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April 23, 2008

Mr. Doug Shulman
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Dear Commissioner Shulman:

Enclosed is a copy of comments recently submitted by the American College of Trust and Estate Counsel (the "ACTEC Comments"), in response to the Advance Notice of Proposed Rulemaking regarding Guidance on Qualified Tuition Programs Under Section 529, published in Volume 73, No. 13, of the Federal Register on Friday, January 18, 2008. Subject to the discussion below, the ACTEC Comments also represent the views of the American Bar Association Section of Real Property, Trust and Estate Law ('RPTE'). The ACTEC Comments and RPTE's discussion below have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

The individuals who are named in the ACTEC Comments as participating in and contributing to their preparation are all members of RPTE, including James V. Roberts, Co-Vice-Chair of RPTE's Estate and Gift Tax Committee, who supervised the preparation of the ACTEC Comments. In addition, the ACTEC comments have been reviewed, on behalf of RPTE, by Ellen K. Harrison, of RPTE's Committee on Government Submissions.

RPTE makes no comment in this submission regarding Section II, B, 2, b of the ACTEC Comments, which discusses potential specific problems with a proposed rule in Section II, B of the Advance Notice. This proposed rule would impose liability upon the account owner ("AO") of a section 529 account for income tax on the entire amount of funds distributed for the AO's benefit, except to whatever extent the AO can substantiate that the AO made contributions to the section 529 account and thus has an investment in the section 529 account within the meaning of section 72. However, RPTE wishes to emphasize that different interpretations of the proposed rule are possible and that the nature and degree of potential problems with the proposed rule will depend on the particular interpretation adopted by Treasury and the IRS. Therefore, if this proposed rule will be retained in forthcoming guidance, RPTE urges Treasury and the IRS to clarify how this proposed rule should be construed and implemented, both by QTPs and by taxpayers. In particular, clarification of the proposed rule and its consequences would be helpful with respect to the particular distribution for the AO's benefit, the assets remaining in the section 529 account, any subsequent contributions by the AO or other persons, subsequent distributions to the AO (which may or may not be for the AO's own benefit), subsequent distributions to the designated beneficiary, and other transactions (including AO changes, DB changes, and rollovers) involving that section 529 account.

Sincerely,

Kathleen M. Martin

Kathleen M. Martin
Chair, Section of Real Property, Trust and Estate Law

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COMMENTS OF
THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL

Advance Notice of Proposed Rulemaking, 73 Fed. Reg. 3441 (Jan. 18, 2008)

Guidance under Section 529 Regarding a Proposed Anti-Abuse Rule,
Rules Relating to the Tax Treatment of Contributions and Participants, and
Rules Governing the Function and Operation of
Qualified Tuition Programs and Section 529 Accounts

On January 17, 2008, the Internal Revenue Service and Treasury issued their Advance Notice of Proposed Rulemaking, 73 Fed. Reg. 3441 (Jan. 18, 2008) ("Advance Notice") with respect to section 529 of the Internal Revenue Code. These comments are submitted on behalf of the American College of Trust and Estate Counsel ("ACTEC") and have been approved by its Executive Committee acting on behalf of the ACTEC Board of Regents.

James V. Roberts supervised the preparation of these comments and participated in their preparation along with Susan T. Bart, Christopher E. Houston, and Robert J. Rosepink. Also contributing to the preparation of these comments were Diana S.C. Zeydel and Julie K. Kwon. Susan T. Bart, Robert J. Rosepink, and Diana S.C. Zeydel are all ACTEC Fellows. James V. Roberts is Co-Vice-Chair of the Estate and Gift Tax Committee of the Section of Real Property, Trust and Estate Law ("RPTE") of the American Bar Association ("ABA"); however, these comments should not be construed as representing the position of the ABA or RPTE.

Although the ACTEC Fellows and other individuals who prepared these comments have clients who are affected by the federal tax principles addressed, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or the outcome of, the specific subject matter of these comments.

Abbreviations and Defined Terms

For ease of use, and in order to conform to the abbreviations used in the Advance Notice, we will use the following abbreviations and defined terms in these comments:

"AO" means the account owner of a section 529 account. Unless otherwise indicated, the AO is also a contributor (but not necessarily the sole contributor) to the section 529 account.

"Code" means Internal Revenue Code.

"Contributor" or "donor" means the person contributing to a section 529 account and and is typically (but not necessarily) the AO, unless otherwise indicated.

"DB" means the designated beneficiary of a section 529 account.
"DNI" means distributable net income.
"GST" means generation-skipping transfer.
"IRS" means Internal Revenue Service.
"Proposed regulations" means the proposed regulations to section 529 published in the Federal Register on August 24, 1998 (REG-106177-97).
"QHEEs" means qualified higher education expenses.
"QTP" means a section 529 qualified tuition program.
"Section 529 account" means an account set up under a QTP.
"Treasury" means the Department of the Treasury.
"UGMA" means Uniform Gifts to Minors Act.
"UTMA" means Uniform Transfers to Minors Act.
"10% additional tax" means the additional tax imposed under section 529(c)(6) and, by extension, under section 530(d)(4).

All references to "section" shall mean and refer to sections in the Internal Revenue Code unless otherwise made clear.

Executive Summary

In the "General Objectives and Premises" section below, we first set forth what we see as the general objectives of the Advance Notice and these comments, along with some general premises that we believe should be taken into consideration in evaluating any proposed rules regarding QTPs and section 529 accounts.

Section I of these comments suggests that existing approaches, such as the step-transaction and sham-transaction doctrines, are sufficient to address most abuse involving section 529 accounts and that a general anti-abuse rule specific to section 529 is unnecessary. If instead Treasury and the IRS maintain that such a general rule is necessary, any such rule should focus on the intended use of section 529 accounts, be general and simple, and include *de minimis* exceptions. Also, any discussion of abuse (with or without a new general rule) should include numerous examples distinguishing abusive and nonabusive situations.

Section II, A of these comments proposes that any deemed transfer resulting from a taxable change of DB should be treated as a transfer by the old DB. However, because of the old DB's lack of control over the section 529 account, the DB should incur liability for the transfer only to the extent the DB consents. To the extent the DB does not consent, liability should be imposed on the AO, who has possession of the assets that are the subject of the deemed transfer.

Section II, B of these comments discusses the tax liability proposed in the Advance Notice on any withdrawal by the AO for the AO's own benefit, to whatever extent the AO did not make all contributions to the section 529 account. The rule proposed in the Advance Notice would apply to many nonabusive situations, and is unnecessary because potential abuse could be addressed by general rules discussed in Section I. The proposed rule also entails significant practical problems. Section II, B also suggests that the forthcoming guidance should explicitly permit joint ownership of section 529 accounts and specify the transfer tax consequences of distributions from section 529 accounts to persons other than the AO or DB.

Section II, C of these comments recommends that any person, as defined under section 7701(a)(1), including a trust or an estate, should be permitted to be an AO or a contributor to a section 529 account. These comments recommend that revocable trusts be treated as the tax alter ego of their grantors. These comments recommend that when an irrevocable trust contributes to a section 529 account it should be treated as a trust investment with no transfer tax consequences. However, a distribution from a trust-owned section 529 account would be subject to income taxation under section 529 and, when made to a beneficiary, would be treated as a trust distribution to which the GST tax rules would apply for transfer tax purposes. Further, the separate share rules would apply where applicable for income tax purposes.

Section II, D of these comments agrees with the proposal in the Advance Notice that when the AO is the same as the DB, and the DB is then changed, the change of DB should be treated as a new contribution for transfer tax purposes and, for income tax purposes, as a distribution to the AO and a new contribution by the AO, which may qualify as a rollover.

Section II, E of these comments is in general agreement with the proposal in the Advance Notice that events occurring within a specified period of administration after a DB's death should be taken into account, as if they occurred prior to the DB's death, in determining whether the section 529 account should be included in the DB's estate. These events may include a change of DB or a distribution to the AO. These comments suggest some refinements of the rules proposed in the Advance Notice.

Section III, A of these comments discusses three areas related to the use of five-year elections for contributions to section 529 accounts. One area concerns the use of multiple five-year elections and provides numerous examples highlighting specific issues where uncertainty exists and guidance is needed. Other areas concern the transfer tax and GST tax treatment of any amounts included in a donor's estate following a five-year election, such as whether the deemed transferee would be the AO or DB (especially for marital deduction and GST tax purposes) and whether or not a direct skip would be deemed to occur for GST tax purposes.

Section III, B of these comments proposes extending the period proposed in the Advance Notice in which QHEEs may be paid in order to qualify a section 529 account distribution for tax-free treatment, both before and after the year of the distribution.

Section IV of these comments suggests some additional rules to carry out the purposes of section 529 in an administratively feasible manner. Part A suggests that any aggregation rule for investment changes should apply, at most, to accounts within the same QTP with the same AO and DB, and preferably should permit a state to treat each savings program separately when a state offers more than one savings program.

Part B recommends that the aggregation rule for rollovers apply only to section 529 accounts with the same AO and DB.

Part C recommends clarification that contributions to a section 529 account qualify for the GST tax annual exclusion as well as the gift tax annual exclusion and that the five-year election operates for purposes of both GST tax and gift tax.

General Objectives and Premises

1. **Objectives**. The Advance Notice makes it clear that one concern of Treasury and the IRS is to prevent the abuse of section 529 accounts for tax purposes wholly unrelated to the purposes of section 529: namely, promoting college savings and, in turn, higher education. In addition, the Advance Notice specifies that the forthcoming guidance will attempt to achieve other objectives as well. These objectives include (i) resolving certain inconsistencies between section 529 and general income tax and transfer tax principles, (ii) reducing uncertainty as to the proper tax treatment and reporting of certain transactions involving QTPs and section 529 accounts, and (iii) reducing uncertainty as to the proper administration of QTPs and section 529 accounts. The foregoing is consistent with section 529(f), added by the Pension Protection Act of 2006, which directs Treasury to propose such regulations as may be necessary or appropriate to carry out the purposes of section 529 and to prevent abuse of such purposes.

Our comments below do address the potential abuse of section 529 accounts and the best means to prevent such abuse. However, these comments do not focus solely on abuse, and in various places, the greater emphasis is on resolving inconsistencies or reducing uncertainty. This helps to promote the purposes of section 529 and is consistent with the other objectives set forth in the Advance Notice and in section 529(f), as described above. Resolving inconsistencies and reducing uncertainty generally reduces the potential for abuse and can make it clearer whether a particular transaction or reporting position is abusive or not.

2. **Premises**. Below are five general premises, which do not pertain solely to any one aspect of the Advance Notice but should be taken into consideration in evaluating any proposed rules for QTPs and section 529 accounts.

(1) *The ability to withdraw funds is a primary virtue of section 529 accounts for parents and others wishing to save for a DB's college education, and where the AO funds a section 529 account for a DB but later withdraws the funds, even for AO's own benefit, sufficient deterrents to abuse already exist under current law.* The AO's ability to withdraw funds is a primary virtue of section 529 accounts because parents and others often wish to save for college without the funds passing irrevocably to the DB if they are not needed for college (*e.g.*, because the DB receives a scholarship or does not attend college). Further, many grandparents wish to save for their grandchildren's education but wish to retain the ability to reclaim the funds if they need such funds for unanticipated health care or other support costs. This virtue is consistent with the purposes of section 529, including encouraging saving for higher education while providing flexibility if circumstances change, and should be maintained. Meanwhile, where the AO funds the section 529 account, the primary existing deterrent to potential abuse (*e.g.*, using the section 529 account for tax deferral alone, with no education-related intentions) is that the earnings portion of any nonqualified withdrawal is subject to ordinary income tax and the 10% additional tax. Another deterrent is that the AO cannot recapture any transfer tax annual exclusion or exemption allocated, or transfer tax paid, on account of a contribution that is later withdrawn by the AO – and where the amount involved is too low for the absence of recapture to be meaningful, then so too is the potential for abuse.

(2) *Permitting contributions from non-AOs is also a virtue of section 529 accounts that is consistent with the purposes of section 529 and should be maintained.* For example, grandparents or other relatives may wish to make contributions for a DB's college education to a section 529 account already established by the DB's parent as AO, without needing to open separate section 529 accounts with themselves as AOs. Similarly, a section 529 account with a deceased person's child as DB and the child's surviving parent or guardian as AO can provide relatives, friends, and co-workers with a meaningful, convenient, and tax-efficient way to honor the deceased and assist the surviving family members. In many cases involving non-AO contributors, the contributions are relatively small (often less than $100) and infrequent (perhaps once per year or even one time only); consequently, the inconvenience and cost of opening and maintaining separate section 529 accounts for these contributions (both for the donor and for the QTP) would not be justified.

(3) *The ability to name a successor AO for a section 529 account at the existing AO's death is indispensable and should continue to be permitted at the account/QTP level (that is, without requiring section 529 account assets to pass through probate or intestacy proceedings).* When an AO dies a successor AO is required, and the original AO, rather than the probate process, is best positioned to determine who would be an appropriate successor AO. Moreover, because most consider death undesirable and the timing of one's death is typically unknown, taxpayers are unlikely to plan abusive transactions that are dependent upon the death of the current AO.

(4) *As a general matter, the ability to name a successor AO for a section 529 account during the existing AO's lifetime offers flexibility but is less crucial.* However, it should remain possible to change the AO of a section 529 account during lifetime, without tax consequences, in certain circumstances (especially, in particular, to a spouse at any time or to a former spouse pursuant to divorce or separation).

(5) *To ensure accuracy and integrity in tax reporting and substantiation with respect to section 529 accounts, AOs and DBs should, with very limited exceptions, be able to use and rely on the information provided to them by QTPs on Form 1099-Q, without further adjustment.* If information reported to an AO or DB by a QTP on a Form 1099-Q is inaccurate, incomplete, or subject to further adjustment, depending on specific circumstances and special rules that may or may not be applicable, it becomes increasingly likely that the AO's or DB's reporting will be erroneous, notwithstanding the AO's or DB's best efforts.

I. Anti-Abuse Rule

The Advance Notice proposes to create a general anti-abuse rule to address misuse of section 529. We suggest that the new general anti-abuse rule might simply be an announcement that Treasury and the IRS will be using the full arsenal of existing approaches available to combat abuses, including the "step-transaction" and "sham transaction" doctrines and the rules regarding "reciprocal gifts" and the use of intermediaries or strawmen, combined with numerous examples. (The application of these existing approaches is illustrated in the Appendix to these comments, describing various potentially abusive scenarios.) In addition to these existing, more general approaches, section 529(c)(6) already provides one specific weapon against abuse of section 529 accounts: namely, the 10% additional tax that may be imposed when distributions are not used for educational purposes.

We believe that, when combined, the approaches above can be sufficient, and as discussed below, guidance detailing how they would be applied to specific abuses would have the necessary deterrent effect. We also note that the efficacy of these approaches (or any others) will be enhanced if Treasury and the IRS place greater emphasis on accurate and useful reporting with respect to section 529 accounts, including the matching of Form 1099-Q with individual returns.

Should Treasury and the IRS feel that, notwithstanding the foregoing, some sort of anti-abuse rule specific to section 529 accounts is appropriate, we would urge a general rule focusing on whether the contributions to the section 529 account are intended to be used for educational purposes when made. We urge that any such rule should recognize that the mere fact that the expected educational use does not occur does not mean that the educational intent was not present. There are legitimate reasons (such as financial hardship, health care needs, or other unanticipated circumstances) why section 529 account funds may not ultimately be used for educational purposes.

We also recommend that any anti-abuse rule specific to section 529 should be kept as simple and general as possible. Rules and limitations that are too specific or technical in nature would add undue complexity, and, in the process, discourage the use of section 529 accounts. This consideration is particularly important to the extent that section 529 is intended to encourage college savings by families whose circumstances and levels of potential savings would make them less willing or able to navigate complex rules themselves or to hire a tax advisor to navigate those rules for them; instead, those families would more likely simply decline to use section 529 accounts at all. [1]

In addition, because so many section 529 accounts and related transactions are small, we suggest that *de minimis* rules may be in order. Most *de minimis* transactions involving section 529 accounts are conducted not for improper tax-related reasons but for non-tax, non-abusive reasons that are quite consistent with the purposes and intentions underlying section 529.[2] *De minimis* transactions are unlikely to be abusive for transfer tax purposes because in most cases the transfer tax annual exclusions (or other exclusions) would prevent taxation of such transactions. *De minimis* transactions are unlikely to be abusive for income tax purposes because

[1] Statistics compiled by the College Savings Plans Network and available publicly reveal that the average size of a section 529 account is about $11,000. Relative to that average amount, the cost and inconvenience of navigating complex rules or employing professional counselors are substantial and inadequately justified.

[2] For these purposes, we suggest that a transaction could be presumed *de minimis* if it involves less than two times the gift tax annual exclusion amount for the year of the transaction (*i.e.*, $24,000, given the current $12,000 gift tax annual exclusion amount), with related transactions being aggregated appropriately. We note that *de minimis* rules would not preclude the application of existing anti-abuse approaches described above, such as the step-transaction and sham-transaction doctrines, so they would not constitute blanket permission or cover for abusive transactions within the amounts presumed to be *de minimis*.

the taxation of earnings as ordinary income and the 10% additional tax are strong deterrents, not to mention that there would be little to gain with a *de minimis* transaction. Without *de minimis* rules, many potential, legitimate users of section 529 accounts could be intimidated and deterred by complex rules intended to apply to the larger transactions where abuse is most likely to occur.

Providing numerous examples of abusive situations – and how those situations would be addressed by existing approaches or by any new anti-abuse rule – will be important and helpful. For example, we illustrate some potentially abusive scenarios in these comments. *See* Appendix.

While one can come up with numerous potential abuses of section 529 accounts, it is less clear empirically the extent to which such potential abuses are in fact employed and not just hypothetical. Thus, we recommend that Treasury and the IRS further study and assess this matter, especially to ensure that any proposed anti-abuse rules do not complicate the use and administration of section 529 accounts, thus discouraging saving for college, in a manner disproportionate to the actual abuse otherwise occurring.

II. Rules Relating to the Tax Treatment of Contributions to and Participants in Section 529 Accounts

A. AO's Liability for Any Gift and/or GST Tax Imposed on a Taxable Change of DB

Section 529(c)(2)(A) provides that a contribution to a section 529 account on behalf of a DB is treated as a completed gift to the DB that is not a future interest. (The forthcoming guidance should make clear that this rule applies only when an outright transfer from the contributor to the DB would be a gift. *See* Section II, D below.) Section 529(c)(3)(C)(ii) permits the DB of a section 529 account to be changed without income tax consequences if the new DB is a "member of the family" of the old DB. However, the gift tax and possibly GST tax will apply to a change of DB unless (1) the new DB is a member of the family of the old DB and (2) the new DB is in the same or a higher generation than the old DB. Only gift tax will apply if the new DB is one generation below the old DB, but both gift tax and the GST tax will apply if the new DB is two or more generations below the old DB.

The proposed regulations apply the gift and GST tax rules to a change of DB by treating it as a gift from the old DB to the new DB and imposing the gift tax liability on the old DB. This is the correct tax treatment under section 529. Because the original contribution to the account was treated as a completed gift to the DB (notwithstanding the AO's power to withdraw the funds), any subsequent gift must be from the DB. However, the fact that the old DB had no control over the section 529 account may make it impractical, if not unconstitutional or otherwise legally impermissible, to require that the DB report the gift and incur any gift tax consequences. Even the use of the old DB's annual exclusions without the old DB's consent deprives the old DB of a property right, namely the opportunity to use such annual exclusions to offset other gifts.

The Advance Notice proposes to depart from the proposed regulations and instead to treat the AO as the transferor by treating a change of DB that is subject to gift tax "as a deemed distribution to the AO followed by a new gift." Presumably, the deemed distribution would fall within the rollover rule exception of section 529(c)(3)(C)(i) and, therefore, would not be treated as a nonqualified distribution. *See also* section 529(c)(3)(C)(ii).

However, treating the AO as the transferor for gift and GST tax purposes is inconsistent with section 529, pursuant to which a completed gift was made to the old DB and, therefore, the old DB should be the transferor of any subsequent gift. Two examples may help to illustrate the problem.

> *Example 1.* Assume Grandparent is the AO of a section 529 account for Child. Grandparent then changes the DB to Child's child, Grandchild. In the framework of section 529, the gift is from Child to Grandchild and should only be subject to gift tax, and Child should be permitted to use Child's exclusions against the gift. Under the theory of the Advance Notice, the gift is from Grandparent to Grandchild, which is inconsistent with the fact that Grandparent already incurred the gift tax consequences of passing the assets down one generation. Even if Grandparent's initial gift was covered by gift tax annual exclusions, the Grandparent relinquished the opportunity to use such exclusions against other gifts the Grandparent may have made to Child, and Grandparent can never recover those exclusions. If Grandparent is treated as now making a gift to Grandchild, even if Grandparent's gift and GST exclusions preclude the imposition of tax, Grandparent is deprived of the opportunity to use such exclusions to make other gifts to Grandchild using such exclusions.

> *Example 2.* Assume Parent is the AO of a section 529 account for Child 1. Parent then changes the DB to Child 2. Section 529(c)(5)(B) mandates that the gift tax rules do not apply. However, the theory of the Advance Notice would require that the change of DB be treated as a deemed distribution to Parent and a gift by Parent to Child 2. The theory of section 529, under which a gift occurs only when the DB moves down one or more generations, does not permit a solely collateral change of DB (to a member of the family of the old DB) to be treated as a gift.

Therefore, consistent with the tax theory of section 529, the gift should be treated as if it were from the old DB. The forthcoming guidance should permit the old DB to agree to be treated as the transferor of the deemed gift and to file a gift tax return reporting such transfer if a gift tax return is required. The AO in such circumstances should only be required to report the deemed transfer on an informational gift tax return and attach a consent signed by the old DB under which the old DB agrees to be treated as the transferor of the deemed gift.

In the case of a minor DB, the forthcoming guidance should permit a parent or guardian to sign such a consent, to file the minor's gift tax return if one is required and potentially to make the five-year election on behalf of the old DB. However, to avoid permitting a parent or guardian to use a minor's lifetime gift tax exclusion or GST exemption, a parent or guardian should only be permitted to report such gifts to the extent they qualify for the gift tax annual exclusion (and when applicable, the GST tax annual exclusion), taking into account any five-year election. Where a parent or guardian files a gift tax return on behalf of a minor DB, to the extent the deemed transfer does not qualify for the annual exclusion, it should be reported on the AO's gift tax return.

To the extent the DB does not consent to report the deemed transfer on the DB's gift tax return, it is consistent with existing gift tax principles to impose the gift tax liability on the person in possession of the gifted property. Although ordinarily this would be the donee, under section 529 it is the AO who has actual access to the property. For administrative convenience, the forthcoming guidance could provide that to the extent the DB does not consent to being treated as the transferor of the deemed transfer, the AO must report the deemed transfer on the AO's gift tax return. However, the AO should be deemed to be assigned to the same generation as the old DB. In a purely theoretical world, because the AO is only reporting and, if required, paying tax on a gift from the old DB, the old DB's annual exclusions, lifetime gift tax exclusion and GST exemption could be applied against such gift. However, they cannot be so applied without the old DB's consent. Therefore, to reach a result that approximates the theoretical result, the forthcoming guidance should permit the AO to apply the AO's own exclusions and exemptions against the deemed transfer.

In Example 1 above, this means the Grandparent/AO would be deemed to be in the Child's generation and would be treated as making a transfer down one generation. Thus to the extent the Grandparent did not have annual exclusions available for the deemed gift to Grandchild, only gift tax, and not GST tax, would apply. Further, Grandparent may use Grandparent's gift tax annual exclusions and lifetime gift tax exclusion.

The forthcoming guidance should also state that neither (1) the DB's consent (or failure to consent) to being treated as the transferor of the imputed gift, nor (2) the AO's reporting of such gift and payment of resulting transfer taxes, if any, shall be treated as a transfer for gift or GST tax purposes.

B. AO's Liability for Tax Imposed on Any Withdrawal by the AO from a Section 529 Account for the AO's Own Benefit and on a Change in AO

Section II, B of the Advance Notice discusses potential AO liability for tax (i) on any withdrawal by the AO for the AO's own benefit or (ii) on any change in AO. The primary impetus for proposing this potential liability is a concern about certain abusive scenarios. Section I of the Appendix illustrates four such scenarios (one of which is also illustrated in the Advance Notice).

1. Limiting AOs to Individuals. One proposal set forth in Section II, B of the Advance Notice would limit AOs to individuals; this proposal, which we strongly discourage, is discussed in more detail in Section II, C of these comments.

2. AO Liability for Income Tax. Another proposal set forth in Section II, B of the Advance Notice would make the AO liable for income tax on the entire amount of funds distributed for the AO's benefit, except to whatever extent the AO can substantiate that the AO made contributions to the section 529 account and thus has an investment in the section 529 account within the meaning of section 72. Under this proposal, in each of the four potentially abusive scenarios illustrated in Section I of the Appendix, the entire amount withdrawn would be subject to both ordinary income tax and the 10% additional tax (presuming no contributions were made by the withdrawing AO). Perhaps this provides rough justice, serving as some sort of proxy for the transfer tax that would have been due if the funds had been initially transferred directly from the donor to the withdrawing AO, but it does not compensate the donor for the gift (and possibly GST) tax consequences incurred when the donor was treated as making a gift to the DB.

a. *General Observations*. In addition, following are some general observations about this proposed rule.

(1) The proposed rule would impose a tax on the withdrawing AO even in situations that are not abusive. For example, grandparents might contribute to a section 529 account for a grandchild as DB, with the grandchild's parent as AO, fully intending to provide for the DB's college education. Then, the DB does not go to college or does not need the funds for college, but is a spendthrift (or worse), so distributing the funds to the DB would be inadvisable. There is no sibling or other family member who would be suitable as a replacement DB, so the AO withdraws the funds. There is no abuse in this situation, but under the proposal at hand, the entire withdrawal (and not just the earnings portion) would be subject to ordinary income tax and the 10% additional tax. This seems inappropriate, in large part because the funds were intended to be used for higher education when the contribution was made. By contrast, as discussed above, the consequences under current law (with only the earnings portion of the withdrawal being subject to ordinary income tax and the 10% additional tax) seem to us more appropriate and still sufficient to deter the abuse of section 529 accounts using AO withdrawals and contributions by non-AOs.

(2) Even if the proposed rule successfully addressed and eliminated abusive scenarios involving AO withdrawals or changes (such as those illustrated in the Appendix), the intended abusive results could still be achieved by strategically designating and changing DBs, with tax-free distributions then being made to the DB, as illustrated in Section II of the Appendix (rather than withdrawn by the AO, as in the four scenarios in Section I of the Appendix). The proposed rule would not apply to distributions to DBs, and extending the proposed rule or creating a new parallel rule to address DB distributions would more likely contradict statutory provisions under section 529.

(3) Abusive scenarios involving AO withdrawals or changes, as well as abusive scenarios involving DB designations and changes, can be adequately addressed by the general anti-abuse rules discussed in Section I above. These would include existing approaches not specific to section 529 and any general anti-abuse rule that may be adopted specifically with respect to section 529.

b. *Specific Problems*. We also note more specific problems with the proposed rule, as we perceive how it would be implemented.[3]

(1) In its current formulation, Form 1099-Q sets forth the earnings portion of distributions from a section 529 account in a given year and is issued to the distributee, who is either the DB (for distributions made to the DB or to an educational institution for the DB) or else the AO (for all other distributions). If the investment in the account were to be reduced, and the earnings portion correspondingly increased, on account of contributions which the AO could not prove were made by the AO, the proper earnings portion to be reported by the AO would differ from the earnings portion shown on the Form 1099-Q. Per one of the premises set forth above, it is bad policy for the amounts properly reportable by AOs to differ from amounts reported on the Form 1099-Q or to require significant adjustments. Moreover, as a practical matter, it would be impracticable and in some cases impossible for the AO to make the necessary adjustments and compute the proper earnings portion accurately, even with best efforts and intentions; this problem would compound as numerous contributions and withdrawals were made over time.

(2) The problem above could theoretically be solved by requiring QTPs to track and allocate amounts in a section 529 account not just by AO but also by contributor. However, this would impose a massive subaccounting burden on QTPs – especially considering that, in most cases, those contributions by non-AO contributors would be relatively small and would not reasonably warrant an additional level of accounting for the life of the section 529 accounts. That burden would result in higher fees being charged to section 529 accounts, directly or indirectly, or more likely, in QTPs deciding to avoid that burden altogether by disallowing contributions by non-AOs (thus negating one important virtue of section 529 accounts discussed above).

(3) Even if the subaccounting by contributor were achieved, other questions would then arise in turn. For example, where contributions have been made by the AO and by any non-AO and certain withdrawals are then made by the AO, the practical effect of the proposed rule would be to convert some of the investment in the account (namely, that which is

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[3] We perceive that this proposed rule would be implemented within the present framework under which distributions from a section 529 account are deemed to consist of earnings and investment in the account on a pro rata basis under section 72. (The proposed rule would affect the computation of investment in the account, at least in certain circumstances, but within that same framework.) It is possible to infer from the Advance Notice that perhaps Treasury and the IRS intend for this proposed rule to replace the pro rata framework with a new one: namely, with distributions from section 529 accounts instead being deemed to consist first of investment in the account, to the extent any remains, and earnings being deemed distributed only if and to the extent there is no remaining investment in the account. We do not perceive that to be intended, in part because (i) it would be such a substantial change from the present framework, with no explicit recognition or discussion thereof, and (ii) the present pro rata framework seems more consistent with the statutory provision in section 529(c)(3) that distributions be includible in income in the manner provided under section 72. Even if this change is intended, we note that the specific problems described here would still apply to varying degrees, at least in principle, and we would request that Treasury and the IRS provide further details about this potential change (with a new comment period), so that we could address that more fully and concretely.

attributable to the non-AO contributions) into earnings, which creates issues including the following:

- Would that "converted" investment portion come out of the section 529 account on a *pro rata* basis with any still-intact investment portion, in proportion to the AO and non-AO contributions, or would there be some sort of worst-in, last-out principle, whereby the AO could at least avoid having any such "conversion" to the extent of the AO's own contributions, at least with respect to nonqualified withdrawals?

- This potential "conversion" of investment to earnings would only occur for certain nonqualified withdrawals, depending on reporting and substantiation by the AO – which will not be known to the QTP. This in turn would increase the risk that the QTP's subsequent accounting and reporting of investment and earnings portions (on statements and Form 1099-Q) will not be accurate, taking into account the AO's treatment of past withdrawals. Unless this risk is sufficiently addressed by any proposed rule, it would violate one of the premises above, regarding the importance of AOs and DBs being able to use and rely on the 1099-Q reporting by QTPs. (Moreover, that risk should be addressed without imposing even further tracking burdens on the QTPs; it was by all accounts a welcome change for 2001 legislation to eliminate the prior requirement that nonqualified withdrawals be monitored and penalized by the QTP, and we would in no way suggest reversing that.)

- Unless current reporting rules are changed, there would no way for the AO to avoid the "conversion" of investment to earnings with respect to a non-AO contribution. For example, imagine that a non-AO makes a contribution to a section 529 account (with the intention that it be used for the DB's education), but the AO determines shortly thereafter that the funds attributable to the AO's own contributions were already sufficient to cover the DB's projected QHEEs. Under the proposed rule, the non-AO contribution would effectively and immediately be converted entirely to earnings, if withdrawn by the AO or even if distributed back to the non-AO contributor (insofar as the AO would be the deemed distributee of that distribution for reporting purposes). The only way to avoid that effective conversion would be to distribute the funds to the DB; and that may be inadvisable, undesired, and unintended by the non-AO, if the funds are not needed for QHEEs.

- There should be some mechanism by which non-AO contributions could be attributed to the AO if made (i) by a spouse of the AO, (ii) if the AO is a parent of the DB, by the other parent of the DB, or (iii) if the AO is a successor AO, by the previous AO (at least where the change of AO occurs as a result of the previous AO's death). Here, too, one difficulty with any such mechanism is that, if any such attribution is not known to the QTP, that would increase the risk that the plan's subsequent accounting and reporting of investment and earnings portions (on statements and Form 1099-Q) will not be accurate – but it would be difficult to address that risk without imposing undue burdens on QTPs.

In summary, we believe that the proposed rule is simultaneously (i) too broad (ensnaring many non-abusive situations), (ii) too narrow (attacking potential abuses involving AO withdrawals and changes, but leaving the same abusive results available by strategic DB designations and changes), and (iii) ultimately redundant if general anti-abuse rules (including approaches already available), and better reporting and monitoring, are effectively implemented. Thus, we would recommend that Treasury and the IRS abandon this proposed rule and rely on the general approaches discussed in Section I above to combat perceived abuses involving AO withdrawals or changes.

3. Additional AO Issues. Because they are tangentially related to the issues addressed in Section II, B of the Advance Notice, we would like to suggest here that the forthcoming guidance concerning section 529 should address the following issues:

a. Joint Ownership. There has been some uncertainty among QTPs and practitioners as to whether a QTP may allow two people to be joint AOs of a section 529 account. However, (i) joint ownership is not prohibited, explicitly or implicitly, by section 529 itself (which is silent as to account ownership) or by the proposed regulations, (ii) in at least one private letter ruling for a QTP that offered joint ownership, and in informal conversations with at least one of us, Treasury and the IRS have found no inherent problem with joint ownership, (iii) joint ownership is not inconsistent with the purposes of section 529 or inherently abusive, and (iv) the flexibility offered by joint ownership would be helpful or preferable in some circumstances – for non-abusive reasons entirely consistent with the purposes of section 529 – and would further encourage the use of QTPs as a college savings vehicle. The primary reason that most QTPs do not offer joint ownership seems to be the uncertainty about whether it is permissible. Thus, we request that the forthcoming guidance eliminate that uncertainty and explicitly provide that QTPs may offer joint ownership.

b. Directed Distribution to Third Party. With some QTPs, the AO may direct a distribution to a third-party recipient who is not the AO, the DB, or an educational institution for the DB. When such a distribution is made, it is clear from prior guidance that the AO is considered the distributee for income tax purposes (and the distribution may qualify for tax-free treatment if made to cover QHEEs of the DB). However, the potential transfer tax consequences of such a distribution, when it is not for QHEEs of the DB, a liability of the DB, or a liability of the AO, are less clear. For example, is the distribution a deemed transfer directly from the DB to the recipient, a deemed transfer directly from the AO to the recipient, or a two-step transaction consisting of a deemed withdrawal by the AO and then a deemed transfer from the AO to the recipient? One advantage of the two-step approach is that the deemed withdrawal by the AO should not be subject to transfer tax, any more than an actual withdrawal by the AO would be, and one thus avoids the problem of ever subjecting the DB to transfer tax consequences beyond the DB's control. Another advantage of the two-step approach is that it provides a consistent reference point for determining whether the second transfer, from the AO to the recipient, is or is not a gift for transfer tax purposes. We request that these transfer tax consequences be addressed in the forthcoming guidance to avoid continued uncertainty.

C. Application of Transfer Tax Where Permissible Contributors to Section 529 Accounts Include Persons Other Than Individuals

Section II, C of the Advance Notice addresses only the transfer tax and income tax issues related to *contributions* by non-individuals. However, because we believe that the proposal to limit AOs to individuals is unnecessary to prevent abuse, this section of our comments also addresses how the transfer tax and income tax rules would apply when a non-individual, such as a trust, is the AO.

1. Should the definition of "person" be limited to individuals? We believe that the definition of "person" under section 529(b)(1)(A) should not be limited to individuals. Narrowing the definition of "person" from that set forth in section 7701(a)(1) would be based on flawed statutory analysis and would deny many non-individuals with perfectly legitimate reasons for doing so the opportunity to contribute to section 529 accounts. Further, as elaborated below, we believe that fair and consistent transfer and income tax rules can be drafted to apply when a contributor or AO is not an individual.

From the standpoint of statutory analysis, the Advance Notice itself points out that section 529(b)(1)(A) uses the word "person," and "person" is defined in section 7701(a)(1) as generally construed to mean and include an individual, trust, estate, partnership, association, company, or corporation. Under that section of the Code, the only cases in which the statutory definition is not to apply are those in which the term is not "otherwise distinctly expressed or manifestly incompatible with the intent thereof." Nowhere in section 529 is there a distinct expression that the word "person" should not have the general meaning ascribed by section 7701(a)(1). Therefore, only if the general meaning of "person" is "manifestly incompatible with the intent" of section 529 should the word have any different meaning.

The legislative history of section 529 reveals no indication that Congress intended to restrict contributors to section 529 accounts to individuals. We believe the decision of Treasury and the IRS in the Advance Notice, to follow the proposed regulations in providing that the definition of "person" as used in section 529(b)(1) will have the same (broad) meaning as under section 7701(a)(1), is sound.

Estates and trusts can and do make contributions to section 529 accounts. An estate may do so pursuant to a specific direction in the dispositive provisions of a decedent's will. An estate or a trust may do so pursuant to a facility of payment clause, so as to avoid distributing property outright to a minor. Permitting contributions to section 529 accounts by an estate or a trust furthers the purposes of section 529 by permitting a decedent or trustee to earmark certain funds for higher education.

We believe that it is appropriate that trusts be permitted not only to make contributions to section 529 accounts, but also to be AOs of section 529 accounts. First, trusts permitting distributions for QHEEs of a trust beneficiary should be able to take advantage of the same tax-favored investment vehicle as individuals when setting aside funds for higher education. Second, a trust limits any potential for abuse, because if the trust revests the section 529 account through a nonqualified distribution to the AO, the funds are received by the trust and not by the grantor or the trustee personally. Finally, it is feasible to draft workable tax rules governing section 529 accounts owned by a trust.

Section 529 accounts provide an investment opportunity for trusts with beneficiaries who have not completed their higher education. Pre-existing trusts that may make distributions for higher education may wish to invest some or all of their assets in section 529 accounts. In other instances, a donor may create a trust specifically for the purpose of owning one or more section 529 accounts.

Furthermore, we do not believe that contributions to section 529 accounts by partnerships, associations, companies, and corporations are widespread in practice or significant in amount. Therefore, absent specific evidence of abuse, Treasury and the IRS should not prohibit partnerships, associations, companies, and corporations from contributing to section 529 accounts.

2. What rules are necessary to ensure appropriate transfer tax consequences where a person other than an individual makes a contribution to a section 529 account? The Advance Notice seeks comments on what rules are necessary to ensure appropriate transfer tax consequences where a person other than an individual makes a contribution to a section 529 account. Treasury and the IRS are also interested in comments regarding whether the complexity of any special rules would outweigh the benefit of allowing non-individual contributors. For gift and GST tax purposes, section 529(c)(2)(A)(i) treats any contribution to a section 529 account as a completed gift of a present interest in property to the DB. Absent that unique statutory treatment, a gift to a section 529 account would not be considered either a completed gift or a gift of a present interest, at least as QTPs and section 529 accounts are typically structured. Therefore, any judgment as to "appropriate" transfer tax consequences can only be judged in the context of that special (anomalous) transfer tax treatment.

a. Irrevocable Trusts. There are two types of trusts that could make contributions to a section 529 account. For convenience we will refer to these types of trusts as revocable trusts and irrevocable trusts. By the term "revocable trust" we mean a trust that has terms such that a transfer to the trust by the grantor will not be treated as a completed gift for gift tax purposes.[4] By the term "irrevocable trust" we mean a trust that has terms such that a gift to the trust by the grantor will be treated as a completed gift for gift tax purposes.[5]

With irrevocable trusts, the analysis begins with two principles: (1) only an individual (not a trust) can make a gift, and (2) the GST tax rules apply to trusts to preserve the integrity of the transfer tax system. A corollary of the first principle is that when an irrevocable trust invests its own funds in a section 529 account it is making a trust investment, not a gift and not a trust distribution. A corollary of the second principle is that assets generally should be subject to one of the transfer taxes at each generation.

If an irrevocable trust invests funds already held in the trust in a section 529 account, no transfer tax consequences should result because the funds in the trust already passed through the transfer tax system when contributed to the trust and because a trust cannot make a gift. So long

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[4] Although such a trust is generally revocable by the grantor, it is possible that it could be irrevocable if the grantor retained other powers over the trust that would make a gift to the trust incomplete.

[5] Such a trust will almost always be irrevocable by the grantor, although others may have a power to revoke the trust. In many cases, the trust will have become irrevocable as a result of the grantor's death.

as the trustee remains the AO and no distribution is made to anyone other than the AO, no transfer tax consequences should result from any change in DB.[6] This should be the case even if the new DB is in a lower generation than the old DB or if the new DB is not a member of the family of the old DB.

Nor should there be any gift tax consequences to a distribution from a section 529 account as to which a trustee is the AO. Once again, a trust cannot make a gift.

However, the GST tax may apply to a distribution from a section 529 account of which an irrevocable trust is the AO if the DB is two or more generations below the generation of the transferor. In determining the generation assignment of the transferor, section 2653(a) provides that if there is a GST of any property and immediately after such transfer such property is held in trust, then for purposes of applying the GST tax rules, the trust will be treated as if the transferor of such property were assigned to the first generation above the highest generation of any person who has an interest in such trust immediately after the transfer. If the original transfer to the trust was not a GST, the transferor would have his or her natural generation assignment.

A distribution from a section 529 account to a DB who is two or more generations below the generation assignment of the transferor should be treated as either a taxable distribution or a taxable termination (as the case may be, depending on whether the distribution fully distributes the trust) for GST tax purposes, subject to the trust's GST tax inclusion ratio. No GST tax would be due if the trust has a zero inclusion ratio or is grandfathered for GST tax purposes.

> *Example 1*. P establishes an irrevocable trust for the education of his descendants. P has one child, C, and one grandchild, GC, when the trust is established. P makes a taxable gift of cash to the trust. The trust establishes a section 529 account with C as the DB. Distributions are made from the section 529 account to C for QHEEs. When C completes C's education, funds remain in the section 529 account and the trust changes the DB to GC. Distributions are made from the section 529 account to GC for QHEEs. After GC completes GC's education, the trust refunds the remaining section 529 account funds to the trust with a nonqualified distribution. P is treated as the transferor of the trust and is assigned to P's natural generation, because the transfer to the trust was not a GST. There are no transfer tax consequences to the trust's contribution to the section 529 account, because a trust cannot make a gift. When distributions are made to C, no GST tax or other transfer tax consequences result, because the transferor is assigned to the generation immediately above C's generation. Nor do any transfer tax consequences result when the trust changes the DB from C to GC. When distributions are made from the section 529 account to GC, they are taxable distributions for GST tax purposes because GC is two generations below the

[6] In these comments, references to a trustee as AO always mean the trustee in that capacity, not individually. Also, the DB of a trust-owned section 529 account is always presumed to be a beneficiary of the trust itself, and we believe it would be inconsistent with a trustee's fiduciary obligations to name as DB an individual who is not a beneficiary of the trust.

generation assignment of P, the transferor.[7] There are no transfer tax consequences when the trust makes a nonqualified distribution to itself as AO.

If the trustee is required to make a principal distribution to a beneficiary, for example because the beneficiary attained a certain age, and the trust owns a section 529 account with such beneficiary as the DB, the trustee could effectuate the trust distribution by making the beneficiary the AO of the section 529 account. Alternatively, where a trust provides for *discretionary* distributions, the trustee could make such a distribution to the beneficiary by making the beneficiary the new AO of all or a portion of a trust-owned section 529 account with the beneficiary as the DB. If the beneficiary is a minor, many trusts would permit a distribution to a custodian under the UTMA for the minor beneficiary. Where a trust owns a section 529 account and wishes to distribute it to a minor DB, the trustee may wish to change the AO to a custodian under the UTMA for the DB. In all of these cases, where the new AO is the same as the DB for transfer tax and income tax purposes, no transfer tax consequences should result under section 529. However, the change of AO should be treated as a trust distribution that may result in a GST tax if the AO/DB is two or more generations below the transferor's generation.

Example 2. Same as Example 1, except that when GC has completed his education P has a great grandchild, GGC, who is also a beneficiary of the trust. The trustee, pursuant to authority in the trust, changes the DB to GGC and then changes the AO to GC, as custodian for GGC under the UTMA. The change of AO is treated as a trust distribution to GGC. Because P is the transferor and GGC is more than two generations below the generation assignment of the transferor, the change of AO is a taxable distribution or termination for GST tax purposes.

It is possible that a trustee may make a distribution to a trust beneficiary by changing the AO of a trust-owned section 529 account to the beneficiary when the section 529 account has as its DB someone other than the new AO.[8] Any such change of AO should be treated as a trust distribution (but not as a section 529 distribution) to the new AO followed by a contribution of the funds by the new AO to the section 529 account for the DB. The distribution should be deemed to be made to the AO because for trust law purposes a distribution should transfer actual property rights to the trust beneficiary or to a fiduciary for the trust beneficiary, and merely being the DB of a section 529 account does not confer property rights. The change of AO would be subject to whatever GST tax consequences result from such trust distribution. The deemed

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[7] If and to the extent that the distributions are paid directly to GC's educational institution for tuition expenses alone, the distributions would be exempt from GST tax under section 2611(b).

[8] For example, a trust-owned section 529 account may have as its DB the child of an adult beneficiary, and the trustee may make a distribution to the adult beneficiary by changing the AO to that adult beneficiary. In most cases, this would be done in consultation with or at the request of the adult beneficiary.

contribution by the new AO would have the same transfer tax consequences as any other contribution by an individual to a section 529 account.[9]

> *Example 3.* Same as Example 1, except that when GC has completed GC's education the trustee changes the AO (of the section 529 account with GC as the DB) to C. The change of AO is treated as a distribution to C, followed by a contribution of funds by C to a section 529 account for GC. Because C is only one generation below the generation assignment of P, the transferor, no GST results. However, C is treated as making a gift to GC, but may make the five-year election.

b. Revocable Trusts. The analysis with respect to revocable trusts begins with two principles: (1) transfers by the grantor in the grantor's individual capacity to a section 529 account would be treated as completed gifts for transfer tax purposes, and (2) a trust cannot make a gift, but while the trust is revocable the gift can be imputed to the grantor.

Contributions to a section 529 account by a revocable trust should be treated as a contribution by the grantor of the trust to the section 529 account. The transfer tax treatment of a contribution to a section 529 account should not change merely because the grantor uses the grantor's revocable trust as the AO. Further, this approach is consistent with the treatment of a revocable trust as a grantor trust for federal income tax purposes under section 676. Therefore, there should be no transfer tax consequences to a revocable trust if such trust makes a contribution to a section 529 account. The transfer tax consequences of the contribution should be treated as belonging to the grantor. The contribution by a revocable trust to a section 529 account should be treated as a completed gift by the grantor to the DB for gift and GST tax purposes.

The transfer tax consequences of any subsequent change in DB by the AO while the trust is revocable should be governed by the general rules applicable to individual AOs. Thus if the DB is changed and the new DB is in a generation below the old DB, the old DB will be treated as having made a gift to the new DB. If the DB is changed and the new DB is two or more generations below the old DB, the gift will also be treated as a direct skip for GST tax purposes. Either the old DB or the grantor, as the imputed AO, would report this gift under the rules proposed in Section II, A above.

A revocable trust will typically become irrevocable at some point in time – usually upon the grantor's death. The assets of a revocable trust are generally includible in a decedent's gross estate for estate tax purposes. However, section 529(c)(4)(A) provides that no "amount shall be includible in the gross estate of any individual for purposes of chapter 11 by reason of an interest in a qualified tuition program." Therefore, a grantor's estate should not include for estate tax

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[9] We recognize that there may be situations in which an adult trust beneficiary cannot act as AO because of disability or for other reasons. Treasury and IRS might consider adopting a rule that would treat a distribution as a distribution to the DB and not the AO where the QTP or a court order imposes restrictions on the section 529 account that prohibit the AO from distributing funds to the AO (unless used for the DB) and from changing the DB unless the DB dies or is unlikely in the future to incur QHEEs.

purposes any interest in a section 529 account, regardless of whether that interest was owned directly or through the grantor's revocable trust and even if the section 529 account funds could be withdrawn and used to pay claims, debts, expenses, or taxes.

A revocable trust may become irrevocable during the grantor's life if the trust is amended or powers are released such that it is no longer a revocable trust. Because the trust's contribution to the section 529 account was treated as a completed gift from the grantor for gift and GST tax purposes, no transfer tax consequences should occur with respect to a trust-owned section 529 account if the formerly revocable trust becomes irrevocable during the grantor's life.

After the trust becomes irrevocable, the transfer tax consequences of future contributions can no longer be attributed to the grantor as the imputed AO. Further, the transfer tax consequences set forth in section 529 cannot apply, because a trust cannot make a gift. However, the GST tax rules can be applied to maintain the integrity of the transfer tax system.

Because the initial transfer to the section 529 account is treated as a completed gift by section 529, even if the section 529 account is owned by a revocable trust the generation of the transferor for GST tax purposes should be determined as of the time of the initial transfer to the section 529 account. For GST tax purposes the contribution to the section 529 account creates a separate trust for GST purposes because the section 529 account portion of the trust is treated as a completed gift warranting the designation of a GST transferor, whereas no transfer has occurred with respect to the remainder of the trust, and therefore there is not yet any GST transferor for the remainder of the trust. For GST tax purposes a portion of a trust is treated as a separate trust if it has a different transferor or if it is a substantially separate and independent share of the trust because it has different beneficiaries. *See* section 2654(b). In this unique situation the section 529 account portion of the trust has a different transferor (because the remainder has no transferor) and is a substantially separate and independent share of the trust from the time of the creation of the section 529 account.

Having established that the section 529 account is treated as a separate trust for GST tax purposes, Section 2653(a) provides that if there is a GST of any property and immediately after such transfer such property is held in trust, for purposes of applying the GST tax rules, the trust will be treated as if the transferor of such property were assigned to the first generation above the highest generation of any person who has an interest in such trust immediately after the transfer. Because the only person who for transfer tax purposes has an interest in a section 529 account is the DB, when the DB is two or more generations below the grantor, section 2653(a) would treat the trust (with respect to the section 529 account) as if the transferor is in the generation above the DB. If the transfer to the section 529 account is not a GST (because the DB is not two or more generations below the grantor), the transferor would be assigned to the grantor's natural generation.

After a revocable trust has become irrevocable, so long as the trustee remains the AO and no distribution is made to anyone other than the AO, no transfer tax consequences should result from any change in DB. This should be the case even if the new DB is in a lower generation than the old DB or if the new DB is not a member of the family of the old DB. Because the trust cannot make a gift, the section 529 rules applicable to changes of beneficiaries cannot apply.

However, the GST tax consequences of any distribution from the section 529 account should be determined by applying the appropriate GST tax rules. If the DB is two or more generations below the transferor's generation, the distribution will be treated as a taxable distribution or a taxable termination for GST tax purposes. If the distributee is one generation below the transferor's generation, or in the same generation as the transferor's generation, there will be no transfer tax consequences to the distribution.

> *Example 1*. G's revocable trust establishes a section 529 account for G's grandchild GC1. During G's life, the revocable trust becomes irrevocable. Consistent with the governing instrument, the trust then changes the DB of the section 529 account to G's grandchild GC2, and then directs a distribution to GC2. When G's revocable trust establishes the section 529 account, G is treated as if G made a gift to the section 529 account directly. Under section 2653(a), because the transfer was a GST, the transferor is treated as being one generation above the generation of GC1. There are no transfer tax consequences with respect to the section 529 account when the trust becomes irrevocable or when the trust changes the DB. When the trust makes a distribution from the section 529 account to GC2, no GST tax consequences result, because GC2 is only one generation below the deemed generation assignment of the transferor.
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> *Example 2*. G's revocable trust establishes a section 529 account for G's child, C. During G's life, the revocable trust become irrevocable. Consistent with the governing instrument, the trust then changes the DB of the section 529 account to G's grandchild, GC, and then directs a distribution to GC. When G's revocable trust establishes the section 529 account, G is treated as if G made a gift to the section 529 account directly. G is treated as the transferor for GST tax purposes, and because the contribution to the section 529 account was not a GST, G is assigned G's natural generation. There are no transfer tax consequences with respect to the section 529 account when the trust becomes irrevocable or when the trust changes the DB. When the trust makes a distribution from the section 529 account to GC, the distribution is treated as a taxable distribution or taxable termination for GST tax purposes, because GC is two generations below G's generation assignment.
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> *Example 3*. G's revocable trust establishes a section 529 account for G's grandchild, GC1. During G's life, the revocable trust becomes irrevocable. Consistent with the governing instrument, the trust then changes the DB of the section 529 account to G's great grandchild, GGC1, and then directs a distribution to GGC1. When G's revocable trust establishes the section 529 account, G is treated as if G made a gift to the section 529 account directly. Under section 2653(a), because the contribution to the section 529 account was a GST, the transferor is treated as being one generation above the generation of GC1. There are no transfer tax consequences with respect to the section 529 account when the trust becomes irrevocable or when the trust changes the DB. When the trust makes a distribution from the section 529 account to GGC1, the distribution is treated as a taxable distribution or taxable termination for GST tax purposes,

> because GGC1 is two generations below the deemed generation assignment of the transferor.

Thus a trust could have a section 529 account with the transferor assigned to a different generation than the generation assignment for the non-section 529 account assets in the trust. This could occur if the section 529 account was created while the trust was revocable and the creation of the section 529 account was a GST, causing the generation assignment of the transferor with respect to the section 529 account to move down a generation. *See* section 2654(b). This may require some recordkeeping by the trustee AO and/or by the DB for future gift and GST tax purposes.

> *Example 4*. G's revocable trust, for the benefit of G's child C and grandchildren GC1 and GC2, establishes a section 529 account for GC1. Under the rules proposed above, this would be a completed gift for gift and GST tax purposes by G at that time. Subsequently, during G's life, the revocable trust becomes irrevocable. G, as the transferor of the non-section 529 assets of the trust, is assigned to G's natural generation because the transfer to the trust is not a GST. However, because the transfer to the section 529 account for GC1 was a GST, the transferor is treated as being in C's generation (one generation above GC1) with respect to the section 529 account (which is treated as a separate trust for GST tax purposes). If after the trust becomes irrevocable the trust establishes a second section 529 account for GC2, G will be treated as the transferor of the section 529 account for GC2 (which is not a separate trust for GST tax purposes) and will be assigned to G's natural generation. Thus, when the trust makes a distribution from GC1's section 529 account to GC1, no GST tax consequences result from the distribution because GC1 is only one generation below the deemed generation assignment of the transferor (C's generation). However, when the trust makes a distribution from GC2's section 529 account to GC2, the distribution is treated as a taxable distribution or taxable termination for GST tax purposes and will be subject to GST tax unless the trust has a zero inclusion ratio or is grandfathered. Similarly, if the trust makes a distribution to GC1 or GC2 from non-section 529 account assets, the distribution is treated as a taxable distribution and will be subject to GST tax unless the trust has a zero inclusion ratio or is grandfathered.

c. Contributions to Trust-Owned Section 529 Accounts. Yet another possibility exists with trust-owned section 529 accounts: someone else may contribute property to the trust-owned account. For example, a trustee of an existing irrevocable trust is the AO of a section 529 account with a minor trust beneficiary as the DB. A grandparent of DB wants to contribute toward DB's higher education. For reasons important to grandparent (such as the trustee's superior reliability and judgment), grandparent wants the trustee (rather than the DB's parent) to control grandparent's contribution. Setting up another separate section 529 account for the same DB would not subject it to the terms of the trust and would cause extra administrative expense. So grandparent would like to contribute funds to the existing trust-owned section 529 account.

We believe that if a donor contributes cash to a section 529 account owned by an irrevocable trust, the donor should be treated as if the donor had made the contribution to the trust for transfer tax purposes and then the trust had contributed the funds to the section 529 account. Thus, the donor should be entitled to claim the gift tax annual exclusion if the contribution to the trust itself qualifies for that, as would be the result in the case of a contribution to a section 2503(b) or 2503(c) trust or a *Crummey* trust; and the donor should also be entitled to claim the GST tax annual exclusion if the contribution to the trust itself qualifies for that, as would be the result in the case of a contribution to a trust that qualifies under section 2642(c)(2).

In addition, when a contribution to the trust would qualify for the gift tax or GST tax annual exclusion (as the case may be) as described above, then for purposes of the particular tax, the donor should be permitted to make the five-year election under section 529(c)(2)(B) with respect to the contribution, but only for up to five times the lesser of (i) the annual exclusion amount in effect at the time of the contribution and (ii) whatever amount of the contribution qualifies for the annual exclusion at such time.[10] Any such election would also be subject to rules and limitations generally applicable to five-year elections. See Section III, A below. As in the case where the five-year election is made with respect to a contribution to a section 529 account with an individual AO, this permits the donor to accelerate the use of the annual exclusions but does not result in granting the donor additional annual exclusions.

> *Example 1.* P establishes a trust for P's child, C, that qualifies as a 2503(c) trust. P contributes cash to the trust, which the trust contributes to a section 529 account with C as the DB. GP, C's grandparent, contributes $60,000 to the section 529 account. Because the trust is a 2503(c) trust, a contribution by GP to the trust would qualify for both the gift tax and GST tax annual exclusions, in its entirety. Therefore, GP may make the five-year election with respect to the contribution to the trust-owned section 529 account, both for gift tax and GST tax purposes.
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> *Example 2.* P establishes an irrevocable spray trust for P's child, C, and P's future grandchildren. The trust gives the beneficiaries *Crummey* rights of withdrawal over contributions to the trust, up to $10,000 per year per beneficiary. The trust establishes a section 529 account for C. P contributes $60,000 to the section 529 account. Because C can withdraw up to $10,000 per year, $10,000 of the contribution by P to the trust would qualify for the gift tax annual exclusion. Thus, P can make the five-year election with respect to five times that amount,

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[10] Alternatively, the forthcoming guidance could simply treat a contribution by a third party to a trust-owned section 529 account in the same way as a contribution by a third party to a section 529 account with an individual as AO. Under this alternative the contribution would qualify for the gift tax and GST tax annual exclusions (and the five-year election) without regard to whether other contributions to the trust would qualify for such annual exclusions. As discussed in Section I above, any abuse would be deterred by existing anti-abuse doctrines (and by any general anti-abuse rule specific to section 529, if Treasury and the IRS deem one necessary), as these would look to the substance rather than form of transactions involving trust-owned section 529 accounts, including whether the trust-owned section 529 accounts and contributions to those accounts were truly intended to be used for the DB's QHEEs.

> $50,000, but the remaining $10,000 is an immediate taxable gift to the trust. If C's grandparent, GP, also contributes $60,000 to the section 529 account, the same consequences would apply to GP for gift tax purposes. However, because GP's contributions to the trust would not qualify for the GST tax annual exclusion, GP would not be able to make any five-year election for GST tax purposes.

We believe that if a third-party donor contributes cash to a section 529 account owned by a revocable trust, the donor should be treated as if the donor had made a contribution to a section 529 account for the DB with the trust grantor as the AO.

The transfer tax consequences of any subsequent change in DB by the AO while the trust is revocable should be governed by the general rules under section 529 applicable to individual AOs. After the trust becomes irrevocable, the GST tax rules would govern the transfer tax consequences. The transferor for GST tax purposes would be the third-party donor, who would be (1) assigned to such donor's natural generation if the original contribution to the section 529 account was not a GST (*i.e.*, the DB is not two or more generations below the donor), or (2) assigned to the generation immediately above the DB's generation if the original contribution to the section 529 account was a GST (*i.e.*, the DB is two or more generations below the donor). If the section 529 account had contributions from different transferors, the respective portions of the account would be treated as separate trusts for GST tax purposes. *See* section 2654(b)(1).

d. *Estates*. As noted above, generally only an individual can make a gift; an estate cannot. Thus, there should be no gift or GST tax consequences if a decedent's estate makes a contribution to a section 529 account. Section 529 provides no federal estate tax deduction or credit for contributions by an estate to a section 529 account. Thus, an estate will obtain no estate tax benefit for a contribution to a section 529 account. If the devisee or heir for whose benefit the estate makes a contribution to a section 529 account is a skip person, GST tax will be imposed at the decedent's death (subject to any applicable GST tax exemption), but the contribution of a skip person's devise or inheritance to a section 529 account does not provide any GST tax advantage to the estate. Therefore, there should be no transfer tax consequences when an estate makes a contribution to a section 529 account.

If an estate becomes the AO of a section 529 account by reason of the original AO's death, the section 529 account should not be included in the original AO's estate. *See* section 529(c)(4)(A). Any post-death transfer tax consequences would occur under the GST tax rules only upon a future distribution from the section 529 account or upon a future distribution of the section 529 account to a new AO. If the estate changes the AO and the DB is the same as the new AO, the change of AO should be treated as an estate distribution to the AO/DB for GST tax purposes. If the estate changes the AO and the new AO is different than the DB, the change of AO should be treated as an estate distribution to the new AO for GST tax purposes followed by a contribution of the funds by the new AO to the section 529 account for the DB. See the discussion above with respect to irrevocable trusts changing the AO of section 529 accounts.

e. *Other Entities*. As noted above, we do not believe that contributions to section 529 accounts by partnerships, associations, companies, and corporations are widespread or significant in amount. As set forth in the Advance Notice, under section 25.2511-1(h)(1) of the Regulations, the IRS has the power to treat a transfer of property by an entity as a gift from the owners of the entity. Absent evidence of abuse, we encourage Treasury and the IRS to rely on that power and the anti-abuse rule, when necessary, and not attempt to promulgate specific regulations dealing with the transfer tax consequences of contributions to section 529 accounts by partnerships, associations, companies, and corporations. Nevertheless, if Treasury and the IRS believe that specific regulations are necessary at this time, *de minimis* rules should be included so that the complexity of any special rules do not outweigh the benefit.

3. What are the income tax consequences when a contribution to a section 529 account is made by a person other than an individual? The Advance Notice seeks comments on the income tax consequences when a contribution to a section 529 account is made by a person other than an individual. Treasury and the IRS are also interested in comments regarding whether the complexity of any special rules would outweigh the benefit of allowing non-individual donors. The narrow question posed by Treasury and the IRS seems to focus only on the income tax consequences of a *contribution* by a non-individual, not on income tax consequences of a distribution from a section 529 account owned by a non-individual. Yet, there is a follow-up question in the Advance Notice that asks: "For example, if a trust makes contributions to a section 529 account, how should the trust treat the contributions to and *distributions* from the account for income tax purposes?" Therefore, this portion of our comments will address the income tax consequences of both contributions to a section 529 account by a non-individual and distributions from a section 529 account owned by a non-individual.

a. Irrevocable Trusts. The income tax consequences of a contribution to a section 529 account by an irrevocable trust should be based on whether or not the trustee has made or should be considered to have made a distribution to a beneficiary of the trust. "Distribution," by itself, is not defined in the Code or in the Regulations. But it is commonly understood to mean a "giving out." In other words, the trustee must give out property to effect a distribution. In order to give out trust property, the trustee must relinquish ownership and transfer, convey, or assign to or for the benefit of the beneficiary.

If the AO is the trustee, then the trustee will not have given out to the beneficiary the cash contributed to the section 529 account because the trustee can revest the contribution (as well as its earnings) and will control the timing and amount of all distributions to the DB from the section 529 account. Moreover, the beneficiary of the trust, who is also the DB, has no property interest in the section 529 account and has not, therefore, received anything in any meaningful sense, which is the other hallmark of a distribution. Therefore, a contribution to a section 529 account in which the trustee (or the trustee's nominee) is the AO should be treated merely as a trust investment and have no income tax consequences for the trust.

For income tax purposes, a section 529 account should be treated as a separate share, except in the case where the DB is the sole beneficiary of the trust. This result is consistent with the intent of section 529, the separate share rules and the administration of QTPs. First, section 529(c) provides that except as otherwise provided in section 529, no amount should be includible in gross income of a DB or contributor. It would be quite odd if, in light of the language, Congress had intended that income from a section 529 account could be included in the gross income of someone other than the AO, DB, or contributor, namely someone who was merely a beneficiary of a trust that owned a section 529 account for a different beneficiary.

Second, the separate share rule applies "if different beneficiaries have substantially separate and independent shares." Reg. § 1.663(c)-1(a). A separate share is created whenever a trust has more than one beneficiary (whether current, future, or contingent) and a section 529 account is created for one of those beneficiaries, because so long as the section 529 account remains in existence, it can only be distributed to the DB. It can be revested by the trust, but that would terminate the separate share. (The trust would incur under section 529 the income tax consequences that accompany a nonqualified distribution.) A separate share may exist even if the share might not ultimately be received by the beneficiary or if in the future it may be recombined with other shares. Reg. § 1.663(c)-3(a).

As a consequence, DNI for all section 529 accounts owned by an irrevocable trust for a particular DB should be determined separately from DNI for the remainder of the trust (and separately from DNI for section 529 accounts owned by the trust for other DBs). Thus a distribution from the section 529 account to the DB should not carry out DNI from non-section 529 account assets, regardless of whether such section 529 account distribution is qualified or nonqualified. Further, assuming the trust owns only one section 529 account for the DB, a nonqualified distribution from a section 529 account to the DB should only carry out income from the section 529 account, determined as provided under section 529.

Practically this must be the result. When a distribution is made from a section 529 account to the DB (or to an educational institution for the DB), a 1099-Q is issued to the DB of the section 529 account. If a trust is the AO, the trustee has no way of knowing the income shown on the 1099-Q and, therefore, cannot be required to use such distribution in determining trust income or DNI for other trust distributions.

If the trustee is required to make a principal distribution to the beneficiary, for example because the beneficiary attained a certain age, and the trust owns a section 529 account with the beneficiary as the DB, the trustee could effectuate the trust distribution by making the beneficiary the AO of the section 529 account. Alternatively, where the trust provides for discretionary distributions the trustee could make such a distribution to the beneficiary by making the beneficiary the new AO of all or a portion of a trust-owned section 529 account with the beneficiary as the DB. If the beneficiary is a minor, many trusts would permit a distribution to a custodian under the UTMA for the minor beneficiary. Where a trust owns a section 529 account and wishes to distribute it to a minor DB, the trustee may wish to change the AO to a custodian under the UTMA for the DB. In all of these cases, where the new AO is the same as the DB for transfer tax and income tax purposes, no income tax consequences should result from the change of AO under section 529 because only the AO has been changed and no 529 distribution has been made. For fiduciary income tax purposes, no income tax consequences should result if the separate share rule applies.

It is possible that a trustee may make a distribution to a trust beneficiary by changing the AO of a trust-owned section 529 account to the beneficiary when the section 529 account has as its DB someone other than the new AO. As suggested in Section II, C, 2 of these comments with respect to transfer tax consequences, any such trust distribution should be treated as a trust distribution to the new AO followed by a contribution of the funds by the new AO to the section 529 account for the DB. The change of AO would not result in any income tax consequences under section 529 because only the AO has been changed and no 529 distribution has been made. For fiduciary income tax purposes, no income tax consequences should result if the separate share rule applies.

Distributions from a section 529 account funded by an irrevocable trust but with respect to which the trustee is not the AO should have no fiduciary income tax consequences, based on the analysis set forth above.

b. *Revocable Trusts*. Since a revocable trust is a grantor trust under section 676, there should be no income tax consequences when a revocable trust makes a contribution to a section 529 account. However, if a revocable trust owns a section 529 account that makes a nonqualified distribution to a DB, the income tax consequences should flow to the DB, which is consistent with the 1099-Q that would be issued on account of such distribution. *See* section 529(c)(3). The section 529 account would be treated as a separate share for fiduciary income tax purposes except in the unusual case in which the DB was the sole beneficiary of the trust.

There should be no special income tax consequences when a revocable trust becomes irrevocable.

c. *Estates*. A section 529 account owned by an estate should be treated as a separate share for income tax purposes. See the discussion above with respect to irrevocable trusts.

As discussed above with respect to changing the AO of a trust-owned section 529 account, when a section 529 account is established for a devisee or heir it should be treated as a distribution to the AO for fiduciary income tax purposes. If the estate is merely changing the AO of a section 529 account of which the estate was previously the AO, there should be no fiduciary income tax consequences resulting from this distribution from the estate if the separate share rule applies.

4. What procedures and reporting mechanisms must be in place to ensure the assessment and collection of all appropriate income, employment, and gift taxes? The Advance Notice requests comments on the procedures and reporting mechanisms required to ensure the assessment and collection of all appropriate income, employment, and gift taxes. We do not believe that it is possible to address all income and employment tax enforcement issues by the deadline for submitting comments to the Advance Notice. Issues such as the potential applicability of section 409 to contributions by employers to section 529 accounts for employees or their children will require much more study. So will enforcement mechanisms for potential employment taxes.

We also believe that the suggestions that appear elsewhere in these comments address the procedures and reporting mechanisms to ensure the assessment and collection of all transfer taxes.

D. Special Rules for Self-Settled and UGMA/UGMA-Funded Section 529 Accounts

Section II, D of the Advance Notice seeks to address the issue of section 529 accounts in two situations. One is the section 529 account created by a donor who names himself or herself as the DB. The other is a section 529 account created for the beneficiary of a UGMA or UTMA account. In the first situation, the donor/DB uses his or her own funds. In the second, the funds in the UGMA/UTMA account are used to fund the section 529 account. The amounts in UGMA/UTMA accounts are deemed to be owned, at least beneficially, by the beneficiary, even if controlled by the custodian who is a different person. And so when the section 529 account is funded from the UGMA/UTMA account, in essence the beneficiary is funding a section 529 account with his or her own funds.

1. Transfer Tax Considerations. Traditional notions related to transfer tax provisions would say that a donor cannot make a gift to himself. But section 529(c)(2)(A) provides:

> (2) GIFT TAX TREATMENT OF CONTRIBUTIONS. For purposes of chapters 12 and 13 –
>
> > (A) IN GENERAL. Any contribution to a qualified tuition program on behalf of any designated beneficiary –
> >
> > > (i) shall be treated as a completed gift to such beneficiary which is not a future interest in property, and
> > >
> > > (ii) shall not be treated as a qualified transfer under section 2503(e).

The use of the word "any" to define both the contribution and the DB creates the difficulty that the Advance Notice addresses. "Any" contribution presumably includes a contribution from "any" source of funds, including the funds of the DB/donor. "Any" DB possibly includes the donor.

But, we note that the quoted portion of section 529 above begins with "In General" indicating an intent that the rule contained therein is not designed to cover every situation. And thus we believe that the general rule set out in section 529(c)(2)(A) allows by its introductory phrase the creation of a specific rule that might address self-funded section 529 accounts.

Employing more traditional concepts, the Advance Notice proposes to say that a donor does not make a completed gift, and, in fact, does not make a gift at all, when the donor sets up a section 529 account for the donor's own benefit. Given that the beneficiaries of UGMA and UTMA accounts are the beneficial owners of those accounts, then they too would be treated as having made no gift at all if the custodian of the account transferred funds from the UGMA or UTMA account to a section 529 account for the same beneficiary.

Treasury and the IRS seem willing to recognize that individuals may want to establish and fund section 529 accounts for their own benefit, to take advantage of the income tax provisions of section 529, and that this may be permitted so long as any subsequent change of

DB is treated as a new contribution. We agree this makes good sense and appears to be in keeping with the will of Congress.

2. Income Tax Considerations. The Advance Notice proposes that when a donor to a section 529 account for herself or himself subsequently changes the DB, the change of DB will be treated first as a distribution of the section 529 account back to the donor, followed by a contribution to a new section 529 account for the new DB. The Advance Notice also anticipates that the deemed transaction should be treated as a rollover, which would prevent income tax on any earnings in the section 529 account and also avoid the 10% additional tax for a nonqualified withdrawal – but these benefits would apply only if the new DB is a member of the donor's (*i.e.,* the old DB's) family. Presumably, although the Advance Notice does not expressly so state, the designation of a new DB who is not a member of the donor's family will be treated differently.

We agree with this approach in general, although it is somewhat cumbersome, and perhaps even contrary to section 529(c)(3)(C), which says that a change in DB is not to be treated as a distribution if the new DB is a member of the family of the old DB. And the fiction of a distribution may spill over into other areas. For example, a deemed distribution may have an effect under state income tax rules, especially in states which allow a deduction for contributions and provide recapture rules in the event of a distribution.

We suggest that the forthcoming guidance confirm whether the change of DB to someone who is not a member of the family of the old DB will be treated as a nonqualifying distribution that is subject to income tax and the 10% additional tax (in addition to being treated as a new contribution for the new DB as described above, for transfer tax purposes).

E. Circumstances Under Which the Section 529 Account of a Deceased DB Will Be Distributed to, and Includible in, the Gross Estate of the Deceased DB for Estate Tax Purposes

Section 529 cryptically says that amounts distributed on account of the death of a DB are included in the DB's estate.[11] The legislative history and the proposed regulations suggest that the value of any interest in a section 529 account will be includible in the estate of a deceased DB. Estate tax inclusion is consistent with the tax theory of section 529 because the original transfer to the account was a completed gift to the DB under section 529. However, unless the section 529 funds are actually distributed to the DB's estate, the fact that the DB had no control over the section 529 account may make it impractical, if not unconstitutional or otherwise legally impermissible, to require that the DB's estate include the section 529 account in the DB's estate and incur any estate tax consequences. Further, we expect that the vast majority of estates of

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[11] Section 529(c)(4)(A) provides that "No amount shall be includible in the gross estate of any individual for purposes of chapter 11 by reason of an interest in a qualified tuition program." Section 529(c)(4)(B) creates an exception to the general rule:

> (B) AMOUNTS INCLUDIBLE IN ESTATE OF DESIGNATED BENEFICIARY IN CERTAIN CASES. – Subparagraph (A) shall not apply to amounts distributed on account of the death of a beneficiary.

DBs will not be required to file federal estate tax returns. The Advance Notice appears to resolve these problems by treating a change of DB or distribution to the AO that occurs within a relatively short time after the death of the DB as if such event occurred prior to the DB's death, thereby avoiding estate tax inclusion if there is a distribution to the AO or a change of DB if the new DB is a member of the family of the deceased DB and is not in a lower generation than the deceased DB. The Advance Notice proposes five rules:

> *Rule 1*. If the AO distributes the entire section 529 account to the estate of the deceased DB within 6 months of the death of the DB, the value of the section 529 account will be included in the deceased DB's gross estate for estate tax purposes.
>
> *Rule 2*. If a successor DB is named in the section 529 account contract or program and the successor DB is a member of the family of the deceased DB and is in the same or a higher generation (as determined under section 2651) as the deceased DB, the value of the section 529 account will not be included in the gross estate of the deceased DB for estate tax purposes.
>
> *Rule 3*. If no successor DB is named in the section 529 account contract or program, but the AO names a successor DB who is a member of the family of the deceased DB and is in the same or a higher generation (as determined under section 2651) as the deceased DB, the value of the section 529 account will not be included in the gross estate of the deceased DB for estate tax purposes.
>
> *Rule 4*. If no successor DB is named in the section 529 account contract or program, and the AO does not name a new DB but instead withdraws all or part of the value of the section 529 account, the AO will be liable for the income tax on the distribution, and the value of the section 529 account will not be included in the gross estate of the deceased DB for estate tax purposes.
>
> *Rule 5*. If, by the due date for filing the deceased DB's estate tax return, the AO has allowed funds to remain in the section 529 account without naming a new DB, the section 529 account will be deemed to terminate with a distribution to the AO, and the AO will be liable for the income tax on the distribution. The value of the section 529 account will not be included in the gross estate of the deceased DB for estate tax purposes.

The Advance Notice proposes sensible rules for when a section 529 account should be included in the estate of the DB. Some of these rules, however, require refinement.

Rule 1 requires inclusion in the deceased DB's estate only if "the entire section 529 account" is distributed to the estate. Does this mean that if all but $100 of the section 529 account is distributed to the deceased DB's estate, and then the DB of the $100 remaining in the section 529 account is changed to a member of the family, there is no estate tax inclusion? The forthcoming guidance should provide for estate inclusion *only to the extent* the section 529 account is distributed to the estate.

Further, Rule 1 requires estate tax inclusion only if the distribution is made within six months of death, while Rule 5 only produces a deemed distribution to the AO to the extent that funds are remaining in the section 529 account on the due date for filing the deceased DB's estate tax return. Does this mean that a distribution to the deceased DB's estate more than six months but less than nine months after death does not cause inclusion? For consistency, both rules should rely on the same point in time.

Presumably, the earnings portion of any distribution to the deceased DB's estate would be subject to income tax as income with respect to a decedent. However, no 10% additional tax should apply because section 530(d)(4)(B)(i) excludes from additional tax a distribution made to the estate of the DB after the DB's death.

Rule 2 should apply only where the successor DB is designated at the time of the deceased DB's death and is then living.

Rule 3 should be clarified to state that it may apply with respect to only a portion of a section 529 account and to specify the date by which the change of DB must be made (perhaps the due date for filing the deceased DB's estate tax return).

The Advance Notice does not cover the situation where a successor DB is named, either pursuant to the contract or program, or by the AO after the death of the old DB, and the successor DB is not a member of the family of the old DB. Section II, A of the Advance Notice would treat such a change of DB, if it occurred prior to the DB's death, as a distribution to the AO and a new gift to a section 529 account by the AO. Under such circumstances the section 529 account should not be included in the estate of the deceased DB.

There also seems to be no rule for what happens if a new DB is designated who is a member of the family of the deceased DB, but is in a lower generation than the old DB. Following the underlying theory of the examples in the Advance Notice, if within the mandated time period after the DB's death a new DB is designated who is a member of the family of the deceased DB, but is in a lower generation than the old DB, the deceased DB should be treated as having made a transfer to the new DB. This is consistent with the discussion in Section II, A of these comments, discussing such a change of DB during the old DB's life. Because under the tax theory of section 529 the deceased DB is making an imputed transfer to the new DB, the estate of the deceased DB may agree to inclusion in the estate of the deceased DB. The AO in such circumstances should be required to report the deemed transfer on an informational gift tax return and attach a consent signed by the personal representative of the deceased DB's estate under which the old DB agrees to be treated as the transferor of the deemed gift.

To the extent the personal representative of the deceased DB's estate does not consent to estate tax inclusion, it is consistent with existing transfer tax principles to impose the transfer tax liability on the person in possession of the transferred property. Section 529 accounts are typically structured in a manner providing the AO actual access to the property. For administrative convenience, the forthcoming guidance could provide that to the extent the estate of the deceased DB does not consent to estate tax inclusion, the AO must report the transfer on the AO's gift tax return. For this purpose the AO should be deemed to be assigned to the deceased DB's generation. In a purely theoretical world, because the AO is only reporting and paying tax on a transfer from the deceased DB, the deceased DB's estate tax exclusion and GST exemption could be applied against such gift. However, they cannot, practically or perhaps constitutionally, be applied without the consent of the estate of the deceased DB. Therefore, the best that the forthcoming guidance can do is to permit the AO to apply the AO's own gift and GST tax exclusions and exemptions against the deemed transfer.

Rule 4, which prevents inclusion in the deceased DB's estate if there is no successor DB named and the AO withdraws the funds, should specify the date by which the funds must be withdrawn (and no successor DB designated). The 10% additional tax would appear to apply to the extent the distribution is included in the AO's income. Section 530(d)(4)(B)(i) states that the additional tax does not apply if the payment or distribution is "made to a beneficiary (or to the estate of the designated beneficiary) on or after the death of the designated beneficiary." There is no exception for a distribution to an AO.

Further, if the AO was not the contributor to the section 529 account, under the Advance Notice Treasury and the IRS would treat the AO as having no "investment" in the section 529 account under section 72 and would tax the entire section 529 account. This is a harsh result, especially when there is no reasonable alternative for a new DB (*e.g.*, the section 529 account was for an only child or the child's siblings have already completed their education), the original AO died, and including the section 529 account in the DB's estate would require probate proceedings that otherwise would be unnecessary.

Rule 5 states that if, by the due date for filing the deceased DB's estate tax return, the AO has allowed funds to remain in the section 529 account without naming a new DB, the section 529 account will be deemed to terminate with a distribution to the AO and the AO will be liable for income tax on the distribution. First, many estates of deceased DBs will not be required to file estate tax returns. Second, the 10% additional tax would appear to apply to the portion of the section 529 account includible for income tax purposes. Third, what will be the income tax consequences if the AO subsequently actually terminates the section 529 account, having already paid income tax on the deemed distribution of the section 529 account? Fourth, if the AO subsequently designates a DB for the section 529 account, presumably that will be treated as a new gift by the AO. *See* Section II, B, 2 above.

Additional rules should be proposed to cover the situation where the deceased DB was a contributor to the section 529 account. In such case, the entire section 529 account should be included in the deceased DB's estate except to the extent (on a proportional basis) that contributions were made to the section 529 account by a third party. To the extent contributions were made to the section 529 account by a third party, the rules outlined above should apply.

III. Rules Governing the Function and Operation of QTPs and Section 529 Accounts

A. Rules for Making the Election Under Section 529(c)(2)(B) To Treat Contributions to a Section 529 Account as Being Made Over a Five-Year Period

1. Multiple Five-Year Elections. Section III, A of the Advance Notice discusses rules for making the election under section 529 to treat contributions to a section 529 account as being made over a five-year period. Section 529, the proposed regulations, and Section III, A of the Advance Notice are all quite clear regarding the operation of the five-year election in Year 1, when an election is first made. However, there is less certainty and agreement among taxpayers and their advisors as to (i) whether additional five-year elections may be made by the same person during years included in the initial election, and (ii) if so, what parameters and limitations are applicable to such additional elections. Thus, in addition to the rules already proposed in Section III, A of the Advance Notice, the forthcoming guidance should make clear that additional five-year elections may be made during the term of a prior election and specify the applicable parameters and limitations.

Nothing in section 529 or the proposed regulations explicitly prohibits additional five-year elections during the term of a prior election. In particular, the provision for five-year elections in section 529(c)(2)(B) is open-ended, referring only to contributions "during the calendar year," with no limitations as to the timing or frequency of such elections. If Congress had intended to allow only one such election in any five-year period, it could have easily added that limitation explicitly to section 529(c)(2)(B); and if Treasury and the IRS had intended to impose such a limitation in the proposed regulations, that could have been done easily and explicitly as well.[12]

Moreover, as a policy matter, it is consistent with the purposes of section 529 to allow additional five-year elections during the term of a prior election. For example, imagine that Parent A is able to come up with $60,000 for college savings in Year 1, while Parent B can only come up with $30,000 for college savings in Year 1 and then another $30,000 in Year 2, with both Parents contributing those college savings to section 529 accounts for their respective children. Why should only Parent A be able to take full advantage of the five-year election for the $60,000 total college savings, and why should Parent B lose the advantage of the five-year election for the $30,000 college savings that could not be raised until Year 2? If the ability to come up with college savings corresponds to economic circumstances, then prohibiting additional five-year elections during the term of a prior election would disadvantage parents in less favorable economic circumstances, when they are the parents whom section 529 should most encourage to save for college.

Even presuming that additional five-year elections are permitted, though, the next task would be to specify what parameters and limitations may be applicable to such additional elections. A range of potential approaches is illustrated by the examples and discussion below. Unless otherwise indicated, each example below presumes (i) contributions from AO to a section 529 account for DB, with no other gifts from AO to DB, and (ii) a $12,000 annual exclusion amount.

[12] Example A in Section III, A of the Advance Notice and a structurally equivalent example in the proposed regulations (section 1.529-5(d)(2)) do illustrate cases where a contribution is made to a section 529 account during the term of a five-year election. However, in both cases, the amount of that year's contribution is less than that year's annual exclusion amount, and the sum of that year's actual contribution plus that year's portion of the prorated contribution does not exceed that year's annual exclusion amount. Thus, the ability to make an additional five-year election in that year is simply irrelevant in those cases, and those cases do not really speak to whether that ability exists or not.

Example 1. In Year 1, AO contributes $40,000 to a section 529 account for DB and makes the five-year election, prorating the gift at $8,000 per year. In Year 2, AO contributes $20,000 to the account. If AO may make an additional five-year election for the Year 2 contribution, the relevant amounts would be as follows:

Example 1	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**
Annual Exclusion	12,000	12,000	12,000	12,000	12,000	12,000	12,000
Actual Gift	40,000	20,000					
Year 1 Deemed Gift	8,000	8,000	8,000	8,000	8,000		
Year 2 Deemed Gift		4,000	4,000	4,000	4,000	4,000	
Non-Proratable Gift							
Total Gifts	8,000	12,000	12,000	12,000	12,000	4,000	
Total Taxable Gift	0	0	0	0	0	0	0

Example 1 strikes us as the most straightforward and uncontroversial application of the principle that additional five-year elections should be permitted within the term of a prior election. It is consistent with the express language and implicit purposes of section 529, without any countervailing policy considerations.

Also, it is clear from section 529 and the proposed regulations that, in Example 1, AO would not have the option to prorate the Year 1 contribution or the Year 2 contribution over fewer than five years (for example, prorating the $40,000 Year 1 contribution at $10,000 per year for four years). However, we are aware of some uncertainty among practitioners as to whether AO could elect to prorate only a portion of the $40,000 (over a full five years) and report the balance of the $40,000 as a gift entirely in Year 1 – for example, prorating $35,000 over five years, at $7,000 per year, and reporting the remaining $5,000 in Year 1. If permissible, this approach would allow full use of the Year 1 annual exclusion and reduce the advance use of annual exclusions for subsequent years. For that reason, we believe this approach is consistent with the purposes of section 529 and should be adopted.[13]

We now move on to examples illustrating points of greater uncertainty among practitioners with respect to multiple five-year elections.

Example 2A. In Year 1, AO contributes $40,000 to a section 529 account for DB and makes the five-year election, prorating the gift at $8,000 per year. In Year 2, AO contributes $30,000 to the account. One possibility is that AO may make an additional five-year election for the Year 2 contribution, for the full $30,000 amount, since it does not exceed five times the Year 2 annual exclusion amount of $12,000. In that case, the relevant amounts would be as follows:

[13] Essentially, section 529(c)(2)(B) would be construed to permit the taxpayer to make the five-year election over the aggregate amount of contributions, or such lesser amount as the taxpayer elects. It is not clear to us whether the express provisions of section 529 would support this approach. Regardless, we encourage the IRS and Treasury to resolve this uncertainty in the forthcoming guidance.

Example 2A	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Annual Exclusion	12,000	12,000	12,000	12,000	12,000	12,000	12,000
Actual Gift	40,000	30,000					
Year 1 Deemed Gift	8,000	8,000	8,000	8,000	8,000		
Year 2 Deemed Gift		6,000	6,000	6,000	6,000	6,000	
Non-Proratable Gift							
Total Gifts	8,000	14,000	14,000	14,000	14,000	6,000	
Total Taxable Gift	0	2,000	2,000	2,000	2,000	0	0

Example 2B. Same as Example 2A ($40,000 contribution in Year 1 and $30,000 contribution in Year 2), except that AO is only permitted to make an additional five-year election for the Year 2 contribution with respect to five times the difference between the Year 2 annual exclusion amount and the deemed gift from any prior elections (namely, $20,000, being five times the difference between the $12,000 annual exclusion amount and the $8,000 deemed gift from Year 1). In that case, the relevant amounts would be as follows:

Example 2B	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Annual Exclusion	12,000	12,000	12,000	12,000	12,000	12,000	12,000
Actual Gift	40,000	30,000					
Year 1 Deemed Gift	8,000	8,000	8,000	8,000	8,000		
Year 2 Deemed Gift		4,000	4,000	4,000	4,000	4,000	
Non-Proratable Gift		10,000					
Total Gifts	8,000	22,000	12,000	12,000	12,000	4,000	
Total Taxable Gift	0	10,000	0	0	0	0	0

If in Example 2B the annual exclusion amount had increased to $13,000 in Year 2, AO could have instead made an additional five-year election in Year 2 with respect to $25,000 (being five times the difference between that $13,000 and the $8,000 deemed gift from Year 1). Then, only $5,000 would have been non-proratable in Year 2, creating a $5,000 taxable gift that year.

Examples 2A and 2B highlight the question of whether the ability to make an additional five-year election during the term of any prior election(s) should or should not be limited by the deemed gifts arising from such prior election(s). The express provisions of section 529 do not include such a limitation, and some would argue not only that such a limitation is unnecessary from a policy standpoint but that Congress could have easily included such a limitation if one was intended. However, others would argue that the ability in Example 2A to defer taxable gifts (and not just the use of annual exclusion) is contrary to the implicit provisions of section 529 or otherwise objectionable from a policy standpoint.[14] Without taking a firm position one way or the other, we strongly encourage Treasury and the IRS to resolve this uncertainty in the forthcoming guidance.

[14] In turn, a counterargument to the policy concern may be that, in the vast majority of cases, the deferred taxable gifts will be well within the donor's gift tax exemption, such that, even where taxable gifts are deferred, there will usually be no deferral of gift tax actually payable.

Example 3A. In Year 1, AO contributes $60,000 to a section 529 account for DB and makes the five-year election, prorating the gift at $12,000 per year. In Year 2, the annual exclusion amount increases to $13,000, and AO contributes $5,000 to the account. One possibility is that AO may make an additional five-year election for the $5,000 Year 2 contribution, because the sum of that amount plus the $12,000 deemed gift from Year 1 (that is, $17,000) exceeds the Year 2 annual exclusion amount. In that case, the relevant amounts would be as follows:

Example 3A	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**
Annual Exclusion	12,000	13,000	13,000	13,000	13,000	13,000	13,000
Actual Gift	60,000	5,000					
Year 1 Deemed Gift	12,000	12,000	12,000	12,000	12,000		
Year 2 Deemed Gift		1,000	1,000	1,000	1,000	1,000	
Non-Proratable Gift							
Total Gifts	12,000	13,000	13,000	13,000	13,000	1,000	
Total Taxable Gift	0	0	0	0	0	0	0

Example 3B. Same as Example 3A ($60,000 contribution in Year 1 and $5,000 contribution in Year 2), except that AO is not permitted to make an additional five-year election for the Year 2 contribution, because the $5,000 amount of that actual contribution (taken alone) is less than the Year 2 annual exclusion amount. In that case, the relevant amounts would be as follows:

Example 3B	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**Year 7**
Annual Exclusion	12,000	13,000	13,000	13,000	13,000	13,000	13,000
Actual Gift	60,000	5,000					
Year 1 Deemed Gift	12,000	12,000	12,000	12,000	12,000		
Year 2 Deemed Gift							
Non-Proratable Gift		5,000					
Total Gifts	12,000	17,000	12,000	12,000	12,000		
Total Taxable Gift	0	4,000	0	0	0	0	0

Examples 3A and 3B highlight the question of whether or not, in determining whether section 529 account contributions in a given year exceed the annual exclusion amount, one is permitted (or even required) to include the deemed contribution(s) for that year arising from any prior election(s). Different practitioners have read section 529 and the proposed regulations to suggest different conclusions on this matter. The issue is whether in section 529(c)(2)(B) the phrase "the aggregate amount of contributions" should be construed to mean only actual contributions during the calendar year or also to include contributions attributed to the calendar year by reason of a prior five-year election. We strongly encourage Treasury and the IRS to resolve this uncertainty one way or another in the forthcoming guidance, and we make two observations:

- The interpretation reflected in Example 3A above is more consistent with the purposes of section 529, encouraging donors to make 529 contributions more rapidly as increases in the annual exclusion amount permit it to be done on a tax-efficient basis, and we do not see any strong policy reason to oppose that interpretation.

- Also, the interpretation reflected in Example 3B above creates some distortions with little or no policy basis. For example, in Example 3B, if the Year 2 contribution were increased by \$8,001, from \$5,000 to \$13,001, that contribution could be prorated over five years (at \$2,600.20 per year), resulting in taxable gifts of \$1,600.20 per year for Years 2 through 5 (\$6,401 total). If instead AO could not come up with that extra \$8,001 until Year 3, but then contributed that to the section 529 account (equalizing the respective contribution amounts), that \$8,001 could not be prorated, either, resulting in taxable gifts of \$4,000 for Year 2 and \$7,001 for Year 3 (\$11,001 total). In other words, the AO with less money available in Year 2 incurs worse gift tax consequences, which has no good policy basis and is arguably contrary to the purposes of section 529.[15]

All of the Examples above could be modified to provide that, in addition to the section 529 account contributions, AO made other outright gifts to DB in Year 1 and/or Year 2. Would those additional non-section 529 gifts affect whatever ability AO may have otherwise had to make five-year elections with respect to the section 529 account contributions in the same year(s)?[16] Here, we believe there is more consensus, and we do take a position, that the non-section 529 gifts should have no such effect. Several considerations support this position, and we hope that it will be made explicit in the forthcoming guidance.

- Section 529 clearly indicates that that the availability of five-year elections should be keyed solely to the full annual exclusion amount for a particular year – that is, to the "limitation for such year under section 2503(b)" – without any reduction for or other references to other gifts in the same year which might also qualify for the annual exclusion.

- The contrary position (that the use of annual exclusion by non-section 529 gifts should affect the availability of the five-year election for section 529 account contributions) effectively presumes that the annual exclusion amount and the amount of non-section 529 gifts from donor to DB will remain constant over the five years covered by the election. This presumption is not accurate, reasonable, or compelled by policy considerations.

- The contrary position would introduce unnecessary complexity for donors and their advisors. For example, it would become more complicated (with greater risk of error) to

[15] We realize that similar distortions may arise even in Year 1 from the provision that contributions may only be prorated if they exceed the annual exclusion amount. However, while we may find those distortions frustrating, they seem inevitable given the express provisions of section 529, unless and until the relevant provision may be amended. By contrast, section 529 does seem to allow a little more room to avoid these distortions where additional five-year elections are concerned, by adopting the interpretation reflected in Example 3A.

[16] The question could be illustrated by numerous permutations of the above examples and corresponding tables. However, in light of our position on this question, we do not include those permutations here.

explain and understand the operation and ramifications of five-year elections, and to track and report the availability of the five-year election, as affected by non-section 529 gifts. Also, new and unnecessary questions would arise, such as, could a donor choose (notwithstanding general gift tax principles) whether or not annual exclusion should be applied to a non-section 529 gift, in order to preserve the availability of the five-year election, or would non-section 529 gifts necessarily and inevitably reduce that availability (on a five-to-one basis at that)?

- Finally, the contrary position would contradict the purposes of section 529, with little or no offsetting policy reason, insofar as it would discourage donors from contributing as much to section 529 accounts as they would under our preferred position, where the availability of the five-year election is not affected by non-section 529 gifts.

2. Transfer Tax Treatment of Portion Included in Estate of Donor. Another issue concerning the five-year election is, what happens when a donor makes a five-year election in Year 1 but dies before the first day of Year 5, such that a portion of the prorated Year 1 contribution is includible in the donor's estate for estate tax purposes.[17] In such a case, who is treated as the transferee receiving the includible amount, particularly for marital deduction and GST tax purposes? Consider the following scenarios, where a donor contributes $60,000 to a section 529 account for a DB in Year 1, makes a five-year election, and dies in Year 2, such that $36,000 of the prorated contribution is includible in donor's estate:

> *Scenario 1.* The donor's child is the DB, and the donor's spouse either becomes the successor AO at the donor's death or was already the AO when the contribution was made. For estate tax purposes, will the includible $36,000 be treated as passing to the donor's spouse, as AO (such that the $36,000 inclusion will be offset by a $36,000 marital deduction), or to the donor's child, as DB (with no offsetting marital deduction)?
>
> *Scenario 2.* The donor's grandchild is the DB, and the donor's child either becomes the successor AO at the donor's death or was already the AO when the contribution was made. For GST tax purposes, will the includible $36,000 be treated as passing to the donor's child, as AO (with no GST tax consequences), or to the donor's grandchild, as DB (such that a GST may be deemed to occur and either use GST exemption or cause GST tax to be payable)?

[17] Implicit in this sentence is the presumption that no portion of the prorated Year 1 contribution will be includible in the donor's estate if the donor survives to the first day of Year 5, because the prorated portion allocable to Year 5 will become treatable as a gift by the donor for gift tax purposes on that first day of Year 5. The donor does not need to survive for a full five years following the Year 1 contribution (that is, into Year 6), or even through the end of Year 5, in order to avoid inclusion. This presumption is based on the fact that section 529(c)(4)(C) includes in the gross estate of the donor the portion of the contributions subject to the five-year election "properly allocable to periods after the death of the donor." The forthcoming guidance should make it explicit that "periods after the death of the donor" means calendar years after the year of the death of the donor.

In each scenario, treating the $36,000 as passing to the DB would be more consistent with the underlying premise of section 529 that a contribution to a section 529 account is a completed gift to the DB, even though the DB may have no effective control over or vested interest in the section 529 account. Such treatment would also be more consistent with the fact that, if the donor had survived into Year 5, the entire $60,000 contribution would have eventually been treated as a completed transfer from the donor to the DB.

Nonetheless, the foregoing treatment does not reflect the practical reality of the AO's ability to withdraw any funds in the section 529 account, and it may have unnecessarily harsh results, especially where the AO does withdraw the funds. As a compromise between the underlying premise of section 529 and the practical reality, we would propose the following approach:

- By default, amounts includible in the estate of a donor as a result of a five-year election should be treated as passing to the DB. However, such amounts may instead be treated as passing to the AO, if and to the extent that (i) the AO withdraws funds from the section 529 account within a specified period after the donor's death (and makes the withdrawal reasonably known to whoever is responsible for the donor's estate tax return) and (ii) this treatment is elected on the donor's estate tax return. The specified period could be established by reference to the due date of the donor's estate tax return or as a fixed number of months. Perhaps it would parallel the corresponding provisions concerning estate tax inclusion following a DB's death, discussed elsewhere in these comments.

- Also, given that the DB of the section 529 account may be changed, amounts includible in the estate of the donor as a result of the five-year election should be considered as passing to whichever individual is the DB at the end of the period determined under the preceding paragraph (except to the extent such amounts are treated as passing to the AO under the preceding paragraph). If and to the extent that funds are distributed from the account to a particular DB during such period, the includible amount may instead be treated as passing to that DB, notwithstanding any subsequent change of DB.

3. GST Tax Treatment of Portion Includible in Estate. Where, after application of any special rules suggested in the preceding section, a portion of a prorated contribution is includible in a deceased donor's estate and the DB of the account is two or more generations below the donor/decedent, the GST tax consequences of such inclusion, and the GST tax consequences of future distributions from such section 529 account, are unclear. We suggest that the includible portion should be treated as a direct skip.

Section 2612(c) provides that the term "direct skip" means "a transfer subject to a tax imposed by chapter 11 or 12 of an interest in property to a skip person." Section 2613(a) defines "skip person" to mean either "a natural person assigned to a generation which is 2 or more generations below the generation assignment of the transferor" or "a trust if all interests in such trust are held by skip persons, or if there is no person holding an interest in such trust, and at no time after such transfer may a distribution (including distributions on termination) be made from such trust to a non-skip person." Section 2652(b) defines the term "trust" to include "any arrangement (other than an estate) which, although not a trust, has substantially the same effect as a trust." Because section 529 treats a contribution to a section 529 account as a completed gift to the DB, if the DB is a skip person the imputed transfer should be a direct skip.

This would be consistent with section 529(c)(2), which for gift tax purposes treats a contribution to a section 529 account as a completed gift to the DB notwithstanding the fact that the DB later may be changed or that the section 529 account may be distributed to the AO. However, absent the adoption of a special rule under section 529 treating the included portion as a direct skip if the DB is a skip person, the transfer might not be a direct skip under the GST tax rules if the DB could be later changed to a non-skip person or if the section 529 account could be distributed to the AO and the AO is not a skip person with respect to the donor.

However, complicated tax problems could be created for a donor wishing to make a five-year election when the donor will not have sufficient GST exemption remaining at the time of death to allocate to the included portion. To carry out the purpose of encouraging contributions to section 529 accounts, the forthcoming guidance could adopt rules similar to the rules proposed in Section II, E of the Advance Notice, and in the compromise approach suggested in Section III, A, 2 above, with respect to inclusion in the estate of a deceased DB, which would permit certain actions taken during a specified period to determine the recipient of the section 529 account contributions deemed to be included in the estate. For example, the distribution from the estate would be treated as passing to the AO if the AO took a distribution during the specified period. Alternatively, the distribution would be deemed to be to a new DB if the AO changed the DB during the specified period. Thus the estate could avoid GST tax consequences with respect to the included portion of the contribution where the DB is a skip person by either, within the specified period, changing the DB of that portion of the section 529 account to a non-skip person or refunding that portion of the section 529 account to the AO if the AO is a non-skip person. This is not abusive because if the DB was subsequently changed to the former DB who was a skip person, transfer tax consequences would ensue.

B. Income Tax Issues Relating to Section 529 Accounts

We were pleased that the Advance Notice does not seek to impose a requirement that, in order to qualify for tax-free treatment, distributions from a section 529 account must be used only for QHEEs paid in the same year as the distribution. Allowing payment of QHEEs through March 31 of the year following distribution seems reasonable, although we would encourage an extension of that date at least to the due date of the taxpayer's return without regard to extensions (typically, April 15). Without materially extending the time period, this would be helpful for taxpayers who might not realize until their returns are prepared that their paid QHEEs did not yet equal their distributions, but who might be able to pay further QHEEs before the returns are filed.

Also, some taxpayers might pay QHEEs from their own funds, expecting to reimburse those funds with a later distribution from a section 529 account. In many cases, that decision is simply a matter of timing, convenience, or concern that a section 529 account distribution cannot be made in time to meet the deadline for an expense. Thus, it would be helpful to extend the available window for a reasonable period prior to the year of distribution, so that a distribution may also qualify for tax-free treatment if effectively used for QHEEs paid prior to the year of distribution but within that reasonable period (*e.g.*, on or after September 15 of such prior year).

IV. ADDITIONAL RULES

Consistent with the objectives of the Advance Notice and section 529(f), we offer comments regarding three areas that we hope will be addressed by the forthcoming guidance, even though they are not specifically mentioned in the Advance Notice.

A. Rules for Changing Investment Options

Section 529(b)(5) requires a QTP to provide that any contributor may not directly or indirectly direct the investment of any contributions to the QTP (or any earnings thereon). However, the proposed regulations provided (in section 1.529-2(g)) that a QTP does not violate this requirement if it permits a person who establishes a section 529 account to select among different investment strategies designed exclusively by the QTP at the time when the initial contribution is made establishing the account. Then, Notice 2001-55 was issued and stated in relevant part:

> The Internal Revenue Service and the Treasury Department recognize that there are a number of situations that might warrant a change in the investment strategy with respect to a §529 account. Accordingly, the Internal Revenue Service and the Treasury Department expect that the final regulations under §529 will provide that a program does not violate §529(b)(5) if it permits a change in the investment strategy selected for a §529 account once per calendar year and upon a change in the designated beneficiary of the account. It is expected that the final regulations will also provide that, to qualify under this special rule, a program must (1) allow participants to select only from among broad-based investment strategies designed exclusively by the program; and (2) establish procedures and maintain appropriate records to prevent a change in investment options from occurring more frequently than once per calendar year or upon a change in the designated beneficiary of the account.

The forthcoming guidance should state the extent to which section 529 accounts will be aggregated for purposes of applying the special rule in Notice 2001-55. Requiring aggregation across section 529 accounts in QTPs offered by different states, or across section 529 accounts within the same QTP but with different AOs, would serve no policy purpose yet be highly impractical and in some cases impossible to coordinate or monitor. Requiring aggregation across accounts within the same QTP but with different DBs would also contradict the policy objectives underlying Notice 2001-55, even where the AO is the same. Thus, any aggregation rule for investment changes should apply, at most, to accounts within the same QTP with the same AO and DB.

The next question is, what exactly should "within the same QTP" mean for these purposes? For example, Notice 2001-81 allows a state to consider a prepaid tuition program separately from a savings-type program for purposes of earnings computations, while requiring the state to aggregate all its programs (of whatever type) for purposes of section 529's prohibition on excess contributions. Also, where a state offers multiple savings-type programs (say, through different program managers), it is generally accepted that all those programs must be aggregated for purposes of earnings computations and treated as one omnibus program, no matter how separate they may be as a functional, administrative, or legal matter.

At the very least, any aggregation rule for investment changes should allow states to take the same approach that Notice 2001-81 offers with respect to earnings computations. Prepaid tuition programs and savings-type programs are so fundamentally different in terms of their investment options (including whether such options even exist) that states should be permitted to consider them separately for purposes of any investment change rules.

Also, we hope that Treasury and the IRS might at least consider the following two extensions of the current investment change rules:

- First, where a state offers multiple savings-type programs, could the state also be permitted to consider those separately for purposes of any investment change rules? Requiring aggregation across section 529 accounts in different programs offered by the same state can give rise to some of the same coordination issues that would afflict aggregation across section 529 accounts in different states, even though the same state is offering the different programs. (In some cases, states have responded to these issues by only allowing a person to be the AO or DB in one and only one of the programs offered by the state, which strikes us as an artificial and unfortunate limitation.) The "broad-based investment strategies" requirement could itself be considered to satisfy section 529's prohibition against investment direction and the concerns underlying that prohibition. Moreover, the "once per calendar year or upon a change of DB" rule would continue to apply to each of the separate savings-type programs offered by the state, if retained (but see our next comment below regarding that rule).

- We also wonder if the "broad-based investment strategies" requirement could alone be deemed sufficient to satisfy section 529's prohibition against investment direction, such that the "once per calendar year or upon a change of DB" rule could be discarded. Restricting section 529 accounts (and their AOs) to broad-based investment strategies eliminates much of the concern that we understand to underlie the prohibition against investment direction – namely, that in light of their purpose and the amounts and timeframes typically involved, section 529 accounts should not be subjected to the additional risks, volatility, and expenses which would likely arise if they could be invested in single issues of stocks and bonds traded at the AO's direction. Meanwhile, looking at the economy and financial markets over the past decade (or even the past year) alone, one can easily see how appropriate it might be to switch from one broad-based investment strategy to another during the course of a calendar year – and how unfortunate and arbitrary it might be if one were precluded from that merely by virtue of a prior (and often equally appropriate) change in that same year.

The forthcoming guidance should also offer further details and a non-exclusive safe harbor as to what constitutes a "broad-based investment strategy." Our sense is that such a safe harbor should at least include the following investments:

- Any registered mutual fund or exchange-traded fund (ETF);

- Any so-called “separately managed account” (or similar account or portfolio) which would generally meet the diversification requirements for a registered mutual fund or which is managed directly by the state offering the QTP (and, in either case, the investments of which are not subject to direction by the AOs or DBs of the section 529 accounts); and

- Any certificate of deposit or other deposit account insured by the Federal Deposit Insurance Corporation (FDIC) or the Federal Savings and Loan Insurance Corporation (FSLIC).

There may be other investments that should also be included in such a safe harbor, and states and their QTPs (and their representative organizations) should have significant input regarding this determination. We reiterate that such a safe harbor should not be exclusive, as there may be investments (*e.g.*, certain hedge fund investments) that might be sufficiently acceptable themselves but are of a class that would not be suitable for broad inclusion in the safe harbor. Also, it would be impossible to foresee all the possible investments that may be offered by QTPs in the future. Finally, the safe harbor should anticipate and accommodate the fact that section 529 accounts may hold investments either directly or indirectly, depending on how the particular QTP is structured by the state.

B. Rules for Rollovers

Section 529(c)(3)(C)(i) provides that a distribution from a QTP is not includible in the income of the distributee under section 529(c)(3)(A) if the distribution, within 60 days, is transferred to another QTP for the benefit of the DB. However, section 529(c)(3)(C)(iii) provides that this rollover exception “shall not apply to any transfer if such transfer occurs within 12 months from the date of a previous transfer to any qualified tuition program for the benefit of the designated beneficiary.”

It is impossible for an AO of a section 529 account for a given DB to know whether other section 529 accounts with different AOs exist for such DB, much less whether any such section 529 accounts have been rolled over during the past twelve months. Therefore, the forthcoming guidance should make clear that section 529(c)(3)(C)(iii) applies only if the particular AO rolled over the same or another section 529 account for the same DB within the last twelve months. Section 529 accounts for the same DB that have different AOs should not be aggregated for this purpose.

C. GST Tax Annual Exclusion

Section 529(c)(2) provides:

> (2) GIFT TAX TREATMENT OF CONTRIBUTIONS. – For purposes of chapters 12 and 13 –
>
> > (A) IN GENERAL. – Any contribution to a qualified tuition program on behalf of any designated beneficiary –
> >
> > > (i) shall be treated as a completed gift to such beneficiary which is not a future interest in property, and
> > >
> > > (ii) shall not be treated as a qualified transfer under section 2503(e).
> >
> > (B) TREATMENT OF EXCESS CONTRIBUTIONS. – If the aggregate amount of contributions described in subparagraph (A) during the calendar year by a donor exceeds the limitation for such year under section 2503(b), such aggregate amount shall, at the election of the donor, be taken into account for purposes of such section ratably over the five year period beginning with such calendar year.

The reference in the introductory phrase to chapter 13 (the GST tax rules) would seem to suggest that section 529(c)(2)(A) is intended to make clear that contributions to a section 529 account qualify for the GST tax annual exclusion as well as the gift tax annual exclusion and that the five-year election operates for purposes of both GST tax and gift tax. The proposed regulations state that the "portion of a contribution excludible from taxable gifts under section 2503(b) also satisfies the requirements of section 2642(c)(2) and, therefore, is also excludible for purposes of the GST tax imposed under section 2601." Prop. Reg. § 1.529-5(b)(1). However, the proposed regulations do not specifically state that to the extent the five-year election is made, the GST tax annual exclusion applies to the contributions attributed to all five years. The forthcoming guidance should clarify this point.

APPENDIX

Illustrations of Potentially Abusive Scenarios

I. Potentially Abusive Scenarios Involving AO Withdrawals or Changes

The Advance Notice illustrates one abusive scenario involving AO withdrawals, and we add to the discussion three other potentially abusive scenarios involving AO withdrawals or changes, as possible examples for inclusion with any general anti-abuse rule.

> *Scenario 1.* AO establishes ten section 529 accounts for DBs 1 through 10. Donor X contributes \$Y to each section 529 account, free of transfer tax, using gift tax and GST tax annual exclusions with respect to the DBs. (The identity of the DBs is irrelevant; they could be complete strangers to AO and X.) AO withdraws the funds, for her own benefit. Under current law, if this is done before any earnings accrue in the section 529 accounts, AO may receive all the funds without transfer tax, income tax, or the 10% additional tax. This is the scenario described in Sections I and II, B of the Advance Notice. The step transaction doctrine would apply because the fact that these transactions would occur close in time would indicate that the purpose of these transactions was to make a gift from X to AO. Further, the identify of the DBs might also suggest that there was no intent to save for their educations (for example, if the DBs had long completed their educations), supporting the application of the step-transaction doctrine and also the sham-transaction doctrine.
>
> *Scenario 2.* AO instead establishes one section 529 account with the intended donor X as DB. X contributes a larger amount, \$Z, to the section 529 account, free of transfer tax, because it is treated under section 529 as a transfer from X to X and thus not as a gift. AO withdraws the funds, for her own benefit. Under current law, if this is done before any earnings accrue in the section 529 accounts, AO may receive all the funds without transfer tax, income tax, or the 10% additional tax. Again the step transaction doctrine may apply because the fact that these transactions would occur close in time would indicate that the purpose of these transactions was to facilitate a gift from X to AO. Further, circumstances may indicate that the donor/DB is unlikely to incur future QHEEs in the amount of the contribution to the account, suggesting the transaction is a sham.
>
> *Scenario 3.* AO1 establishes ten section 529 accounts for DBs 1 through 10 and contributes \$Y to each section 529 account, free of transfer tax, using gift tax and GST tax annual exclusions with respect to the DBs. (The identity of the DBs is irrelevant; they could be complete strangers to AO1 and AO2). AO1 changes the AO of the section 529 accounts to AO2. AO2 withdraws the funds, for his own benefit. Under current law, if this is done before any earnings accrue in the section 529 accounts, AO2 may receive all the funds without transfer tax,

income tax, or the 10% additional tax. The step transaction doctrine would apply because the fact that these transactions would occur close in time would indicate that the purpose of these transactions was to make a gift from X to AO. Further, the identify of the DBs might also suggest that there was no intent to save for their educations (for example, if the DBs had long completed their educations), supporting the application of the step-transaction doctrine and also the sham-transaction doctrine.

Scenario 4. AO1 instead establishes one section 529 account for herself as DB and contributes a larger amount, $Z, to the section 529 account, free of transfer tax, because it is treated under section 529 as a transfer from AO1 to AO1 and thus not as a gift. AO1 changes the AO of the section 529 accounts to AO2. AO2 withdraws the funds, for his own benefit. Under current law, if this is done before any earnings accrue in the section 529 account, AO2 may receive all the funds without transfer tax, income tax, or the 10% additional tax. Again the step transaction doctrine may apply because the fact that these transactions would occur close in time would indicate that the purpose of these transactions was to facilitate a gift from AO1 to AO2. Further, circumstances may indicate that the donor/DB is unlikely to incur future QHEEs in the amount of the contribution to the account, suggesting the transaction is a sham.

In each of these scenarios, Treasury and the IRS could combat the illustrated abuse by applying the step-transaction and/or sham-transaction doctrines. Pursuant to those approaches, the use of the section 529 accounts would be disregarded in each case, and the donor who is the source of the funds would be treated as making a gift of all the funds directly to the AO who withdraws and receives the funds.[18] This treatment would be appropriate and could be achieved by existing approaches, without need for a general anti-abuse rule specific to section 529.

II. Potentially Abusive Scenarios Involving DB Designations or Changes

We also add to the discussion two more potentially abusive scenarios, involving DB designations or changes.

Scenario 1. AO establishes ten section 529 accounts for DBs 1 through 10 and contributes $Y to each section 529 account, free of transfer tax, using gift tax and GST tax annual exclusions with respect to the DBs. DBs 2 through 10 are all members of the family of DB1 under section 529, and no DB is in a generation higher than DB1's generation for GST tax purposes. (It is irrelevant whether the DBs are members of AO's family; any of them could be a complete stranger to AO). AO changes the DB of the section 529 accounts for DBs 2 through 10 to DB1 and then directs a complete distribution of funds from all the accounts to DB1. Under current law, if this is done before any earnings accrue in the section

[18] The use of these existing doctrines to address these abusive scenarios is similar to the IRS's approach in the *Heyen* case. *Heyen v. U.S.*, 945 F.2d 359 (10th Cir. 1991). That strategy would be no less available to the IRS just because these scenarios involve section 529 accounts.

> 529 accounts, DB1 may receive all the funds without transfer tax, income tax, or the 10% additional tax.
>
> *Scenario 2.* AO1 gives $Y to each of nine people (AOs 2 through 10), free of transfer tax, using gift tax and GST tax annual exclusions with respect to those AOs. Each AO then establishes a section 529 account for DB and contributes $Y to the account, also free of transfer tax, using gift tax and GST tax annual exclusions with respect to DB. (The relationship of the AOs to DB is irrelevant; any of them could be a complete stranger to DB.) All the AOs then direct complete distributions of funds from their respective section 529 accounts to DB. Under current law, if this is done before any earnings accrue in the section 529 accounts, DB may receive all the funds without transfer tax, income tax, or the 10% additional tax.[19]

Here, too, Treasury and the IRS could combat the illustrated abuse in each of these scenarios by applying the step-transaction and/or sham-transaction doctrines. Pursuant to those approaches, the use of the section 529 accounts would be disregarded in each case, and the donor who is the source of the funds would be treated as making a gift of all the funds directly to the DB who receives the funds from the section 529 account. This treatment would be appropriate and could be achieved by existing approaches, without need for a general anti-abuse rule specific to section 529.

[19] We recognize that the use of the section 529 accounts in this scenario may be superfluous, as each AO could transfer the $Y to DB directly, without sending the funds through the 529 accounts. *See Heyen*, supra. Nonetheless, the point of the scenario is to illustrate how section 529 accounts might be used in an abusive manner involving DB designations, and adding more circumstances and details to this bare-bones scenario could make the use of section 529 accounts distinctly preferable for the parties.