529 Plans: Estate Tax and Income Tax Advantages

Article By:

John P. Dedon

The $5 million exemption from **federal estate tax** eliminates the need for many to do complex estate planning. Because the exemption amount is indexed for inflation, a married couple's assets must exceed $10,680,000, before estate tax would apply, and then only at the second of their deaths.

So in contrast to prior years, when many taxpayers were encouraged to make lifetime gifts to reduce a 55% federal estate tax, now the advice for all but the very wealthy is to retain your assets to ensure there is enough to live on for your lifetime. Passing assets at death has a second advantage: the recipient of the assets obtains a "step up" in the assets' basis to fair market value, thereby avoiding income tax on the sale.

When is gifting appropriate for tax purposes? Certainly taking advantage of 529 plans makes sense for grandparents and parents seeking to accumulate funds for run-away college tuition costs. Contributions to a 529 plan are treated as gifts for tax purposes. The contributions qualify for the $14,000 annual gift tax exclusion (also indexed for inflation). Also, contributions can be pre-funded for five years, meaning $70,000 per parent (or $140,000 for a married couple). Thus, funds in the 529 are removed from the donor's estate faster than if contributions were made each year. The donor must survive the five years, or a portion of the gift is retained to the taxable estate.

For federal income tax purposes, the investment grows tax-free, and distributions to pay for the beneficiary's college costs come out tax-free. State law can affect the state income tax treatment.

There are other advantages, such as the donor controls the funds in the 529. Contrast the donor's control over a 529, with the donor's lack of control (1) in a custodial account, where the recipient receives the funds at either age 18 or 21; or (2) with other gift strategies, where typically control is lost in order to receive the benefit of estate tax exclusion. Perhaps the only disadvantage for 529's is if you are relying on financial aid, the 529 can be considered an asset, depending on who set up the plan, such as a parent or grandparent.

Even though many gifts no longer make tax sense, 529 plans remain viable options for both estate tax exclusion and income tax reduction, without much complexity and cost.

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