

Trust Owned 529 Accounts- Taxes (Part II)

Take-Away: The tax consequences of funding a 529 account, or distributions from a 529 account, or the change of beneficiaries of a 529 account are all interesting. Particularly so, when you consider that the creation and funding of a 529 account is essentially a *revocable completed gift* for tax reporting purposes.

Background: The first missive dealt with the provisions that should be included in a trust instrument if the trustee plans to hold 529 accounts for trust beneficiaries. This installment addresses the rather *interesting* tax consequences associated with the creation and the administration of a 529 account by the trustee. While the Regulations do not require the account owner to account to or even notify the 529 beneficiary of the existence of the 529 account, a trust that is subject to the Michigan Trust Code would impose such reporting duties on the trustee. While the trustee, as 529 account owner, may change the designated beneficiary, that power can be subject to some tax-related limitations, and in one case, fiduciary duty limits.

Fiduciary Duty Exposure: In *Alberhasky v. Alberhasky*, Iowa Court of Appeals, 928 N.W.2d 867 (2019) a father, acting as the trustee of a trust of which his son was the beneficiary, owned a 529 account. The son was the designated beneficiary of the trust-owned 529 account. The father, acting as trustee, changed the designated beneficiary of the 529 account from the son to the son's brother. The son sued his father for breach of fiduciary duty. The Court held that the father could be subject to a suit for breach of fiduciary duty for changing the beneficiary of the 529 account.

Income Taxes: Some of the basic income tax rules regarding 529 accounts are:

Tax-Free: Generally, interest and dividends earned in a 529 plan are exempt from federal income taxes.

Contributions Not Deductible: Contributions to a 529 plan are not deductible for federal income tax purposes but some contributions can be deductible for some state income tax purposes.

Distributions Not Taxable, If..: The taxability of a distribution from a 529 account depends on whether the distribution is a *qualified distribution* for *qualified higher education* expenses. A *qualified higher education* expense includes tuition, fees, books, supplies, equipment required for enrollment or attendance, computer expenses, and room and board for students who are enrolled at least half-time. A 529 account can also cover tuition expenses for elementary or secondary schools, but with a distribution limitation of \$10,000 a year.

Same Year Limitation: To be tax-free the distribution from the 529 account *must be made in the same year* in which the expenses are paid. This distribution timing constraint sometimes causes unexpected tax problems. Distributions that are not *qualified distributions* are subject to income tax at ordinary rates on the earnings portion of the distribution and a 10% penalty on the *entire* distribution from the 529 account.

Change of Beneficiary: The change in the designated beneficiary of a 529 account does not have any income tax consequences, but only if the new beneficiary is a *member of the family of the original beneficiary*. [IRC 529(c)(3)(i)(II).] *Member of the family* is broadly defined to include spouse, descendant, sibling or stepsibling, ancestor, stepparent, niece or nephew, aunt or uncle, son-daughter-father-mother-or sister-in-law, or the spouse of any of the foregoing individuals, or a first cousin.

Gift Taxes: A gift to a 529 account is treated as a *completed* gift for gift tax purposes, despite the owner's retained ability to change beneficiaries or terminate the 529 account. [Regulation 1.529-5(b).]

Annual Exclusion: A gift to the 529 account is not treated as a *future* interest gift, which means that the donor's gift tax annual exclusion applies to the transfer to the 529 account. If a trustee is 'investing' in a 529 account, there is no gift. Instead funding a 529 account is effectively an investment decision made by the trustee.

Super-funded 529 Account: In addition, the donor may elect to *super-fund* a 529 account with five years' worth of annual exclusion gifts in a single year if a gift tax return is filed, and the proper election is made on the return. [IRC 529(c)(2)(B).] Any gifts above the annual exclusion amount will consume a portion of the donor's applicable exemption amount. There is no prohibition in the Regulations on a trustee *super-funding* a 529 account if the trustee is concerned about accumulating income inside the trust and thus incurring income taxes at the trust-level.

Change of Beneficiaries: Changing the beneficiary of a 529 account results in a taxable gift unless the new beneficiary of the account is (i) in the same generation as the original beneficiary or of a higher generation, and (ii) a member of the family of the prior beneficiary, using the *member of the family* definition summarized above.

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

529 Owner: The above Tax Code provision means that a 529 account is not includible in the taxable estate of the 529 account owner. This is a surprising result since the account owner retains the power to change beneficiaries and control distributions from the 529 account. In all other situations, this retained power by the account owner would cause estate inclusion under IRC 2036. Since a trust is not an individual, there should be no estate tax consequence to the donor who funds the trust. However, if the donor of the trust names himself/herself as trust director with respect to the 529 account, including the ability to change 529 account designated beneficiaries, there is a good chance that the value of the 529 account will be included in the trust director's taxable estate, due to that retained control under IRC 2036(a)(1).

529 Beneficiary: Less clear is whether the value of the 529 account is includible in the taxable estate of the 529 designated beneficiary on the beneficiary's death. If the account assets are distributed to the beneficiary's estate on death, they would be included for estate tax purposes, although it may be possible to avoid this result by having the trustee change the beneficiary of the 529 account. In practice, most 529 beneficiaries do not have

taxable estates, so this may not present much of a problem. Perhaps estate inclusion of the account will turn on whether the beneficiary of the 529 account is treated under the 529 plan as holding a vested interest subject to divestment by the account owner.

GST Tax: A contribution to a 529 account of which a grandchild or a more remote descendant is the designated beneficiary is a *direct skip* that is subject to the generation skipping transfer (GST) tax, although again the rules are somewhat unclear, since a contribution to a 529 account of which a grandchild or more remote descendant is the designated beneficiary is also eligible for the GST annual exclusion, which is the same amount as the federal gift tax annual exclusion amount. A problem lies if the trustee creates a 529 account for a grandchild of the trust settlor, and the settlor has not previously allocated to the funded trust his/her GST exemption amount; in that case the trustee opening a 529 account for a grandchild might trigger a GST tax. Any gifts above the GST annual exclusion amount will consume a portion of the donor's applicable exemption amount. It is unclear what the transfer tax consequences are if the trustee *super-funds* a 529 account for a *skip-person* beneficiary.

Change of Beneficiaries: If the beneficiary of the 529 account is changed by the trustee to a new beneficiary who is two or more generations younger than the old beneficiary, the GST tax will apply to that change of beneficiary, even when a trust owns the 529 account.

Conclusion: Sadly, there are many unanswered questions regarding tax consequences when a trust or another legal entity like an LLC owns a 529 account. Practically speaking, the decision to fund a 529 account is simply an investment made by the trustee. But unlike a donor who funds and controls the 529 account, a trustee also has fiduciary duties to the designated beneficiary of the 529 account. In addition, the IRS has not spent much time in its Regulations addressing the interesting, or unusual, tax consequences associated with a 529 account which is not owned by the donor but by an entity, like an irrevocable trust, which has made an investment decision to hold trust assets inside a 529 account.

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