The Section 529 College Savings Account: A Gift and Estate Tax Planning Perspective

By Kristen M. Walsh

As the costs of post-secondary education outpace the consumer price index and household incomes, parents must carefully plan to pay for the education of their children. This financial planning often includes a qualified tuition plan authorized by § 529(b) of the Internal Revenue Code (a 529 account).[1] A 529 account is a tax-advantaged savings vehicle established solely for paying the account's qualified education expenses. It provides not only an opportunity for education savings, but also opportunities to reduce both income tax and estate tax exposure while allowing the contributor continued control over the 529 account funds. This article discusses how a 529 account works as well as its advantages from a gift and estate tax planning perspective.

The 529 Account

An individual can set up a 529 account for a named beneficiary (the "beneficiary") and manage the account and distributions from it as the account owner (the "owner"). The owner is also typically the person who contributes cash to the account (the "contributor"). There is no income limit restricting who can contribute to a 529 account. A 529 savings plan program is established and maintained by a state or state agency.

Unlike other types of savings accounts, funds in a 529 account are exempt for federal income tax purposes and can grow income tax-free. The funds will not be subject to income tax upon withdrawal so long as the amounts withdrawn are used to pay the qualified education expenses of the beneficiary (discussed below). The 529 account is funded with after-tax dollars and there is no federal income tax deduction available for 529 account contributions; however, many states allow state income tax deductions for account contributions, though there is often a cap on the state deduction. New York, for example, allows a deduction of up to $10,000 per year for married couples filing jointly and $5,000 per year for a single taxpayer for contributions to its "Direct Plan."[2]

Qualified educational expenses include tuition, room and board expenses, enrollment fees, books, supplies, computers and computer equipment, as well as certain other expenses incurred by students with special needs.[3] Qualified tuition expenses are not limited if related to post-secondary education expenses. However, § 529 limits qualified withdrawals for elementary or secondary education expenses to $10,000 per year per beneficiary and payment of principal and interest on qualified loan repayments are limited to a lifetime total of $10,000.[4] It is important to note, however, that withdrawals used to pay for such qualified loan repayments or elementary or secondary education are not considered qualified for New York income tax purposes, and state tax benefits that have accrued may be subject to recapture.

The tax year of withdrawal must be the same as the tax year the expense is paid in order to avoid a taxable event. Withdrawing more than the amount of qualified expenses will make the earnings attributed to that portion taxable income at the beneficiary's income tax rate and subject to a 10% penalty.[5] If an excess withdrawal is made, it can be corrected without penalty by depositing the excess into another 529 account for the same within a 60-day period.

As of this writing, unused funds in a 529 account must be distributed to a 529 account for a different beneficiary or distributed outright to the original beneficiary, subject to taxes and penalties. However, beginning in 2024, unused funds in a 529 account of up to $35,000 can be transferred to a Roth IRA via direct trustee-to-trustee transfer in the name of the original 529 account beneficiary, provided certain conditions are met.[6] For example, the 529 account must have existed for at least 15 years and the amount must fall within the taxpayer's regular IRA contribution limit for the year.

In addition, 529 account assets can be rolled over into an ABLE plan account without triggering income tax, subject to the ABLE account limits, until December 31, 2025.[7]

Gift and Estate Tax Planning Considerations

The 529 account is also a useful gift and estate planning device if education savings for beneficiaries is desired.[8] Contributions to a 529 account are eligible for the annual gift tax exclusion, meaning that the contributor can give up to $17,000 per recipient per year (or $34,000 if the contributor is married and his/her spouse agrees to "split" the gift)[9] to a 529 account without triggering the need to file a gift tax return and use up part of the contributor's available lifetime gift and estate tax exemption.[10] In addition, a contributor can front-load a 529 account and contribute up to five times the annual gift tax exclusion amount by electing to treat a 529 account contribution as made over a

five-year period. This allows compounded opportunity for tax-free appreciation within the 529 account. A transfer to a 529 account within these limits is also not subject to generation-skipping transfer tax. The account value is not includible in the owner's taxable estate.

The owner retains control over the funds for the life of the 529 account. Only the owner, and not the beneficiary, can access the funds in the 529 account. This makes the 529 account a more attractive option than a custodial account (such as a Uniform Transfer to Minors account), which the beneficiary is entitled to access upon reaching the applicable age of majority (typically 18 or 21 years of age).

Funds in the 529 account are generally considered on a beneficiary's federal financial aid application. However, there are some special rules for 529 accounts owned by the beneficiary's grandparent (or any individual other than the beneficiary's parent). Unlike a parent-owned 529 account, funds in a grandparent-owned 529 account do not factor into a beneficiary's federal financial aid formula; however, withdrawals from a grandparent-owned 529 account do count as income to the beneficiary and have an impact on eligibility for financial aid in the following year.

If the funds are not exhausted on the educational expenses of the original beneficiary, the designated beneficiary can be changed without consequence so long as the new beneficiary is (1) a member of the family of the original and (2) is assigned to the same or higher generation of the original beneficiary. This change of is not a taxable gift and is not subject to generation-skipping transfer tax if those criteria are met.

Finally, the owner can and should designate a successor owner upon creation of the 529 account. Even though the 529 account is not includible in the account owner's taxable estate, a fiduciary would need to be appointed by the Surrogate's Court having jurisdiction over the owner's estate in order to transfer ownership of the account upon the owner's death if a successor owner is not named.

Conclusion

529 accounts offer unique benefits for saving for education, including reducing income tax exposure, reducing the estate tax exposure of the contributor, and allowing the contributor to retain control of the assets with ease of management and flexibility. While the rules can be intricate and vary by state, individuals can look to 529 accounts as opportunities for financial planning with gift and estate tax advantages.

Endnotes

1. 26 U.S.C. § 529. Although there are two types of § 529 plans, this article will focus on the 529 account authorized by § 529(b)(1)(A)(ii) rather than the prepaid tuition program authorized by § 529(b)(1)(A)(i). The prepaid tuition program allows an individual to purchase tuition credits for participating educational institutions at the current tuition rates, avoiding the risk of future tuition increases. The beneficiary can use the credits as payment for tuition at those participating institutions or redeem the credits for cash to pay for a non-participating institution (possibly incurring a penalty for the latter).
2. *See* N.Y. Consol. Law, Ch. 60, art. 22§ 612(c)(32).
3. *See* 26 U.S.C. § 529(e)(3)(A).
4. *See id.*; 26 U.S.C. § 529(c)(9)(B).
5. *See* 26 U.S.C. § 529(c)(6).
6. *See* Consolidated Appropriations Act, 2023, PL 117-328, 136 Stat 4459 (2022).
7. *See* 26 U.S.C. § 529(c)(3)(C)(i)(III).
8. It is important to note that tuition paid directly to a qualifying educational organization on behalf of a beneficiary for that beneficiary's education is a gift tax exclusion not subject to gift tax. 26 U.S.C. § 2503(e). However, this exclusion applies only for direct payment tuition and not to other education expenses or college savings.
9. *See* 26 U.S.C. § 2503(b). These amounts are for 2023 and subject to change.
10. *See id.* Gift splitting is permitted only if both spouses consent to split all their gifts for the calendar year by filing a gift tax return and certain other requirements are met. 26 U.S.C. § 2513; 26 C.F.R. § 25.2513-2(a).

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