529 Plans: Estate Planning Magic

Article By:

The most common way to reduce state and federal estate taxes is to make lifetime gifts to irrevocable trusts. However, in order for an irrevocable trust to escape estate taxation at the grantor's death, the grantor may not retain the power to "designate the persons who shall possess or enjoy the property or the income therefrom." (IRC § 2036(a)(2).) In other words, the grantor cannot change the beneficiaries of the trust.

This poses a problem. What if circumstances change? What if a grantor creates a trust for a child, but the child no longer needs the funds? What if the grantor ends up needing the funds themselves? A grantor can build flexibility into irrevocable trusts by granting powers of appointment to the beneficiaries or by appointing a trust protector, but these powers may not be held by the grantor. Thus, reluctance to give up control keeps many clients from making gifts to irrevocable trusts.

The general rule that a grantor must relinquish all control over gifted assets has been seared into the mind of every estate planning professional fearful of accidentally causing estate tax inclusion. But there is one exception: the humble 529 Plan.

Section 529 of the Code contains a shocking statement:

"No amount shall be includible in the gross estate of any individual for purpose of [the estate tax] by reason of an interest in a qualified tuition program." (IRC § 529(c)(4)(A))

There are, of course, exceptions. 529 plans are (likely) includible in the estate of the beneficiary upon the beneficiary's death. Also, if the grantor has made the election to "front load" five years of annual exclusion gifts to the 529 Plan (discussed further below) and dies before the five years expires, a portion of the gifted amount will be includible in the grantor's estate.

Still, 529 Plans offer unparalleled flexibility in estate tax planning. A grantor can remain the "owner" of a 529 Plan and retain the power to change the beneficiary to a qualifying family member (which includes grandchildren, nieces and nephews, and others), while still removing the assets in the 529 Plan from his or her estate. This is in contrast with an irrevocable trust, in which the grantor cannot act as trustee and cannot retain the power to change the beneficiaries.

The other "magic" of 529 Plans is the ability to "front load" annual exclusion gifts. The annual exclusion from gift tax allows a grantor to transfer up to $15,000 per year, per person. But, if a grantor makes the proper election on a gift tax return, he or she can make five years of annual exclusion gifts in a single year and use no transfer tax exemption. If the grantor is married and elects "gift?splitting," the couple can transfer $150,000 to a 529 Plan in a single year and use *no* estate and gift tax exemption.

529 Plans are, of course, designed for education, and are not complete substitutes for irrevocable trusts. The "earnings portion" of non-qualified distributions (i.e., distributions not used for "qualified higher educational expenses") from a 529 Plan are subject to ordinary income tax at the beneficiary's tax rate plus a 10% penalty, and for this reason, care should be taken not to "overfund" a 529 Plan. However, 529 Plans can nevertheless serve as effective wealth transfer vehicles because of their income tax benefits and the high probability that a grantor will wish to make significant contributions to the education of at least *some members* of his or her family. Combined with their unparalleled estate tax features, this makes 529 Plans "estate planning magic."

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