NEW AND REVAMPED 529 PLAN REGULATIONS SOON TO BE PROPOSED

By

Jim Roberts
Glast, Phillips & Murray, P.C.
Dallas, Texas

On January 17, 2008, Treasury and the Internal Revenue Service issued an Announcement of Proposed Rule Making ("ANPRM")[1] regarding Section 529 college tuition plans. This ANPRM should be of interest to every estate planner and return preparer because it seeks to: (I) propose an anti-abuse rule (with changes to the preparer penalty provisions, all such rules now assume larger importance); (II) determine the estate, gift and GST tax results of contributions, transfers and withdrawals; and (III) create rules for making the 5 year election, addressing some income tax issues, and creating new record keeping requirements.

Written and electronic comments must be submitted by March 18, 2008.

<u>I - Anti-Abuse Rule.</u> In the Pension Protection Act of 2006, Congress permanently extended the changes EGTRRA, and added a new subsection (f) to Section 529[2] which gave the Secretary authority to publish regulations to carry out the intent of Section 529 and prevent abuse. In the Technical Explanation prepared by the Joint Committee on Taxation, two examples of abuse were cited. One was repeated in the ANPRM and described grandparents who wanted to gift $1 million to a child without using any of their lifetime exclusion. In the example, the grandparents used college tuition plan accounts for their grandchildren, placing $120,000 in each (the $12,000 annual exclusion, times 2 for 2 grandparents, times 5 to use the 5 year averaging rule) times the number of grandchildren (whether they were all children of the child or of other children)(the example supposed there are 10 grandchildren), and naming the child as the account owner. After the 5 years, the child designates a new beneficiary for each account, naming himself. Because Section 529 says no gift occurs if the new beneficiary is in the same family and at the same or a higher generational level, the grandparents have succeeded in giving the child $1.2 million without using any of their applicable exclusion.

Treasury announced its intent to issue regulations that would have a general anti-abuse rule that will apply when 529 accounts are established or used for purposes of avoiding or evading transfer tax or for other purposes inconsistent with section 529. And mixed into that part of the announcement, Treasury indicated it would reissue the regulations proposed in 1998, incorporating subsequent guidance and making modifications.

<u>II - Tax Treatment.</u> The ANPRM next announces five areas where Treasury intends to propose regulations related to the tax treatment of donors and participants in

529 accounts. Part A involves a re-examination of exactly who should bear the gift tax burden occurring when a new beneficiary is designated – the old designated beneficiary (who may be a minor or not even aware of the existence of the account) or the account owner who causes the change to occur – and then by what mechanism that determination would be justified.

Part B looks at the liability for income tax and the penalty under Section 530 for withdrawals by the account owner, especially when the account owner is not the donor, and also in connection with a change in beneficiary. Part C looks at what rules should apply when the donors are not individuals. In other words, what rules should apply if trusts, corporations or other non-individual donors are involved?

Part D addresses 529 accounts created by a donor for the donor, and, in a similar vein, 529 accounts created for the beneficiary of a UTMA or UGMA account which are funded from that account. Section 529 seems to say there is a completed gift, but traditional transfer tax notions would dictate that there is no completed gift where the donor sets up an account for himself. And finally Part E looks at the estate tax consequences when the account is distributed, or, if not distributed within a yet-to-be-determined time frame, what consequences attach to whom when a post-death change in designated beneficiary occurs.

III - Function and Operation. The third major portion of the ANPRM looks at three issues. In Part A, the main focus is exactly how and when to make the 5 year election. In Part B, income tax issues are examined including how to recognize a loss, and the timing of distributions relative to when expenditures for education are made (in order to determine whether income tax would be due and penalty imposed for non-qualifying distributions). And Part C simply announces that the new proposed regulations may contain new recordkeeping requirements to facilitate implementation, particularly the anti-abuse rule.

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[1] REG-127127-05. See Tax Notes Today Doc 2008-1030

[2] Pub. L. 109-280, *120 Stat. 780*