# Estate & Gift Tax Planning using 529s

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DATE: September 8, 2015

# Agenda

- 529 Plan Basics
- Estate Planning Tax Benefits – Gift, Income & Estate
- Typical Donors
- Ownership Options
- Pros and Cons of 529 Plans v Custodial / Trust Accounts
- Resources
- Questions

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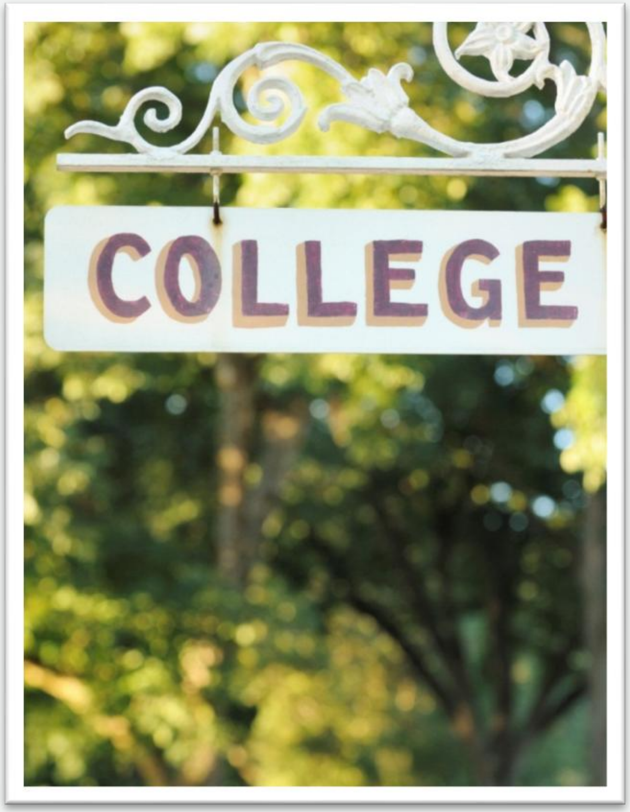
# CollegeInvest: Who we are

- Colorado Department of Higher Education
- Since 1979…
  - Scholarships
  - College Savings Plans
  - Financial Resources



# CollegeInvest:

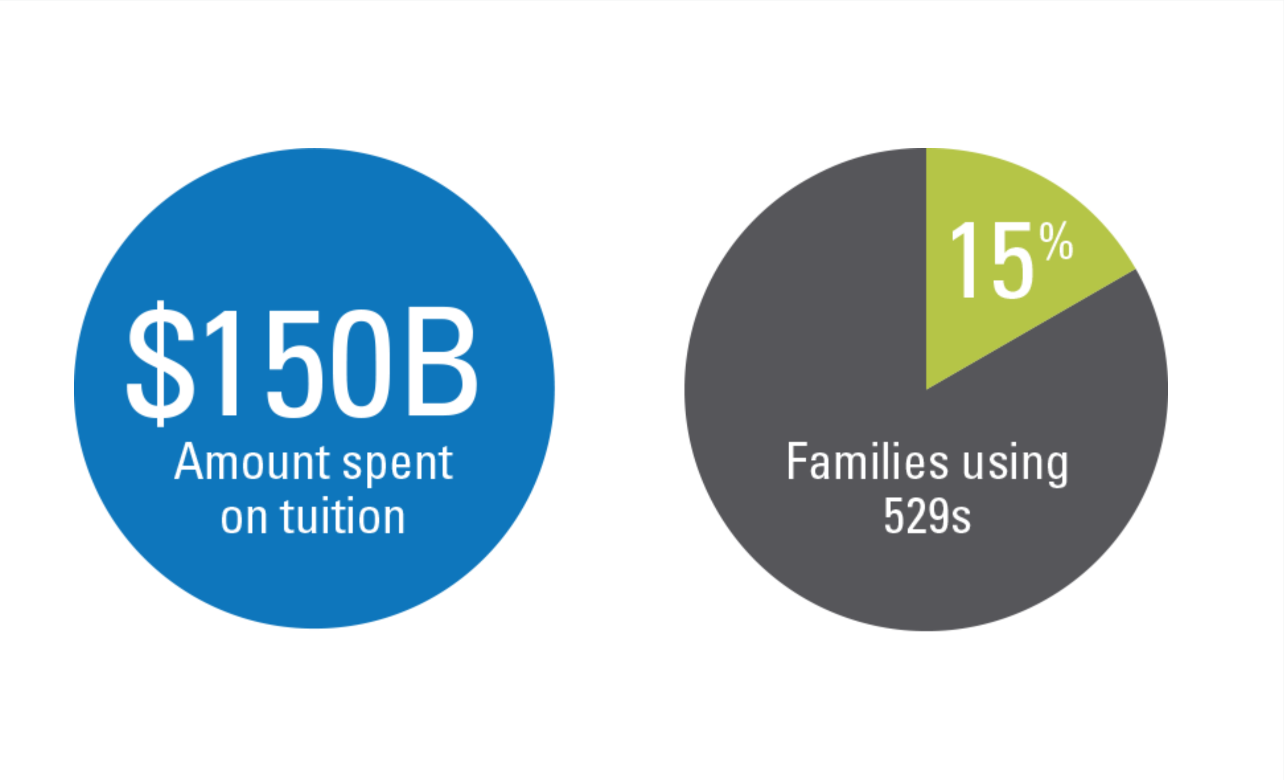
## VISION:

- To make higher education financially attainable by saving.

## MISSION:

- To be Colorado's trusted resource in breaking down the financial barriers to attaining a higher education through tax-advantaged college savings plans, scholarships, and matching grants.

# 529s: Overlooked Opportunity?




Sources: Strategic Insight, Sallie Mae; "How Americans Pay for College 2014."

# Basics - What is a 529 Plan?

Named after the federal tax code by which they are governed, 529 college savings plans are tax-favored, qualified tuition programs administered by each state, for the purpose of helping families save for college nationwide and, in many cases, overseas as well.

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# 529 Plan Overview

- **Administered** – By individual state
- **Managed** – By “program managers” (typically mutual fund firms)
- **Purchased** – Sold through advisors or directly purchased by account owners (online or paper application)
- **Investments** – Offers the opportunity to invest in various investment options, typically age-based and individual mutual fund options or cash-equivalents (Stable value and FDIC insured)
- **Tax Deduction**

  - in Colorado, contributors receive a dollar-for-dollar in-state tax deduction (up to the filer’s taxable income level).

Source: CollegeInvest, IRS (http://www.irs.gov/pub/irs-pdf/p970.pdf),
MSRB (http://emma.msrb.org/EducationCenter/FAQs.aspx?topic=PlanBasics)

# Distribution Guidelines

**Qualified Distributions** – "Qualified" educational expenses, at any higher education institution, which participates in the U.S. Department of Education's Federal Student Financial Aid program (which includes many non-US schools), including:

- Tuition
- Fees
- Room & Board
- Required Supplies. (H.R. 529 update)
- Computers

**Non-Qualified Distributions** – any earnings are subject to ordinary income tax + a 10% penalty.

Source: CollegeInvest, IRS (http://www.irs.gov/pub/irs-pdf/p970.pdf), MSRB (http://emma.msrb.org/EducationCenter/FAQs.aspx?topic=PlanBasics)

# Qualification Requirement for Owners & Beneficiaries

- **Account Owner:**
  - Must be a U.S. resident & have a Social Security or federal tax ID number
  - No age or income restrictions on owner or beneficiary
  - Maintains full control of the account, including distributions, investment choices & revocations
  - A successor account owner may be named to take over ownership of the account in the event of the account owner’s death or incapacity
- **Beneficiary:**
  - Does not need to be living in the U.S. at time of account opening, but must have a valid Social Security or Federal Tax ID number
  - May be changed to another “qualifying family member” of the beneficiary at any time without penalty or negative tax consequences
  - Accounts may be held without a beneficiary in the case of scholarship accounts or 501c(3) organizations as owners

# Typical Donors and Owners:

- Donors & Owners:
- Parents
- Grandparents
- Students / Beneficiaries
- Aunts, Uncles
- Other relatives
- Friends
- Colleagues
- Custodial Accounts
- Trust Accounts
- Charitable Organizations
- Employers

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# Limitations on Change of Beneficiary

**Beneficiary**

- Account owners may change the beneficiary. No 10% penalty or adverse income tax consequences if the new beneficiary is a "member of the family" of the current beneficiary:

- Natural or legally adopted children
- Parents or ancestors of parents
- Siblings or stepsiblings
- Stepchildren
- Grandchildren
- Stepparents
- First cousins
- Nieces or nephews
- Aunts or uncles

- The spouse of the original beneficiary or the spouse of any of those listed above also qualifies as a "family member. "

- If the new beneficiary is not a "family member, " the change is a non-qualified withdrawal, subject to federal and state income tax (including possible recapture of state deductions) on account earnings and may be subject to the 10% federal penalty.

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# General Tax Advantages

- Tax-deferred growth of assets (federal and state) while inside the plan.
- Tax-free distributions for qualified higher educational expenses (tuition, room and board, books, fees and required equipment).
- Allowance of tax-free rollovers once per rolling 12 calendar months, per beneficiary, into another account for the same beneficiary in a *different state's* 529 plan account.

# Estate Tax Planning with 529s

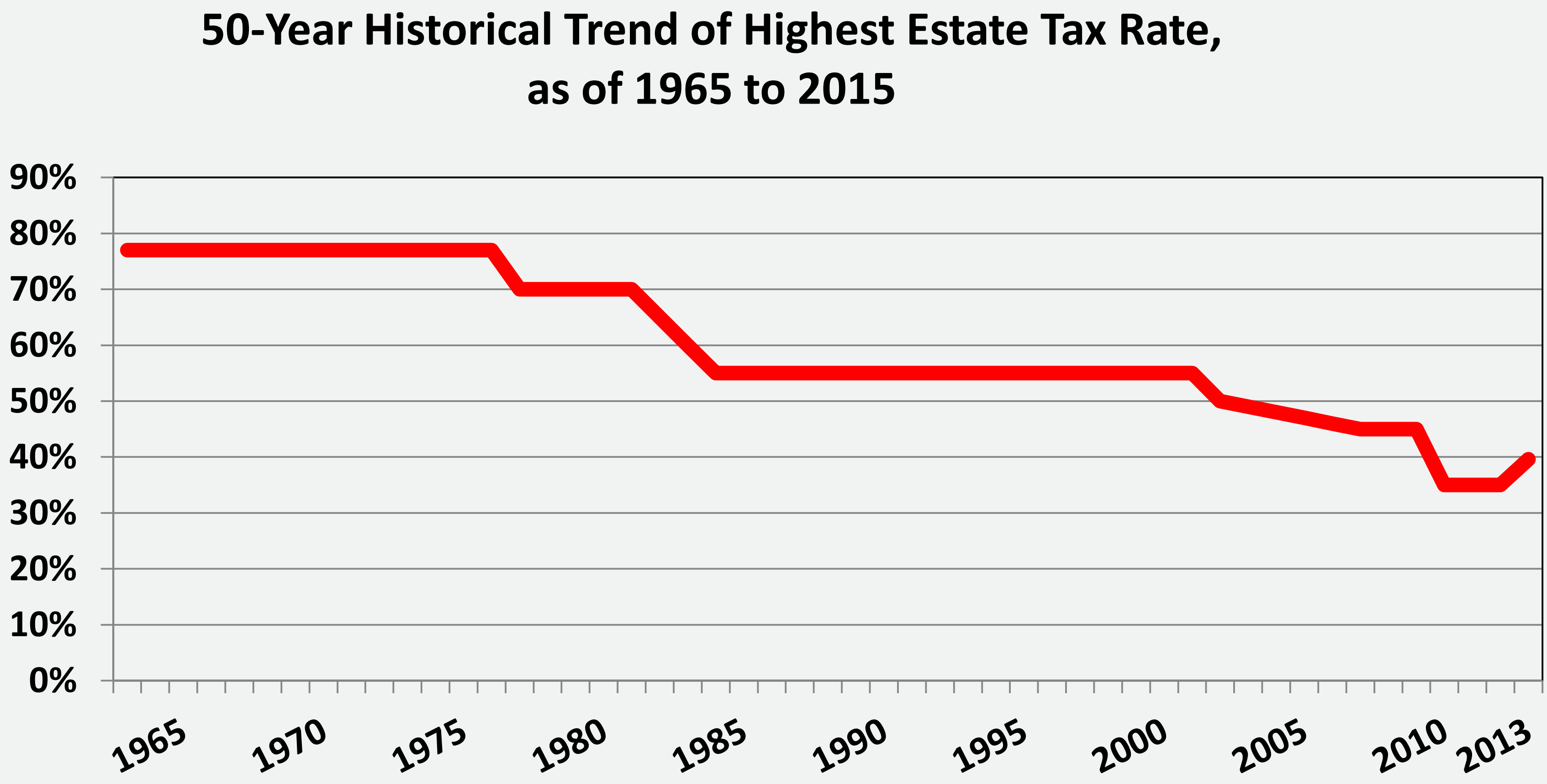
- Current Exemption – the federal unified "Lifetime" exemption from gift & estate tax for individuals is currently $5.43 million*

- Estate Tax Rate – for estates valued over $5.43 million, the current Estate Tax rate is 40%.

- Forward Elections

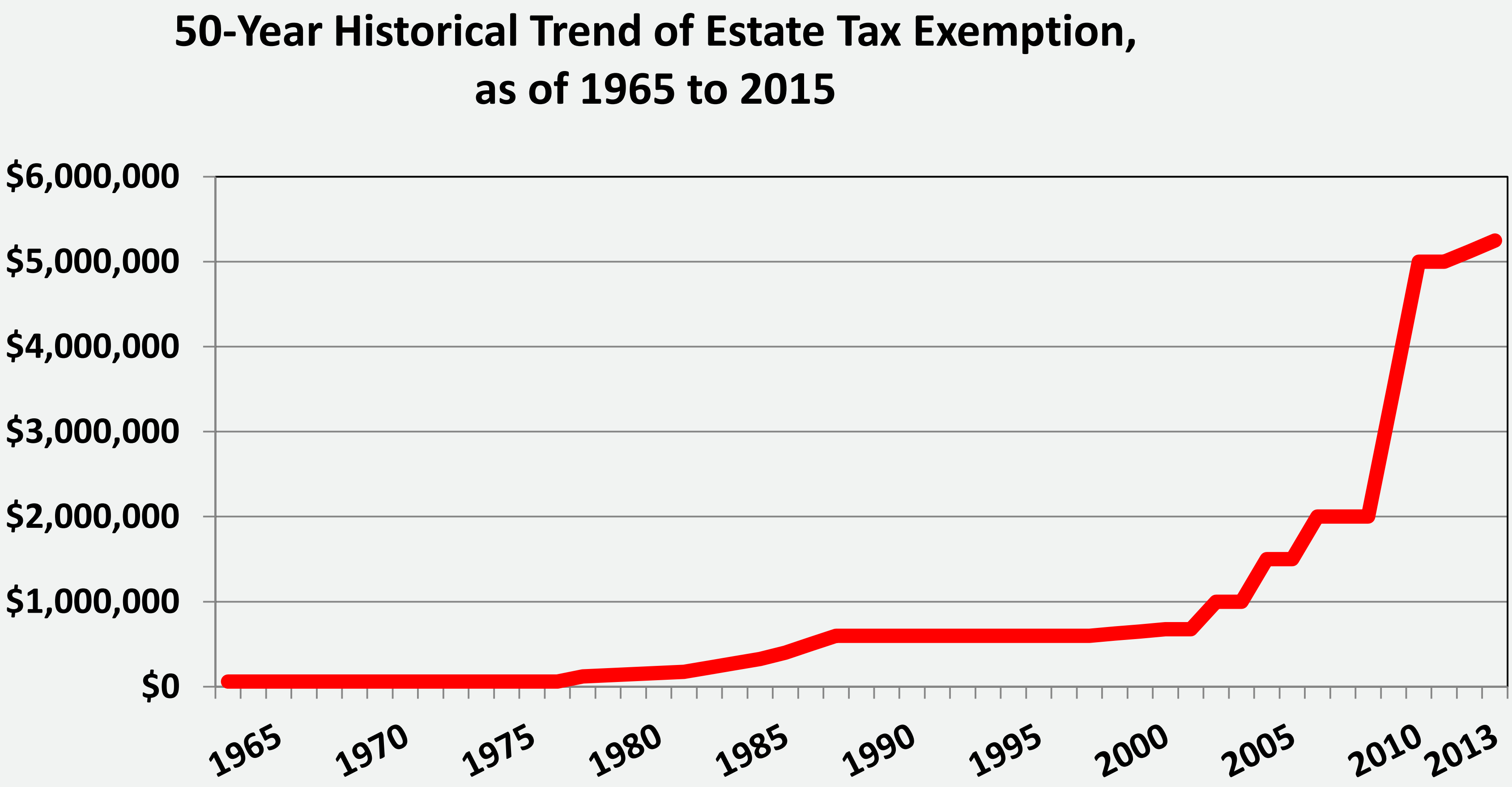
*Exemption indexed to inflation annually. **As of 2014. Source: IRS Publication 950

# 50-Year History of Estate Tax Rates




Sources: IRS (http://www.irs.gov/uac/Newsroom/Annual-Inflation-Adjustments-for-2013),
IRS (http://www.irs.gov/pub/irs-soi/ninetyestate.pdf)

# 50-Year History of Estate Tax Exemption




Sources: IRS (http://www.irs.gov/uac/Newsroom/Annual-Inflation-Adjustments-for-2013),
IRS (http://www.irs.gov/pub/irs-soi/ninetyestate.pdf)

# Gift Tax Exclusion

- **Federal Gift and Transfer Tax Exclusions:**
  - **Gift Tax Exclusion**: A donor may give up to $14,000 per year without paying gift tax. The amount is $14,000 for 2015, and may change over time.
  - **Generation-Skipping Transfer Tax Exclusion**: A donor may give up to $5.43 million over the course of his/her lifetime to any chosen beneficiary(ies) without paying gift or estate tax. The amount may change over time as indicated in the next slide.

Source: IRS (http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/What%27s-New---Estate-and-Gift-Tax; http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Frequently-Asked-Questions-on-Gift-Taxes#2)

# Gift & Generation-Skipping Taxes

- **Federal Gift or Transfer Tax Do Not Apply When:**
  - A change of the beneficiary to another qualified “family member”
  - A transfer of an account to another qualified “family member”
- **Exclusions**
  - Donor may be able to qualify for a limited gift tax exclusion to anyone including “family members”
  - Donor may be able to qualify for a limited generation-skipping transfer (GST) exclusion when the beneficiary is two or more generations younger than the account owner such as between grandparents and grandchildren.

Source: IRS (http://www.irs.gov/irm/part7/irm_07-025-044.html; http://www.irs.gov/pub/irs-pdf/p950.pdf)

# Gifting Pursuant to Section 2503 versus a 529

- **Direct Payments for Educational Expenses**
  - Unlimited direct payments to the educational institution
- **Shortcomings:**
  - Mortality risk
    - If donor dies before direct payment, the assets are subject to estate tax and not available to the beneficiary
  - Tuition only
    - Not for books, supplies, dorm fees, meal plans, computers or similar expenses
  - Financial aid impact
  - Student must be a full- or part-time student at the time of payment

Source: IRS (http://www.irs.gov/pub/irs-pdf/p970.pdf;
http://www.gpo.gov/fdsys/pkg/USCODE-2011-title26/pdf/USCODE-2011-title26-subtitleB-chap12-subchapA-sec2503.pdf)
IRS Publication US Code 2011 Title 26 Subtitle B Chapter 12 Subchapter A, Section 2503, page 2444);
http://www.gpo.gov/fdsys/pkg/CFR-2011-title34-vol3/pdf/CFR-2011-title34-vol3-sec673-5.pdf;
page 673.5 in section: 34 CFR 673.5(c)(1)(xiii));
http://thechoice.blogs.nytimes.com/2012/01/13/kantrowitz-answers-part-5/?_r=0;
http://www.fastweb.com/financial-aid/articles/3673-paying-the-college-directly-to-avoid-gift-taxes

# Gift Tax Forwarding Election

- **Forwarding Election:**

**529 Plans allow a lump sum contribution in an amount equal to five times the federal annual gift tax exclusion up to $70,000 ($140,000 if married couple) per beneficiary in a single year, with his special five-year forwarding gift election.**

- Pares down donor's estate, which reduces potential estate tax liabilities
- Considered completed gift
- Eliminates annual income tax that otherwise would be paid on investment earnings
- Value of the account will be included in the beneficiary's estate
- Permits tax-free growth outside of donor's estate
- Example #1

Source: IRS (www.irs.gov/pub/irs-pdf/p950.pdf)

# Example 1 - Forward Election

## Total Contribution Over 10 Years: $200,000

| Donor Contributor | Year Amount | Amount of Gift Contribution | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 |
| Grandfather | 2015: $70,000 | $14,000 | $14,000 | $14,000 | $14,000 | $14,000 | | | | | |
| Grandmother | 2015: $14,000 | $14,000 | | | | | | | | | |
| Grandmother | 2016: $46,000 | | $9,200 | $9,200 | $9,200 | $9,200 | $9,200 | | | | |
| Grandfather | 2020: $70,000 | | | | | | $14,000 | $14,000 | $14,000 | $14,000 | $14,000 |
| | | | | | | | | | | | |
| **Total Contributed Per year** | | **$28,000** | **$23,200** | **$23,200** | **$23,200** | **$23,200** | **$23,200** | **$14,000** | **$14,000** | **$14,000** | **$14,000** |

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# Forward Election Caveat

- **Forward gifted amounts inside a 529 are not considered part of an estate**
  - Forward gifted amounts, with the exception of any earnings, will be counted as part of the estate if the donor passes away within the 5-year timeframe.

Source: IRS (http://www.irs.gov/irb/2008-09_IRB/ar17.html#d0e2976; http://www.irs.gov/irb/2008-09_IRB/ar17.html); http://www.gpo.gov/fdsys/pkg/USCODE-2011-title26/pdf/USCODE-2011-title26-subtitleA-chap1-subchapF-partVIII-sec529.pdf)

# Example 2 - Forward Election

## Grandparents Gifting to Two Grandchildren; Death of Donor

| Recipient | Year Amount | Amount of Gift Contribution | | | | |
|---|---|---|---|---|---|---|
| | | 2015 | 2016 | 2017 | 2018 | 2019 |
| Grandchild 1 | 2015: $140,000 | $28,000 | $28,000 | $28,000 | $28,000 | $28,000 |
| Grandchild 2 | 2015: $140,000 | $28,000 | $28,000 | $28,000 | $28,000 | $28,000 |
| | | | | | | |
| **Total Contributed Per Year** | | **$56,000** | **$56,000** | **$56,000** | **$56,000** | **$56,000** |
| **Removed from Estate** | | **$56,000** | **$56,000** | **$56,000** | **$56,000** | **$0** |

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# Qualifies for State Income Tax Deductions & Credits

- **Refundable Credit**
  - IRS Definition: If the total of certain credits, withheld federal income tax and estimated tax payments is more than your total tax, the excess can be refunded to the taxpayer.
- **Implications for 529s**
  - Certain states offer state income tax deductions for contributions to 529 plans
    - In Colorado, the donor receives a dollar-for-dollar refundable deduction up to the resident's taxable income level.
    - In Utah, the donor receives a 5% state income tax credit up to $95 per beneficiary for single taxpayers. Amount increases to $190 for married couple, and increases each year.
  - Contributing to 529 plans may take the tax payment due down to zero.

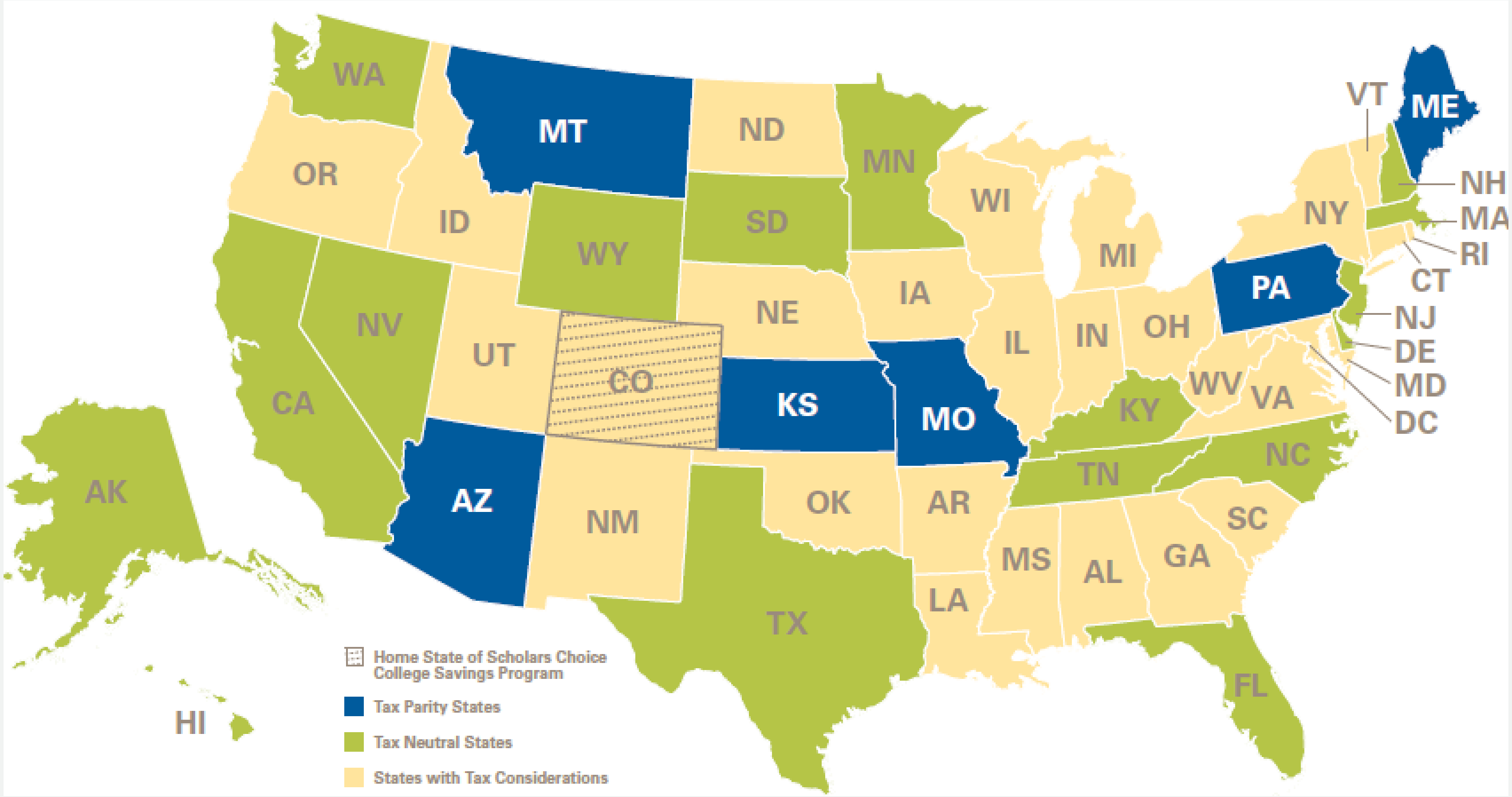
Source: IRS (http://www.irs.gov/publications/p17/ch36.html#en_US_2012_publink1000174964)
UESP (http://www.uesp.org/taxadvantages?gclid=CLj_5sC387kCFcqZ4AodHw4AEQ)

# Estate Tax Benefits of 529 Plans

- **Key features of combining the capabilities of estate planning with 529s**
  - Use special gift tax exclusion:
    - Leverage $14,000 annual gift tax exclusion
    - 5-year gift tax forwarding election funding in one calendar year
  - Maximize capabilities of 529 plans with trusts
    - Eliminates mortality risk with corporate trustee as owner
    - Prevents untimely termination of 529 plan by individual owner
  - Reduce assets subject to the $5.43 million estate tax exemption.

# State Tax Map:





# Donor / Owner Benefits of 529 Plans

- **Reduce Exposure to Estate Tax (D)**
  - Considered completed gift so not subject to estate tax and removes mortality risk
- **Available for All QUALIFIED Expenses (O, D)**
  - Expands usage of direct payment from tuition to other qualified expenses (books, supplies, room & board, required computers and equipment)
- **Financial Aid Impact (O, D)**
  - For third-party owners such as grandparents, assets do not impact the financial aid calculation, but distributions can increase the financial aid calculation by as much as 50% the following year because those distributions are treated as unearned income
- **Student Status (O)**
  - Can be full-time, part-time or credit-by-credit basis student, or not currently enrolled

Source: IRS (http://www.irs.gov/pub/irs-pdf/p970.pdf; http://www.gpo.gov/fdsys/pkg/USCODE-2011-title26/pdf/USCODE-2011-title26-subtitleB-chap12-subchapA-sec2503.pdf)

# Donor / Owner Benefits of 529 Plans (continued)

- **Retained Control (O)**
  - Ensure assets are spent on education as assets are revocable
  - Depending on family situations, changes in beneficiaries can be made
- **Unlimited Number of Beneficiaries (D)**
  - One owner and one beneficiary per 529 account
- **No Expiration Date (O)**
  - 529 assets are revocable and tax-advantaged
- **Solution for Required Minimum Distributions (D)**
  - Clients who don’t need their required minimum distributions can reinvest those assets in 529 plans
- **Potentially Qualifies for State Tax Deductions or Credits (D)**

Source: IRS (http://www.irs.gov/pub/irs-pdf/p970.pdf)

# Pros and Cons of 529 Plans versus Custodial / Trust Accounts

- Advantages of Selecting 529 Plan
- Advantages of Selecting Custodial or Trust Account
- Considerations in Allocating Custodial Assets to Fund a 529 Plan
- Advantages of Trust-Owned 529 Plans – Two Versions

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# Advantages of Selecting 529s Over Custodian /Trust Accounts

- Owners retains control of assets
- Asset growth & qualified withdrawals are tax free
- Investment income not subject to federal "kiddie tax"
- State income tax advantages in some states.
- No time/age restrictions (unless imposed by plan)
- Counted as parent's asset for financial aid purposes (assessed by college at lower parental asset rate of 5.64% than a student's non-529 asset rate of 20%)
- Owner may make non-qualified withdrawals (subject to income tax and 10% federal penalty)
- Less expensive to set up and maintain

Source: FINRA (http://www.finra.org/web/groups/investors/@inv/@smart/@college/documents/investors/p124094.pdf); IRS (http://www.irs.gov/pub/irs-pdf/p970.pdf; http://www.irs.gov/pub/irs-pdf/p929.pdf; http://www.irs.gov/taxtopics/tc553.html; http://www.irs.gov/pub/irs-pdf/i8615.pdf)

# Advantages of Selecting Custodial / Trust Accounts over 529 Plans

- **Investment Flexibility**
  - Custodial / Trust Accounts are not limited to a lineup of available options
- **Contribution Flexibility**
  - Custodial / Trust Accounts do not have a maximum contribution limit in comparison to any given state's 529 contribution limit ($350k, CO)
- **Qualified Usage**
  - Use of assets are not restricted to qualified education expenses
    - However, assets must be used for the benefit of the child
  - Can be used for non-qualified education expenses
    - TRAVEL to and from college, dorm room supplies, medical expenses, etc.

Source: IRS (http://www.irs.gov/pub/irs-pdf/p970.pdf)

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# Considerations re Custodial Assets to Fund a 529 Plan

**Pros:**

- 529 plan assets are not subject to termination at a given age
- Avoid having to pay taxes on the earnings year-over-year
- Increase potential of qualifying for financial aid

**Cons:**

- Beneficiary will still assume control when reaching age 18 or 21
- 529 assets transferred from Custodial / Trust Accounts can't be transferred to a new beneficiary
- 529 plans can only be funded in cash
  - Assets in custodial / trust accounts need to be sold prior to transferring
  - Sale could trigger taxable event - capital gains

Source: IRS(http://www.irs.gov/pub/irs-pdf/p970.pdf);
FINRA (http://www.finra.org/web/groups/investors/@inv/@smart/@college/documents/investors/p124094.pdf)

# Advantages of a Trust-Owned 529 Plan – Version 1

- **Setting Up a 529 Plan Account with a Trust as the Account Owner *outside* the main Trust Account**
  - Eliminates any year-over-year taxes on 529 Plan earnings
    - Helps to offset the expenses of the trust (trust accounting costs, attorney fees, custody charges, court fees, etc.)
    - Especially beneficial for trusts in order to avoid the compressed tax brackets imposed on trusts
  - Maximizes the after-tax return on assets in trust intended for education
  - Simplifies the trust's investment options for the assets in the 529 plan and could reduce trustee fees
  - Helps to ensure assets are ultimately used for higher education

Source: IRS Form 1041-ES (http://www.irs.gov/pub/irs-pdf/f1041es.pdf)
http://www.morningstaradvisor.com/articles/printfriendly.asp?s=&docId=12968&print=yes;
http://wills.about.com/library/rp-13-15.pdf

# Advantages of a Trust-Owned 529 Plan – Version 2

**Revocable Trusts:**

- Set up a separate 529 plan subaccount *within* the trust account prior to funding.
- Trust should contain provisions authorizing or directing 529 plan investments and the trustee's right to change account owner and/or beneficiary of the 529 plan. Consider adding a provision directing the trustee not to include the value of the funds in the 529 plan to the market value fee calculation for all the other assets in the trust account.

**Irrevocable Trusts:**

- Set up a separate 529 subaccount within the trust account for 529 plan prior to funding.
- For **new** irrevocable trusts, include provisions noted above.
- For **existing** irrevocable trusts, trustee will have to look to the terms of trust to determine if investment in a 529 plan is authorized if investment in a 529 plan is authorized or directed.

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# Income Tax Rate Schedule for Estates and Trusts

Tax Rate Schedule, 2015:

| Taxable Income Over | But Not Over | The Tax Is | Of the Amount Over |
|---|---|---|---|
| $0 | $2,500 | 15% | $0 |
| $2,500 | $5,900 | $375 + 25% | $2,500 |
| $5,900 | $9,050 | $1,225 + 28% | $5,900 |
| $9,050 | $12,300 | $2,107 + 33% | $9,050 |
| $12,300 | — | $3,179.50 + 39.6% | $12,300 |

*Source: IRS (http://www.irs.gov/pub/irs-pdf/f1041es.pdf)*

# Additional Information, Important Resources

- Resources to Learn More
- Questions?
- Important Disclosure

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# Important Resources

- IRS Publication 970: Tax Benefits for Education
- IRS Tax Topics
- IRS Tax Tips
- http://www.irs.gov/irm/part7/irm_07-025-044.html
- FINRA.org "Smart Saving for College – Better Buy Degrees"
- www.collegeinvest.org
- www.fafsa.ed.gov
- www.nces.ed.gov
- www.savingforcollege.com

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# Important Resources, cont'd.

- IRS Publication 929: Children and Dependents
- IRS Publication 950: Estate and Gift Taxes
- IRS-2013-4 Announcement (http://www.irs.gov/uac/Newsroom/Annual-Inflation-Adjustments-for-2013)
- MSRB Education Center (http://emma.msrb.org/EducationCenter/529Plans.aspx)
- eFile.com on Exclusions (http://www.efile.com/tax/estate-gift-tax/#exclusions)
- H.R. 529 (http://www.law.cornell.edu/uscode/text/26/529)

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# Important Resources, cont'd.

- http://www.gpo.gov/fdsys/pkg/CFR-2011-title34-vol3/pdf/CFR-2011-title34-vol3-sec673-5.pdf
  - page 673.5 in section: 34 CFR 673.5(c)(1)(xiii))
- http://thechoice.blogs.nytimes.com/2012/01/13/kantrowitz-answers-part-5/?_r=0
- http://www.fastweb.com/financial-aid/articles/3673-paying-the-college-directly-to-avoid-gift-taxes
- http://taxandaccounting.bna.com/btac/display/batch_print_display.adp?searchid=24738186

# Wrap Up & Questions

## Questions?

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