifts made for college funding beyond the reach of the estate and generation skipping taxes upon donor's death prior to the use of the gift by the beneficiary.

To avoid estate and generation skipping taxes, the gift must be considered "completed" for gift tax purposes. Also, the gift is free from gift tax if the gift does not exceed the $11,000 annual exclusion per donor. A married couple can give each loved one $22,000 per year. The annual exclusion will be adjusted for inflation. A second tax provision allows you to make gifts of *more than* $11,000 by current use of your Unified Credit. The amount of your Unified Credit which is used to shelter life-time gifts of more than $11,000 will be unavailable to shelter the estate tax upon death. This has become less of a problem due to the 2001 Tax Relief Act which increases the Unified Credit to 1 million dollars per person in 2002.

With two exceptions, the retention of control in a strategy makes the gift subject to estate tax. The exceptions are Section 529 plans and Education IRAs, which allow for retention of control and still provide an exemption from estate tax.

5. Access to College Tuition Assistance. To assess qualification for tuition assistance, most colleges use a formula to calculate aid that requires the family to contribute 35% of any assets in the *child's* name. In contrast, parents are expected to devote 12% of their assets to tuition costs. Therefore, assets saved in the child's name can work to the family's disadvantage when financial aid is calculated. A deposit into a Section 529 plan by a grandparent will be completely disregarded for purposes of determining a family's expected family contribution towards the cost of college.

6. Growth Potential. The type of strategy selected should provide growth which exceeds inflation and matches or exceeds future increases in tuition costs.

7. Flexibility and Simplicity. It is also desirable that a strategy be as simple, flexible and inexpensive as possible in setting the plan up, maintaining it and finally accessing benefits.

8. Portability. It is also desirable that the funds can be used for any college within or without your state of residency.

9. Available to All Income Groups. It is not desirable to deny access to the higher income groups.

10. Contribution Limitations. It is not desirable when a donor is restricted in the amount he or she can contribute.

C. COMPARING THE STRATEGIES

1. UGMA/UTMA Custodial Accounts. A traditional way to establish a college fund was to establish a state law custodial gift under the Uniform Gift to Minors Act (UGMA) and more recently the Uniform Transfers to Minors Act (UTMA). Under UGMA, funds are turned over to a child when the child attains the age of 18. Under UTMA, the child receives the funds at age 21. Wisconsin switched from UGMA to UTMA in 1988. Although UTMA is an improvement, age 21 may still be too young to receive substantial unrestricted gifts. Moreover, under both UGMA and UTMA, there is no guarantee that funds must be used for college. For these and other reasons, UGMA and UTMA are not favored, except for small gifts.

2. Minor's Trust or 2503(c) Trusts. Attorney-drafted discretionary Living Trusts are another option to be considered. In setting up a Living Trust, you have complete control in deciding what age and use restrictions you deem advisable. The drawbacks to a Living Trust include the legal fees involved at the onset to create

it, the cost of preparing annual income tax returns, the potential Trustee fees, and the IRS audit risk.

3. **Series EE U.S. Savings.** Due to the introduction of Education IRAs and Section 529 plans under the 1997 and 2001 tax laws, Series EE U.S. savings bonds have lost their appeal as college savings strategies. The exemption from income tax for Series EE U.S. Savings bonds is more broadly available to Education IRAs and Section 529 plans. The disadvantages for these bonds include historically low growth rates.

4. **Education IRAs.** Education IRAs were introduced by the Tax Relief Act of 1997 which limited annual contributions to $500. The 2001 Tax Relief Act has expanded the dollar contribution limit from $500 to $2,000 starting in the year 2002 and invested funds can now be used for "qualified elementary and secondary school expenses", such as tuition, tutoring, books, supplies, computers and other items needed for K-12 education.

The contributions are nondeductible. The ability to contribute is phased out for adjusted gross income over certain amounts, in similar way like other IRAs. Thus, the phase-out range for married taxpayers filing a joint return is $190,000 to $220,000 of modified adjusted gross income. A big advantage is that if the account is used for qualified education expenses, all earnings will be tax-exempt, not just tax-deferred. However, this advantage is now also available to Section 529 plans. A drawback is that if the funds are not used for qualified education, then earnings are taxable to the child and a 10% penalty is imposed.

A child has until age 30 to use the funds for college. At age 30, the funds must be turned over to the child. The donor can change the designated beneficiary of an Education IRA to other family members, but cannot receive the funds back.

The donor retains control over decisions on the selection of (a) a brokerage company or other financial institution and (b) the types of investments.

Like other IRA's you can contribute until April 15th for the preceding year.

When applying for financial aid, an Education IRA will be counted as a child-owned asset.

5. **Section 529 plans.** The option of choice after the Tax Relief Act of 1997 and even more so now after the 2001 Tax Relief Act is the Section 529 education saving plan. Although these plans are established under Section 529 of the Internal Revenue Code, they must be sponsored by state government or a private educational institution.

Almost every drawback of the other college funding strategies are corrected under a Section 529 plan. Section 529 plans are simple to set up and easy to handle continuing contributions. They generally have no start up legal expenses nor any continuing accounting or Trustee fees.

Section 529 plans may either be a prepaid tuition program or education savings account. Wisconsin has set up the education saving account type of Section 529 plans. It is called the ED-VEST Plan and it is distributed by Strong Investments, a mutual fund servicing company located near Milwaukee, Wisconsin. It is available through most major stock brokerage firms and many financial advisors.

Section 529 plans do not have the small contribution limits that Education IRAs have. Some state plans (Rhode Island and Wisconsin) permit contributions to Section 529 plans to be as high as $246,000. Moreover, Section 529 plans do not have the income eligibility restrictions that Education IRAs have.

As in Education IRAs, contributions are not tax deductible. All benefits paid out from Section 529 plans used for qualified education expenses are *tax-free*. Even the accumulated earnings paid out are *tax-free*. Compare that result to a traditional IRA in which assets grow tax-deferred, and when withdrawn are taxable. As in Education IRAs, control can be maintained by the donor and beneficiaries can be switched to other family members, now including first cousins of the original beneficiary. This "tax-free rollover" feature from one beneficiary to another, gives the Section 529 plan great flexibility. Unlike Education IRAs, benefits in Section 529 plans may be withdrawn after age 30.

As in Education IRAs, earnings inside the Section 529 plans are not subject to the Kiddie Tax.

As in Education IRAs, the portion of benefits not used for qualified education expenses trigger income tax and a 10% penalty on the related earnings.

Unlike Education IRAs, the donor of Section 529 plans can actually obtain the return of the funds in the plan, however the earnings portion will be subject to income tax and a 10% penalty.

The donor <u>controls</u> how much to take out and when to take it out.

As in Education IRAs, the estate tax does not apply against a donor who dies before the funds are used by the beneficiary. This is because contributions to Education IRAs and Section 529 plans are treated as completed gifts even though the donor has maintained so much control. One of the permitted exceptions to the control requirement that I discussed earlier. Unlike Education IRAs, donors can make a contribution of $55,000 for each beneficiary in a single year and elect to treat the contributions as having been made ratably over 5 years. Many Section 529 plans can be started for as little as $25.

Unlike Education IRAs, Section 529 plans are set up under state-administered programs, but neither the donor nor the beneficiary need to be residents of the state sponsoring the plan. For example, a Wisconsin grandparent or parent can set up an Ohio-sponsored Section 529 plan for a child residing in Wisconsin.

The 2001 Tax Relief Act provides that a transfer of credits (or other amounts) from one qualified tuition program for the benefit of a designated beneficiary to another qualified tuition program for the benefit of the same beneficiary is not considered a distribution. This tax-free rollover treatment does not apply to more than one transfer within any 12 month period with respect to the same beneficiary.

As in Education IRAs, Section 529 plans may be transferred, without tax consequences, to other plans. This privilege helps to neutralize the potential drawback that each state's Section 529 plans are locked into one investment company. For example, the investment company hired to invest funds in the Wisconsin Education Savings Program (ED-VEST), a Section 529 education savings account, is Strong Investments, a respected Milwaukee-based firm. If a donor is dissatisfied with their investment results, the donor can transfer the Wisconsin Section 529 plan to another state's plan.

An advantage the Education IRAs have over Section 529 plans is that investment decisions in Education IRAs can be self-directed. Another advantage for an Education IRA is that the use of benefits for K-12 education expenses is not permitted for Section 529 plans.

The growth potential of Education IRAs and Section 529 plans should be good and is expected to exceed the growth of Series EE U. S. savings bonds, and should easily surpass taxable strategies, such as UTMAs.

As in Education IRAs, Section 529 education savings accounts do not generally restrict the selection of colleges.

Section 529 prepaid tuition programs may restrict portability to other states.

6. The Use of Life Insurance. What if a parent intending to make annual contributions to a college funding strategy for a child or children prematurely dies? The purchase of life insurance on the parent's life can save the day. Proceeds are tax free. If the parent doesn't die but instead lets the cash surrender value build up inside the policy, then this money could be withdrawn on a loan basis, tax free. Then, at the death of the parent, the death proceeds pay off the policy loan tax-free.

7. Employing Your Child in a Business. If your child is old enough to work, consider giving the child a job. The wages received will not be subject to the Kiddie Tax and will escape income tax to the child if they do not exceed the child's standard deduction. The wages are deductible. The negative is the need to pay social security taxes if the business is incorporated.

The wages can then be placed in a Roth IRA or other investment to be saved for college expenses. To sustain an IRS audit, you must keep good records to prove that your child actually performed work.

8. Penalty-Free Withdrawals from Traditional IRAs. You can take withdrawals from a traditional IRA to pay higher-education expenses for your child without having to pay the 10% penalty that usually applies to withdrawals before age 59 ½. However these withdrawals are subject to federal income tax by you.

Using a traditional IRA account to pay for your child's college expenses should be your last resort because you will lose the important opportunity for continued tax-deferred growth and will be paying higher current income taxes now. However, this strategy would allow you to maintain complete control of the funds to an even greater extent than in a Section 529 plan or Education IRA.

D. HOW TO INVEST

1. Stock Brokerage Firms and Financial Advisors. Almost all Stock Brokerage Firms and Financial Advisors can steer you to a Section 529 Education Savings Plan.

2. Wisconsin State Income Tax Break. Wisconsin has the ED-VEST Plan managed by Strong Capital Management, Inc., a registered investment advisor with securities distributed by Strong Investments, Inc., an affiliated company. A unique thing about the ED-VEST Plan is that starting January 1, 2001, up to $3,000 per year per dependent beneficiary may be deducted from your Wisconsin taxable income. For most people, this will be worth more than $200. There is no income limit for this tax deduction. As a result of a change in Wisconsin Law, effective January 1, 2002, a grandparent can claim the $3,000 deduction on the grandparent's Wisconsin tax return.

3. Availability. There are currently over 47 states which have Section 529 plans. Therefore, you have many different investment plans that you can choose from.

4. Amount of the Contribution. I would recommend that you use a Financial Advisor to help you select from amongst the 40 different state plans. It is important to look at factors including the maximum contribution permitted ($100,000 - $246,000). Some plans have very low limits - $100,000. Other plans have high limits - $246,000.

5. Expenses. The plan investments generally are in mutual funds. Mutual funds have expenses. These will vary from plan to plan. The $200 Wisconsin tax savings that you get by using the Wisconsin plan, ED-VEST, could be more than offset by the fact that it's expense ratio is higher by as many as 25 basis points (0.25%) than say the Rhode Island plan distributed by Alliance Capital. Therefore, if the amount that you invest is large, the extra cost associated with the higher expenses in the Wisconsin plan will eat up the special Wisconsin tax break for Wisconsin residence in that plan.

6. Flexibility of Investments. You need to look at the flexibility of the type of investments that you can make with a particular state's plan. Some state plans are set up on an age based portfolios. That is to say as the beneficiary ages and gets closer to needing to use the money for college, then the asset allocation within the various mutual fund investments will move from high risk (growth orientated-high tech mutual fund) and move more into conservative investments such as a bond mutual fund. Other state plans are set up on a static portfolio. That is to say, they do not change.

7. Section 529 Rollover. One of the advantages of the 2001 Tax Relief Act is that you can do a tax free rollover from one state's Section 529 plan into another state's Section 529 plan. This gives you tremendous control and flexibility in that if you do not like your investment mix in one state's plan, you can simply move it to a different mutual fund company which sponsors a different state's plan.

8. Changing Your Asset Allocation (Stocks vs Bonds). Various state plans will not let you change your asset allocation mix once the plan is set up. However, if you were to change your beneficiary, the state plan will then permit you to change your asset allocation mix.

9. Changing Beneficiary. You do have the right to change your beneficiary. This is very important. Some people may want to set up a Section 529 plan for their grandchildren. The problem is they do not have grandchildren yet, but they want to start accumulating money for their future grandchildren's college expenses. They can do this by setting up a Section 529 plan for their child, and when that child has children, they can change the beneficiary. This will allow the "grandparent" to get a jump start on funding a grandchild's college education. Remember, the growth in the plan will be totally tax-free. Therefore, the sooner you start, the better off you are. If there never are any grandchildren, the beneficiary could be switched over to a different beneficiary.

10. Negative of Section 529 Plan. The negative of the Section 529 plan, if you can find one, is that you are unable to do self-directed investments as you could in an Educational IRA. However, remember that by using the flexibility of a Section 529 rollover, you can in effect, "self-direct" your investments by moving

from one state plan to another state plan. Obviously, this is not as simple as in a self-directed IRA where you instruct your brokerage firm to sell one stock and buy another or sell one mutual fund and buy another.

11. Conversions of Plans. It is possible to convert from a Uniform Gift to Minors Act account or Uniform Transfers to Minors Act account into a Uniform Gift to Minors Act-Section 529 account, or a Uniform Transfers to Minors Act-Section 529 account. That is to say, you can convert, on a tax free basis, from UGMA and UTMA into a restricted UGMA-Section 529 plan. When you do so, you will not have control over the UGMA-Section 529 plan the way you would over a new Section 529 plan. However, this may have an advantage in that the Section 529 plan grows tax free.

12. The New 2001 Tax Relief Act. The major advantage of the 2001 Tax Relief Act as it applies to Section 529 plans is that it converts the earnings from being *tax deferred* to being *tax free*. A good comparison would be it takes it away from being treated like a traditional IRA (Tax Deferred Growth) to being treated like a Roth IRA (Tax Free Growth). This is a wonderful tax break and will further encourage the use of Section 529 plans.

13. IRS Eases Restriction On Investment Directions. On September 7, 2001 the IRS eased restrictions on investment directions for Section 529 Savings Plans. Up until September 7, 2001 participants in a Section 529 Savings Plan were not permitted to direct the investment of their accounts. The investment option you placed your contribution into is the one it had to stay in. That is no longer the case. Realizing that Section 529 Savings Plan participants may have good reason to desire a switch in their investments (family circumstances change, the market goes the wrong way, etc.), the IRS announced a new policy that permits Section 529 Plans to give their participants the opportunity to change their investment strategy once every year. (Notice 2001-55). This new policy represents a significant loosening of the rules and should help Section 529 Savings Plans attract many families who otherwise might be spooked by the investment restrictions. The new policy takes effect immediately, although it will be up to the individual states to make the appropriate changes to their program rules.

14. IRS Releases New Guidance For Section 529 Plan Distribution Reporting. On December 10, 2001 the IRS released new guidance for Section 529 plan distribution reporting. The IRS has released Notice 2001-81, finally giving some guidance on implementing certain changes made to Section 529 by the 2001 EGTRRA tax cuts. The most significant change described in Notice 2001-81 is that Section 529 plans will not have to verify the use of distributions after 2001. This means that a program can simply pay out a distribution upon request, without requiring documentation. Of course, it may take some time for many of Section 529 plans to jettison its current procedures, particularly in states where the state income tax, transaction charges, or distribution waiting periods depend on the characterization of a withdrawal as qualified or non-qualified.

Notice 2001-81 also describes the program record keeping requirements for rollover contributions and for calculating the earnings portion of distributions. The IRS will no longer require the end-of-year aggregation of all distributions made to the beneficiary in computing the earnings, and will no longer require that accounts for the same beneficiary with different account owners be aggregated. This should simplify things somewhat and resolve some difficult problems caused by the old aggregation rules.

A newly developed Form 1099-Q reporting 2002 distributions from Section 529 plans has been posted to the IRS web site. A new form is necessary to reflect the changes of the 2001 EGTRRA. For 2001 distributions, Form 1099-G will continue to be used.

There are several things to note about Form 1099-Q. It will report gross distributions along with the earnings portion and the portion representing basis. It will not indicate whether the earnings are taxable or exempt because the recipient will have to figure that out with his or her 2002 tax return. The Section 529 plan is instructed to issue the 1099-Q to the beneficiary, if amounts are paid directly to the institution or to the beneficiary, otherwise to the account owner.

15. Tax Penalty Break. On March 9, 2002 the Job Creation and Worker Assistance Act of 2002 was signed into law by President Bush. While the legislation was not targeted to higher education, the new law does contain a technical correction to the 2001 EGTRRA affecting Section 529 plans.

The correction makes clear that the 10% additional tax on non-qualified withdrawals does not apply to taxable income caused by the reduction in "qualified higher education expenses" for taxpayers claiming the Hope or Lifetime Learning credit. This is a welcome change, because prior to the technical correction a Section 529 plan participant could be exposed to the penalty simply by qualifying for the credit. The exception will work much like the exception for scholarship withdrawals, i.e. the earnings portion will be subject to federal income tax but will not incur the 10% additional tax.

16. Impact Of A Section 529 College Savings Plan On Applying for Government Benefits. The question is often asked what is the impact of a Section 529 College Savings Plan on applying for Government benefits. Although I am not aware of any specific Federal interpretation, applying the basic Federal rules dealing with qualifying for Government benefits to pay for nursing home care costs under Title 19, I reached the following conclusions.

If you were to give money to a child so the child could create or fund a Section 529 plan for your grandchildren, this gift would constitute a divestment and there would be a period of ineligibility.

If you fund your own Section 529 plan, this would be an available asset, as you have the right to remove all assets that you have placed into a Section 529 plan.

If you fund a Section 529 plan in your own name for the benefit of a child or grandchild, then this should be treated as an available asset as you have the right to withdraw the assets from the Section 529 plan.

E. SUMMARY

It is predicted by many financial planners that Section 529 plans will become as popular as 401K plans. It is my opinion, that if more than $1,000 is involved, people should use a Section 529 plan instead of a Uniform Gift to Minors Act account or Uniform Transfers to Minors Act account.

It is time for your clients, friends and relatives to take action NOW. They can call my office toll free at 1-888-634-6675 to set up a free consultation to discuss their situation.

"Those Who Plan Ahead Win.
Those Who Don't Plan Ahead Lose."

This article is for informational purpose only and is not intended as legal advice. It is recommended that you call Timothy P. Crawford for a free conference to discuss your situation in more detail. Attorney Crawford can be reached at 1-262-634-6659. Please refer to this article when you call.

*Attorney Timothy P. Crawford is a Nationally Board **C**ertified **E**lder **L**aw **A**ttorney (**CELA**). He has been Board Certified by the National Elder Law Foundation which has been approved as the Sole Certifying Organization for Elder Law Attorneys by the American Bar Association.

Timothy P. Crawford was invited to join the **Council of **A**dvanced **P**ractitioners (**CAP**) of the **N**ational **A**cademy of **E**lder **L**aw **A**ttorneys (**NAELA**) in August of 2005. **CAP** is a small group of premier elder law attorneys, all of whom have been members of NAELA for at least 10 years, are certified as elder law attorneys by the National Elder Law Foundation, and are AV rated by Martindale Hubbell, a service that provides an independent rating of the quality of attorneys, as one of the top attorneys in the nation.

Attorney Timothy P. Crawford has been selected as a **Fellow** of NAELA. **Fellow** is the highest honor bestowed by the Academy. Selection as a **Fellow** signifies that his peers recognize the lawyer as a model for others and as an exceptional lawyer and leader.

Attorney Timothy P. Crawford has a superb rating of 10 out of 10 with A V V O.

A V V O has awarded to Attorney Timothy P. Crawford the A V V O Client's Choice Award.

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"Helping Families in Wisconsin for Over 40 Years
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