BRIAN T. WHITLOCK, CPA, J.D., LL.M., is a Practicing Attorney and Of Counsel with Golan Christie Taglia, LLP. He is also an Adjunct Member of the faculty at the Northwestern University Pritzker School of Law.

Untaxingly Yours

A Practical Guide to Saving for College with Code Sec. 529 Accounts

By Brian T. Whitlock

The cost of higher education in the United States has risen astronomically over the past 40 years. As the Federal government has increased the availability of loans and grants, colleges and universities have had less pressure to keep the cost of tuition low. Tax-efficient savings strategies are critical towards helping parents, grandparents, and students as they seek to accumulate the funds necessary to avoid the crushing debt that graduates might otherwise face without family assistance.

Qualified Tuition Programs

College savings plans were initially created by state governments as a means of helping in-state students meet the rising costs of post-secondary education at state universities. States offered individuals the opportunity to freeze the cost of college *via* "prepaid college savings plans" or the purchase of state-backed "college savings bonds," which like municipal bonds offered the purchaser the opportunity to avoid both Federal and State income taxes on the bond interest.

The U.S. Congress jumped on the college savings bandwagon when it enacted legislation as part of the Small Business Job Protection Act of 1996. The initial legislation merely confirmed the Federal income tax exclusion on certain state programs by deferring the tax on undistributed earnings and excluding distributions for qualifying expenses from the beneficiary's gross income. Code Sec. 529 was enacted the following year as part of the Taxpayer Relief Act of 1997; the Act offered tax-free status to the accumulated value of "529 Accounts" that were in fact used to pay for qualifying expenses.

529 Accounts have become a preferred way of saving for a college education for several reasons. First, over the years the definition of qualifying expenses has been expanded by Congress. Second, the assets accumulating in the account can be sheltered from creditors for both the account owner and the designated beneficiary. Third, the assets in the 529 Account can receive some favorable treatment for financial aid purposes. Fourth, unused balances can be transferred to meet the educational goals of other family members or aid in retirement planning.

This column will explore some of the key terminology and offer some tips and traps in designing a college savings plan involving 529 Accounts as a key investment strategy.

Account Owner[1]

The Account Owner of the 529 Account is the person who effectively controls the investment account. The Account Owner may select among available investments and investment strategies, authorize distributions for the beneficiary's education, change the beneficiary of the account, or distribute cash out of the 529 Account for themselves. The donor can name not only the initial custodian, but they can name successor custodians, in the event that the initial custodian should fail or cease to act.

The Account Owner is frequently referred to in account documents created by the plan sponsor (*i.e.*, bank or brokerage firm where the account is maintained) as the "Custodian". The term custodian may sound familiar. This same term is used to refer to the person that controls accounts that are created and held under the Uniform Transfers to Minors Act (UTMA) or its precursor the Uniform Gifts to Minors Act (UGMA).

Seasoned practitioners are familiar with the estate tax risks of permitting a donor to serve as the custodian of an UTMA account or as trustee of a Minors Trust authorized under Code Sec. 2503(c).[2] Code Secs. 2036 and 2038 can cause the fair market value of donor controls UTMA accounts or Minors Trusts to be included in the gross estate tax of the owner at death. Under the application of Code Secs. 2036 and 2038, the donor has in effect retained power to control the beneficial enjoyment of the property, therefore resulting in inclusion in the donor's gross estate at death.

In order to avoid Code Sec. 2036 and 2038 inclusion of UTMA or UGMA assets, commentators typically warn against the donor acting as the custodian. Similarly, in order to avoid Code Sec. 2036 and 2038 inclusion of investments held in Minor's Trust, commentators typically warn against the donor acting as the trustee of the Minor's Trust, at least with respect to holding the power to distribute income and corpus. Even a non-donor parent acting as trustee could run afoul of Code Sec. 2041, which deals with powers of appointment, if the parent had the power to make distributions to a child that would discharge that parent's support obligation.

Despite the fact that the statute contains a fairly broad exclusion of 529 Accounts from estate taxation,[3] the safe play is to not permit the donor to serve as the Account Owner or custodian of the 529 Account.

Designated Beneficiary

The Designated Beneficiary is the person who is identified in the account documents as the beneficiary of the income and principal accumulating in the 529 Account. Only individuals may be a Designated Beneficiary of a 529 Account.[4] There is no language in the statute that would restrict the age of the individual the account beneficiary or require that the course of studies ultimately lead to a degree. As a result, in today's world where we might change careers, satisfy continuing education requirements of a profession, or merely pursue educational curiosities, these accumulated assets can provide a lifelong benefit.

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Gift Tax and GST Impact

The statute only permits cash to be contributed to a 529 account.[5] Contributions to 529s are considered present interest gifts to the designated beneficiary,[6] and to the extent that the contribution exceeds the gift tax annual for present interest gifts set forth in Code Sec. 2503(b), then the gift may be taxable.[7] Code Sec. 2503(e) does contain an exception for both gifts that are either medical or educational payments, but since the funds being contributed to the 529 Account may ultimately be distributed or spent on non-qualifying expenses, applying the blanket Code Sec. 2503(e) exception to contributions to the account would be premature. In addition, the definition of qualifying expenses from 529 Accounts is much broader than the Code Sec. 2503(e) gift tax exception. Code Sec. 2503(e) applies only to direct tuition payments. Qualifying expenses from 529 Accounts include not only tuition, but also fees, books, supplies, and equipment (including computers and peripheral equipment) required for enrollment in a qualified educational institution.[8] Expenses for room and board can also be made for "eligible students" that are at least enrolled half-time.[9] It is interesting to note that for the purposes of room and board, the eligibility rule is tied to the standard used for the American Opportunity

Tax Credit, which is restricted to individuals carrying at least ½ of the normal full-time course of studies.[10] *See* Reg. §25.2503-6(b)(2).

Contributions made to the 529 Accounts of grandchildren (*i.e.*, skip persons) are treated as direct skips and thus eligible for the generation-skipping tax (GST) annual exemption applicable to nontaxable gifts.

Accelerated Funding—Spreading the Gift

In order for a 529 Account to qualify under the Code Sec. 529(b), it must be sponsored by a State or an agency of a State, and it must meet certain statutory criteria involving the segregation, accounting, and reporting requirements of the separate accounts by the sponsoring agency. Among the requirements is also a maximum contribution amount designed to prevent donor from contributing funds in excess of the educational needs of a single individual beneficiary.

Despite the aggregate funding limits, Code Sec. 529 permits a donor to (pre-fund) contribute amounts in excess of the single-year annual gift tax exclusion. Under Code Sec. 529(c)(2)(B), donors are permitted to elect to spread contributions *pro rata* over a period of five years for gift tax purposes. If the donor dies before the beginning of the fifth year, then the contributions attributable to the post death period are includable in the gross estate of the donor for Federal Estate Tax purposes. Nevertheless, prefunding accounts can be a useful strategy for grandparents who are concerned that they might die before the grandchildren have completed their educational goals.

Gift Tax Impact of Change of Designated Beneficiary

As we will discuss in more detail shortly, it is possible to change the beneficiary of a 529 Account. Where the new beneficiary is of the same generation as the old beneficiary, there are no gift or GST implications so long as the beneficiary meets the "family member" qualifications.[11]

Qualified Education Expenses

Tax-free distributions may be made from 529 Accounts to cover qualified education expenses. Qualified expenses include not only tuition, but also fees, books, supplies, and equipment (including computers and peripheral equipment) required for enrollment in a qualified educational institution, and a limited amount of room and board (*i.e.*, what it would cost the student to live on campus at the school).[12]

Primary Schools, Religious Education and Apprenticeship Programs

Code Sec. 529 has been expanded over the years to permit distributions for some things other than qualified higher education expenses at the collegiate level. Distributions can provide for primary and secondary schools, private high schools, and religious schools.[13] In addition, Section 302 of the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act) amended Code Sec. 529 to add Code Sec. 529(c)(8), and apprenticeship programs registered with the Secretary of Labor under Section 1 of the National Apprenticeship Act.[14]

Student Loan Repayments

The SECURE Act also added Code Sec. 529(c)(9), which permits tax-free distributions from Code Sec. 529 accounts to pay "principal or interest on any qualified education loan (as defined in Code Sec. 221(d)) of the designated beneficiary or a sibling of the designated beneficiary."

The limit on distributions for repayment of educational loans is *an aggregate* of $10,000 per beneficiary. The limitation is not imposed on the account, nor is the limit imposed on only the initial Designated Beneficiary.[15] Therefore, it is possible to repay $10,000 of loans for multiple individuals.

Tax Treatment of Distributions from 529 Accounts

Distributions from the 529 Accounts are required to be reported by the institution holding the assets on Internal Revenue Service (IRS) Form 1099-Q. The Form 1099-Q includes both qualified and non-qualified distributions, so the taxpayer receiving the distribution needs to report the total amount received on IRS Form 5329, Part II. The portion of the distribution which paid qualifying expenses can be subtracted from the total and is thus not taxable. Non-qualified distributions are subject to not only additional income tax but also a 10% penalty.

Changing the Designated Beneficiary—529 Rollovers

The benefits of a 529 Account are not restricted to the original Designated Beneficiary. The Account Owner may change the Designated Beneficiary and thus "rollover" some or all of the account and designate a new beneficiary, subject to the limitations of Code Sec. 529(c)(3)(C)(ii), which provides: "Any change in the designated beneficiary of an interest in a qualified tuition program shall not be treated as a distribution for purposes of subparagraph (A) if the new beneficiary is a member of the family of the old beneficiary."

"Member of the family" is defined in Code Sec. 529(e)(2) as follows:

> "The term "member of the family" means, with respect to any designated beneficiary—
> (A) the spouse of such beneficiary;
> (B) an individual who bears a relationship to such beneficiary, which is described in subparagraphs (A)–(G) of section 152(d)(2)[16];
> (C) the spouse of any individual described in subparagraph (B); and
> (D) any first cousin of such beneficiary.

ABLE Account (529A) Rollovers

The Stephen Beck Jr. Achieving a Better Life Experience Act of 2014 (the ABLE Act) was enacted on December 19, 2014. The ABLE Act added a new Code Sec. 529A, which provides for a tax-advantaged savings program, the "qualified ABLE program," to help in meeting the financial needs of blind and disabled individuals and of families raising children with disabilities.[17]

Prior to January 1, 2026, funds may be transferred tax-free from a 529 Account to an ABLE 529A Account for the same beneficiary or some other "member of the family."[18] The amount that can be transferred each calendar year, however, cannot exceed the annual contribution limit that is imposed under Code Sec. 529A(b)(2)(B)(i); in other words, the amount of the rollover cannot exceed the gift tax annual exclusion amount available under Code Sec. 2503(b).

ROTH IRA Rollover

Section 126 of the SECURE 2.0 Act amended Code Sec. 529(c)(3) by adding Code Sec. 529(c)(3)(E), which permits limited distributions from a section 529 college savings account to be tax-free if they are rolled over to a ROTH IRA maintained for the benefit of the designated beneficiary of the 529 Account.

Beginning in 2024, the beneficiaries of Code Sec. 529 Accounts that have been open for more than 15 years will be able to roll over up to an aggregate total of $35,000 during their lifetime from the 529 Account to their own ROTH IRA. However, the amount that may be rolled over each calendar year is subject to significant limitations.

The requirements are that (1) the 529 Account must have been maintained for the 15-year period ending on the date of the distribution, (2) the distribution cannot exceed the amount contributed to the Code Sec. 529 Account (plus earnings) during the five-year period ending on the date of the distribution, and (3) the distribution must be paid in a direct trustee-to-trustee transfer to a ROTH IRA maintained for the benefit of the designated beneficiary of the Code Sec. 529 Account.

The amount rolled over each year is subject to two limitations. *First*, the amount rolled over cannot exceed the annual limit on Roth IRA contributions for the designated beneficiary reduced by the aggregate contributions made during the year to all IRAs maintained for the benefit of the designated beneficiary. For example, the limit on Roth IRA contributions for 2024 is $7,000 for a person under 50 years of age and $8,000 for a person over 50 years of age. If the designated beneficiary of a 529 Account (under age 50 years) contributes $1,000 to their traditional IRA or a ROTH IRA for the year, then the maximum amount that the individual could roll over from the Code Sec. 529 Account to the ROTH IRA would be $6,000. *Second*, the amount rolled over in the current year and in all prior years cannot exceed the lifetime limit of $35,000.

Trusts as Account Owners

An Account Owner need not be an individual. Donors may find it advantageous to create their own definition of "qualified educational expenses." Donors may wish to be more restrictive than the Internal Revenue Code's definition under Code Sec. 529. For example, a donor may wish to require the beneficiaries to only attend a select group of schools, pursue a certain major or course of studies, maintain a minimum grade point average, or comport with set rules of decorum (*e.g.*, limiting the use of alcohol and drugs) in order to receive benefits. The donor can create their own guidelines and restrictions on distributions by creating an irrevocable trust to hold the 529 Account.

Donors may wish to restrict the definition of Designated Beneficiaries to exclude certain persons, such as the descendants of a family member who has behaved badly in the past. Trusts provide the donor the opportunity to establish their own rules and also provide for additional asset protection.

The cash that is contributed to the irrevocable trust can be invested by the trustee in one or more 529 Accounts, for one or more trust beneficiaries. If the cash that is contributed to the irrevocable trust is invested by the trustee in one or more 529 Accounts, for one or more trust beneficiaries, then the 529 Accounts will be owned by the trust as the Account Owner. The trustee will not have gross income on the portion of the 529 Account income that is retained in the 529 Account for fiduciary income tax purposes. Although the trust can be the Account Owner, the trust itself cannot be the Designated Beneficiary because Code Sec. 529 requires the Designated Beneficiary to be an individual.

Disadvantages of Using Irrevocable Education Trusts

Irrevocable trusts have their limitations and disadvantages, as well, which may make them more cumbersome to administer than simply maintaining a 529 Account in the name of a Designated Beneficiary. Irrevocable trusts must jump through a number of administrative hoops.

Indirect Gifts Made to Trusts Are Subject to Different Gift Tax Rules

Gifts of cash made to a 529 Account are treated as completed gifts to the Designated Beneficiary and are not deemed to be a future interest in property. Contributions to an irrevocable trust, on the other hand, are indirect gifts to the beneficiaries of the trust. Without more, these gifts may be treated as gifts of a future interest (*i.e.*, something not available for current enjoyment) and therefore not eligible for the Code Sec. 2503(b) gift tax annual exclusion. Gifts of future interests will consume a portion of the donor's Unified Credit for Estate and Gift Tax.

The irrevocable trust needs to be designed in a manner that will allow contributions from the donor to the trust to qualify as gifts of present interest. One way to meet this design goal is to give the trust beneficiaries limited withdrawal rights over contributions to the trust. By giving each of the individual beneficiaries a temporary right to withdraw additions that are made to the trust, it is possible to treat the additions as gifts of present interests rather than indirect gifts of future interests. These withdrawal rights are frequently referred to as "Crummey Withdrawal Rights" in homage to Mr. D. Clifford Crummey, who prevailed in the Ninth Circuit Court of Appeals when challenged by the IRS.[19]

Gifts to Trusts May be Subject to GST

Gift to irrevocable trusts which are for the possible benefit of multiple generations are typically referred to as indirect skips, rather than direct skips. Indirect skips do not qualify as "nontaxable gifts" under Code Sec. 2642(c)(3). Nontaxable gifts are eligible for an automatic GST exemption equivalent in amount to the gift tax exemption under Code Sec. 2503(b). If a portion of the donor's GST exemption is not allocated in accordance with Code Sec. 2632, in order to cover additions to the trust benefitting multiple generation, then distributions from the trust to skip persons will likely be subject to GST.

Contributions to Trusts Cannot be Front Loaded

As mentioned earlier, Code Sec. 529 permits a donor to contribute up to five times the Code Sec. 2503(b) annual exclusion amount in the first year and to elect to treat the gift as if it were made *pro rata* over five years (the current calendar year and the subsequent four calendar years). No similar election to spread gifts is available for gifts to an irrevocable trust, even if the trustee intends to invest the gifted assets in a 529 savings account. Gifts in excess of the annual exclusion amounts to the trust are taxable gifts and forced to consume a portion of the donor's Unified Gift and Estate Tax Credit.

Non-529 Account Trust Assets may Generate Gross Income

If an irrevocable education trust generates gross income, then the trust may be required to file a fiduciary income tax return and the fiduciary will be required to report the income as being taxable to either a grantor of the trust, the trust fiduciary, or a beneficiary of the trust. The custodians of 529 Accounts are not required to file any income tax reports.

Fiduciaries Are Subject to Higher Income Tax Rates than Individuals

Non-qualified distributions from the 529 Account that are not distributed to the beneficiary will be "triple taxed" to the trust at the federal level. Investment income from a non-qualified distribution which is retained by a Complex trust would generally be subject to the highest federal income tax rate, the Net Investment Income Tax (NIIT), and also a 10% penalty.

If the non-qualified distributions are paid to or for the benefit of a beneficiary, then the trust will likely issue a Schedule K-1 to the beneficiary, and the beneficiary will pay the income tax, at their applicable income tax rate, the NIIT, and the 10% penalty.

No State Income Tax Deduction

Some states (*e.g.*, Illinois) offer state income tax deductions of up to $10,000 per individual donor who contributes to the State's sponsored Code Sec. 529 Account. Where the fiduciary of the irrevocable trust is the Account Owner, neither the donor, the trust, nor the beneficiary may claim the state income tax deduction.

No Refund Available to Donor

Where the donor contributes assets to an irrevocable education trust rather than to self-managed 529 Account, the donor will generally give up all rights to the future enjoyment of the gifted assets. As a result, the donor loses the ability to take back the contribution. On the other hand, contributions made directly to a 529 Account where the donor acts as the Account Owner could be returned to the donor or in part rolled over to a ROTH IRA, as discussed above.

Student Financial Aid

529 Accounts owned directly by a grandparent may be ignored on financial aid applications filed by the grandchild (student). 529 Accounts owned by the parent, the student, or a trust for the sole benefit of the student (as designated beneficiary) may not be ignored on financial aid applications.

Conclusion

Code Sec. 529 Accounts are extremely powerful and flexible savings vehicles. Parents, grandparents, and others can contribute to one or more accounts for students who wish to pursue their educational dreams with the assistance of family and friends. The funds accumulating inside of the 529 Accounts grow tax deferred and if they are ultimately spent on qualifying expenses, they will ultimately yield tax-free distributions to the Designated Beneficiary. 529 Accounts are a tremendous tool that should be considered in every student's financial plan.

ENDNOTES

1 The term "account owner" is defined in the Reg. §1.529-1(c) as the person who is entitled to select or change the designated beneficiary of any account.

2 Normally gifts will only be eligible for the gift tax annual exclusion if the gift constitutes the transfer of a present interest to a beneficiary. Gifts in trust are typically considered to be gifts of future interests and thus not eligible for the gift tax annual exclusion. Code Sec. 2503(c) treats certain qualifying trusts for the benefit of a minor beneficiary as eligible for the annual gift tax exclusion.

3 Code Sec. 529(c)(4) contains the following language which may be of comfort to donors who want to also be Account Owners: "No amount shall be includible in the gross estate of any individual for purposes of chapter 11 by reason of an interest in a qualified tuition program." The words "an interest" were likely intended to refer to a "beneficial interest," but it is possible to read the words to also apply to the custodian's interest and ability to control the account The only clear exception to the inclusion rule is found later in the statue as regards excess contributions that are being spread over a five-year period. Where the donor dies during the five-year period, the portion of the contribution that relates to the remaining years is definitely included in the gross estate of the donor.

4 Code Sec. 529(e)(1).

5 Code Sec. 529 Accounts can only be funded with cash contributions. Code Sec. 529(b)(2).

6 Code Sec. 529(c)(2)(A)(i).

7 The Code Sec. 2503(b) annual exclusion for transfers made in calendar year 2024 is currently $18,000 per donee. This amount is indexed for inflation and will likely increase in calendar year 2025. A married couple acting as donor's can elect to split gifts made by one spouse and therefore married couples can gift up to $36,000 per donee if the gift constitutes a present interest.

8 Code Sec. 529(e)(3)(A)(iii).

9 Code Sec. 529(e)(3)(B).

10 Code Sec. 25A(b)(3).

11 Code Sec. 529(c)(5).

12 Code Sec. 529(e)(3)

13 Code Sec. 529(c)(7).

14 Code Sec. 529(c)(8). Although the author has not been able to confirm this fact prior to publication, it has been rumored that professional golf schools such as the PGA Tour School, which qualifies individuals to be golf professionals may qualify under either the high education guideline or the apprenticeship guideline.

15 To the extent that amounts withdrawn tax-free from a Code Sec. 529 account are used to pay interest on an educational loan, the taxpayer's deduction for student loan interest under Code Sec. 221 is reduced.

16 Code Sec. 152(d)(2)(A)-(G) defines the term "qualified relative" (in the context of dependents for income tax purposes) as including the following:

- (A) A child or a descendant of a child.
- (B) A brother, sister, stepbrother, or stepsister.
- (C) The father or mother, or an ancestor of either.
- (D) A stepfather or stepmother.
- (E) A son or daughter of a brother or sister of the taxpayer.
- (F) A brother or sister of the father or mother of the taxpayer.
- (G) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

Code Sec. 152(f) provides that "child" includes a stepchild, an adopted child, and certain foster children; "brother" and "sister" include brother or sister by the half blood.

17 Code Sec. 529(c)(3)(C)(i)(III).

18 For a more comprehensive discussion of 529A Accounts, *see* Whitlock, *UNTAXINGLY YOURS—Code Sec. 529A UnABLE to Serve America's Most Deserving*, TAXES, Vol 96, No. 04 (April 2018).

19 *D. Clifford Crummey*, CA-9, 68-2 USTC ¶12,541, 397 F2d 82.