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Estate Planning and 529 Plans

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When you contribute to a 529 plan, you'll not only help your child, grandchild, or other loved one pay for college, but you'll also remove money from your taxable estate. This will help you minimize your tax liability and preserve more of your estate for your loved ones after you die. So, if you're thinking about contributing money to a 529 plan, it pays to understand the gift and estate tax rules.

Overview of gift and estate tax rules

If you give away money or property during your life, you may be subject to federal gift tax (and, in certain states, state gift tax). The money and property you own when you die may also be subject to federal estate tax and some form of state death tax.

Federal gift tax generally applies if you give someone more than the annual gift tax exclusion amount, currently \$13,000, during the tax year. (There are several exceptions, though, including gifts you make to your spouse.) That means you can give up to \$13,000 each year, to as many individuals as you like, gift tax free. In addition, you're allowed a gift tax credit, which effectively exempts from gift tax up to \$1 million in gifts that you make during your lifetime which would otherwise be subject to tax.

When you die, your estate will be entitled to a tax credit for federal estate tax purposes. In 2009, this credit effectively exempts up to \$3.5 million from federal estate tax. However, this estate tax credit will be reduced by the amount of any gift tax credit used during your lifetime. Because the credit works this way, it is often referred to as the "unified credit," but the amount excluded from tax is more properly known as the "applicable exclusion amount."

Note: Since state tax treatment may differ from federal tax treatment, look to the laws of your state to find out how your state will treat a 529 plan gift.

Contributions to a 529 plan are treated as (federal) gifts to the beneficiary

A contribution to a 529 plan is treated under the federal gift tax rules as a completed gift from the donor to the designated beneficiary of the account. Such contributions are considered present interest gifts (as opposed to future or conditional gifts) and qualify for the annual federal gift tax exclusion. This means that you can contribute up to \$13,000 per year to the 529 account of any beneficiary without incurring federal gift tax.

So, if you contribute \$15,000 to your daughter's 529 plan in a given year, for example, you'd ordinarily apply this gift against your \$13,000 annual gift tax exclusion. This means that although you'd need to report the entire \$15,000 gift on a federal gift tax return, you'd show that only \$2,000 is taxable. Bear in mind, though, that you must use up your applicable exclusion amount of \$1 million before you'd actually have to write a check for the gift tax.

Special rule if you contribute over \$13,000 in a year

Section 529 plans offer a special gifting feature. Specifically, you can make a lump-sum contribution to a 529 plan of up to \$65,000, elect to spread the gift evenly over five years, and completely avoid federal gift tax, provided no other gifts are made to the same beneficiary during the five-year period. A married couple can gift up to \$130,000.

For example, if you contribute \$65,000 to your son's 529 account in one year and make the election, your contribution will be treated as if you'd made a \$13,000 gift for each year of a five-year period. That way, your \$65,000 gift would be nontaxable (assuming you didn't make any additional gifts to your son in any of those five years). A married couple can make a joint gift of up to \$130,000.

If you contribute more than \$65,000 (\$130,000 for joint gifts) to a particular beneficiary's 529 plan in one year,

the averaging election applies only to the first \$65,000 (\$130,000 for joint gifts); the remainder is treated as a gift in the year the contribution is made.

What about gifts from a grandparent?

Grandparents need to keep the federal generation-skipping transfer tax (GSTT) in mind when contributing to a grandchild's 529 account. The GSTT is a tax on transfers made during your life and at your death to someone who is more than one generation below you, such as a grandchild. The GSTT is imposed in addition to (not instead of) federal gift and estate taxes. Like the applicable exclusion amount, though, there is a GSTT exemption, which is \$3.5 million in 2009. No GSTT will be due until you've used up your GSTT exemption, and no gift tax will be due until you've used up your applicable exclusion amount.

If you contribute no more than \$13,000 to your grandchild's 529 account during the tax year (and have made no other gifts to your grandchild that year), there will be no federal tax consequences--your gift qualifies for the annual federal gift tax exclusion, and it is also excluded for purposes of the GSTT.

If you contribute more than \$13,000, you can elect to treat your contribution as if made evenly over a five-year period (as discussed previously). Only the portion that causes a federal gift tax will also result in a GSTT.

Note: Contributions to a 529 account may affect your eligibility for Medicaid. Contact an experienced elder law attorney for more information.

What if the owner of a 529 account dies?

If the owner of a 529 account dies, the value of the 529 account will not usually be included in his or her estate. Instead, the value of the account will be included in the estate of the designated beneficiary of the 529 account.

There is an exception, though, if you made the five-year election (as described previously) and died before the five-year period ended. In this case, the portion of the contribution allocated to the years after your death would be included in your federal gross estate. For example, assume you made a \$50,000 contribution to a college savings plan in Year 1 and elected to treat the gift as if made evenly over five years. You die in Year 2. Your Year 1 and Year 2 contributions of \$10,000 each (\$50,000 divided by 5 years) are not part of your federal gross estate. The remaining \$30,000 would be included in your gross estate.

Some states have an estate tax like the federal estate tax; many states calculate estate taxes differently. Review the rules in your state so you know how your 529 account will be taxed at your death.

When the account owner dies, the terms of the 529 plan will control who becomes the new account owner. Some states permit the account owner to name a contingent account owner, who'd assume all rights if the original account owner dies. In other states, account ownership may pass to the designated beneficiary. Alternatively, the account may be considered part of the account owner's probate estate and may pass according to a will (or through the state's intestacy laws if there is no will).

What if the beneficiary of a 529 account dies?

If the designated beneficiary of your 529 account dies, look to the rules of your plan for control issues. Generally, the account owner retains control of the account. The account owner may be able to name a new beneficiary or else make a withdrawal from the account. The earnings portion of the withdrawal would be taxable, but you won't be charged a penalty for terminating an account upon the death of your beneficiary.

Keep in mind that if the beneficiary dies with a 529 balance, the balance may be included in the beneficiary's taxable estate.

Note:

Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in the issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.



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