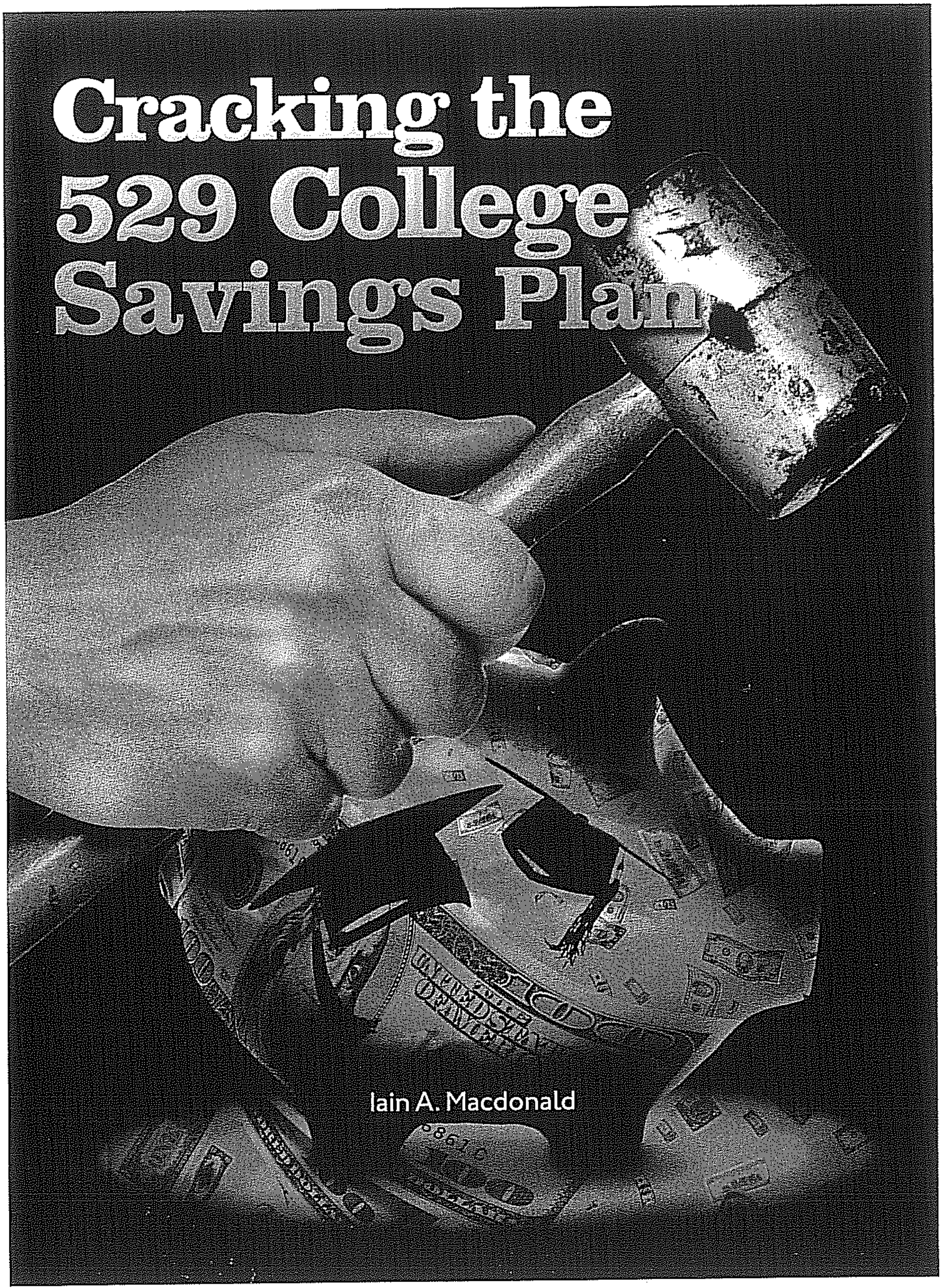
Cracking the 529 College Savings Plan



Iain A. Macdonald

Debtors have a number of options when it comes to pre-bankruptcy planning, one of the most advantageous of which is the "529 College Savings Plan", a federal investment plan named after the Internal Revenue Code (IRC) section under which it was created. Contributions to the plan may be in reasonable amounts necessary for tuition, books and most other expenses directly related to the cost of attending an accredited institution of higher learning, in some states as much as $350,000 per beneficiary. It is one of the few new benefits afforded to debtors by the BAPCPA amendments.[1] The incredible planning opportunity comes from the fact that the contributions remain property of the debtor but are not property of the estate if made more than two years before bankruptcy – the debtor is free to withdraw the funds and use them for personal use by paying a 10% penalty.

BACKGROUND

The 529 Plan (also called a Qualified Tuition Program, or "QTP") is an education savings plan created by federal statute but operated by the individual states, which in turn, generally use private brokerages to administer them. Every state has its own sponsored 529 Plan, which is available to be purchased either directly or through a broker. For example, California's 529 plan, branded the "ScholarShare College Savings Plan," is administered by Fidelity Investments. Alaska's plan, the *John Hancock Freedom* 529, is, at the date of this writing, the one recommended by Wells Fargo Advisors. The specifics of each plan vary. The state plan in which one invests is important because there are varying rates of return. No residency requirements are in place, and money from the plan can be used for qualifying educational expenses anywhere in the United States.

Each 529 Plan is one of two basic types: a savings plan or a prepaid plan. Savings plans operate similar to a Roth IRA in that contributions are made from after tax income (i.e., there is no federal deduction for contributions to a 529 plan) and invested into mutual funds, or similar financial instruments, with a choice of options. The available investments depend on the particular plan. Rarer, prepaid plans are upfront payments for tuition at a public, in-state institution. The tuition rate is locked in, and the plan can sometimes be converted for use at private or out-of-state institutions.

It is important to note that the 529 Plan is owned by the *Account Holder*, i.e, the one who establishes the account in the trust. The *beneficiary* is the one for whose benefit the contributions are made; there may also be a third-party *donor*, such as a grandparent. Because neither the beneficiary nor the third-party *donor* has any right of control over the 529 Plan, there will not be an issue over whether the 529 Plan belongs to the estate of either the third-party *donor* or the beneficiary. It will only be the *Account Holder* who has an ownership interest and only his trustee who will consider whether to administer it.

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FEATURES

The 529 Plan has several features:

- **No Tax on Growth** – It has significant tax savings benefits over a simple college savings account at a bank. Interest and investment growth made in a 529 Plan is not taxed as income on federal income taxes. It is like a Roth IRA because the savings can grow without any limit and then be taken out tax-free as long as the money is used for qualifying educational expenses.
- **Federal Estate and Gift Tax Treatment** – Contributions to the Plan, together with all other gifts from the account owner to the beneficiary are treated as gifts, but may qualify for an annual federal gift tax exclusion of $13,000 per donor ($26,000 for married contributors), per beneficiary. If an account owner's contribution for a beneficiary in a single year exceeds $13,000 ($26,000 for married contributors), the account owner may elect to treat up to $65,000 of the contributions, or $130,000 for joint filers, as having been made over a period of up to five years for federal gift tax exclusions. But the tax treatment of the contributions is irrelevant to both the viability of the 529 Plan and whether it is property of the estate.
- **Control** – The Account Holder maintains control of the standard 529 Plan. Funds may be withdrawn at any time for any purpose by paying a 10 percent penalty and associated income tax; additionally, the beneficiary may be changed in the event that the beneficiary foregoes college.
- **Large Deposits** – The 529 Plan allows for contributions of up to a specified maximum per beneficiary account as long as the total balance of all accounts for the beneficiary does not exceed that amount. (e.g., $350,000 for California and $325,000 for Alaska). It is permissible for earnings (but not contributions) to exceed these amounts.
- **Ability to Transfer to Another Beneficiary** – If the beneficiary does not attend an eligible educational institution, the donor may name another eligible beneficiary. The new beneficiary must be a member of the previous beneficiary's family in order to avoid having this change treated as a non-qualified withdrawal. The donor can designate himself as beneficiary.

"HYBRID" TRUST

If you see an incongruity in the foregoing, you are not alone. If the Account Holder controls the funds in the 529 Plan, why does the IRS treat the 529 contribution as a completed gift to the beneficiary? Doesn't the Account Holder have fiduciary duties that would prevent him from raiding the fund? These are controversial issues, and have led commentators to call for reform.[2]

About the Author

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The conclusion generally drawn is that the 529 Plan is a "hybrid" of a revocable and irrevocable trust.

Like both types of trusts, an initial 529 Plan contribution requires the donor to have the intent to pay future education costs of the beneficiary.[3] Aside from this, the only other structural resemblance to an irrevocable trust is that both require a legal transfer from the "contributor" to the "account owner."[4]

The § 529 savings account and the revocable trust have much more in common. The 529 Plan donor may name himself or anyone else to the position of Account Holder[5] retains an unchecked ability to change beneficiaries and make personal withdrawals. If the donor assumes the role of Account Holder, as it typically done by the settler in the revocable trust, there is clearly no "part[ing] with dominion and control."[6] Notwithstanding these extensive similarities, the I.R.S. treats 529 Plan contributions as a completed gift even though no property rights are transferred to the beneficiary.[7]

In fact, courts have found that '[a] designated beneficiary has no rights or legal interests in an account unless the designated beneficiary is also the account owner."[8] Similarly, "contributions to the accounts 'made by persons other than the account owner become property of the account owner,' not the beneficiary."[9]

Designated beneficiaries are also denied the benefit of any type of fiduciary protections, leading commentators to suggest that the 529 Plan should be placed in a trust.[10]

THE TRUSTEE'S ANALYSIS

The 529 Plan is not *exempted* from the estate, but is *excluded* by virtue of Bankruptcy Code Section 541(b)(6). Because the 529 Plan is not property of the estate, the debtor is not strictly speaking required to schedule it, although the debtor is required to disclose it on the statement required by Section 521.[11]

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There are a number of technical requirements necessary to exclude the 529 Plan from the estate. The trustee should not fail to administer such a plan without scrutinizing it for compliance with the statute.

The starting point is Bankruptcy Code Section 546(b)(6), with significant language underlined:

541(b) Property of the estate does not include -

(6) funds used to purchase a tuition credit or certificate or contributed to an account in accordance with section 529(b)(1)(A) of the Internal Revenue Code of 1986 under a qualified State tuition program (as defined in section 529(b)(1) of such Code) not later than 365 days before the date of the filing of the petition in a case under this title, but—

(A) only if the designated beneficiary of the amounts paid or contributed to such tuition program was achild, stepchild, grandchild, or step grandchild of the debtor for the taxable year for which funds were paid or contributed;

(B) with respect to the aggregate amount paid or contributed to such program having the same designated beneficiary, only so much of such amount as does not exceed the total contributions permitted under section 529(b)(7) of such Code with respect to such beneficiary, as adjusted beginning on the date of the filing of the petition in a case under this title by the annual increase or decrease (rounded to the nearest tenth of 1 percent) in the education expenditure category of the Consumer Price Index prepared by the Department of Labor; and

(C) in the case of funds paid or contributed to such program having the same designated beneficiary not earlier than 720 days nor later than 365 days before such date, only so much of such funds as does not exceed $5,475;

Analysis of the highlighted language reveals the following:

1. Timing of Contributions. No funds contributed within one year are excluded from the estate.[12] As to funds placed in the account during the second year prior to bankruptcy, the exclusion is limited to $5,850.[13] The debtor would have to use an available exemption to shelter these transfers.[14]

2. Identify the Beneficiary. The exclusion only applies if the designated beneficiary of the account is a "child", "step-child", "grandchild", or "step-grandchild" of the debtor for the taxable year for which funds were placed in the account.[15] This is significant because a 529 Plan can be set up, not only for a minor child who is a niece or nephew, but for an adult. The Wall Street Journal reported that, because of the weak economy, many companies eliminated the education reimbursement program they used to encourage employee training. Later-in-life individuals may use a 529 Plan to set aside money to pay for their own education, such as to implement a career change.[16]

3. Source of the Contribution is Irrelevant. The critical factor is in the timing of the contributions, as set forth above, not the source of the funds. In *In re Bourguignon*[17], the debtors established a "Scholar's Edge, New Mexico" College Savings Account for the benefit of their eldest daughter. Debtors deposited $14,500 into the account and the debtors' grandmother deposited $40,000.[18] All deposits were made within 30 days of bankruptcy. The plan language provided that the monies in the account belonged to the "account owner" and not to the "designated beneficiary." The plan further provided that, as the account owner, debtors could terminate the account at any time. If debtors terminated the account, the balance would be distributed to them. The court rejected the debtors' contention that the funds belonged to their minor children. Moreover, and consistent with our discussion above, the court ruled that the contributions made by the debtors' grandmother to the account owned by the debtor were property of the estate.

4. Overriding Cap on Contributions. Given the debtors' right to contribute large amounts to a fund more than two years before bankruptcy, the opportunities for sheltering large amounts of money are obvious. The Internal Revenue Code limits total contributions to "those necessary to provide for the qualified higher education expenses of the beneficiary."[19] As mentioned above, California allows a maximum of $350,000 per beneficiary; Alaska allows $325,000. Anyone doing the arithmetic can see that a debtor with three children or grandchildren can shelter more than $1 million.

TRUSTEE'S REMEDY

The trustee's remedy is to scrutinize all educational plans of the beneficiary and determine whether it is reasonable to expect the beneficiary to utilize the entire fund, keeping in mind that the fund will accrue earnings between the time of bankruptcy and the time education is completed. The trustee may take the position that the debtor has funded an unreasonable amount. Where the debtor has made withdrawals or is likely to make withdrawals, the trustee's job is easier. However, it is not certain that the trustee can attack the plan based on reasonableness if the amount of the fund is within the limits imposed by the plan. The analogous language of Bankruptcy Code §541(b)(7) regarding the parameters of exclusion of I.R.C. §403(b) Accounts has led courts to consistently exclude those accounts from the bankruptcy estate as long as the contributions are within the permissible contribution limits.[20] The distinction to be made is that 529 plans contain a reasonableness limitation, whereas a retirement plan has more specific statutorily controlled contribution limits.

CONCLUSION

A modest and reasonably-funded plan, where contributions are made at appropriate times, will not be property of the estate. But careful scrutiny by the trustee might result in value for creditors.

Footnotes:

[1] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

[2] *Pick on Someone Your Own Size: Exposing The Account Owner's Silent Assault on §529 Savings Accounts*, Adam Winger, 35 ACTEC J. 277, Winter 2009

[3] *See, e.g.*, Advanced Notice of Proposed Rulemaking, 73. Fed. Reg. 344, at 3442 § I (Jan. 18, 2008) (promising to deny favorable tax benefits if it is found that "contributions to those accounts are intended or used for purposes other than providing [qualified higher education expenses] of the beneficiary").

[4] *See* I.R.C. § 529(b)(1)(A)(ii).

[5] Prop. Treas. Reg. § 1.529-1(c), 63 Fed. Reg. 45019, 45025 (Aug. 24, 1998).

[6] Advanced Notice of Proposed Rulemaking, 73. Fed. Reg. 3441, 3443 II A (Jan. 18, 2008).

[7] See Susan T. Bart, the Best of Both Worlds: Using a Trust to Make Your 529 Savings Accounts Rock, 34 ACTEC JOURNAL 106, 106 (Winter 2008) (stating "the account owner of a 529 savings account has no fiduciary duties to the beneficiary of the account."

[8] *In. re* McFarland, No. 04-01623, 2004 WL 4960367, *2 (Bankr. D. Idaho 2004) (citing Idaho Code § 35-5407(1)(a)).

[9] *In re* Addison, 540 F 3d 805, 819 (8th Cir. 2008) (citing Minn. Stat. Ann. § 136G.09(1)).

[10] See Bart, *supra* note 7, at 130 (in the § 529 context, "unless the beneficiary is the account owner, the beneficiary has only a mere expectancy, and does not have any property interest.")

[11] 11 U.S.C. Section 521(c). The sanction for failing to make this disclosure is automatic dismissal of the case effective on the 46th day after the date of the filing of the petition, subject to the debtor's right to extend the time, or the trustee's right to obtain relief from dismissal. Section 521(i)(4).

[12] 541(b)(6).

[13] 541(b)(6)(c).

[14] Currently, 27 states have passed statutes protecting 529 plans. Among the states providing the most protection from creditors include Colorado, Florida, South Dakota, and Virginia as these state statutes specify that 529 savings accounts are protected from the creditors of the beneficiary, account holder, and contributor. In comparison, other states such as Michigan, California, and Illinois have not passed creditor protection laws for 529 plans (other than what is stipulated under the *Bankruptcy Abuse and Prevention and Consumer Protection Act of 2005).* (Barbara Rosen. "State Creditor Protections for 529 Plans."cfed; Savings for Education, Entrepreneurship, and Down payment (SEED) Initiative 1 (April 2007): page 2.

[15] 541(b)(6)(a).

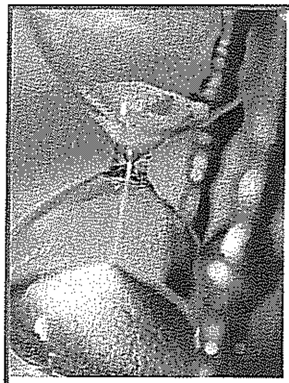
[16] *Wall Street Journal*, April 4, 2011, Not Just Kid Stuff: Why Mom Might Want a 529 Plan, Too.

[17] *In re Bourguignon*, 416 B.R. 745 (Bankr. Idaho, 2009).

[18] A grandparent is generally advised to transfer funds to a parent's account because third party-owned accounts are counted as student income on financial aid applications. However, as noted above, the grandparent loses ownership and control of the funds to the Account Holder.

[19] 24 U.S.C. Section 529(b)(6).

[20] *See In re Leahy*, 370 B.R. 620, 623 (Bankr.D.Vt. 2007), *In re Nowlin*, 366 B.R. 670, 675 (Bankr.S.D.Tex. 2007), and *In re Njuguna*, 357 B.R. 689 (Bankr.D.N.H. 2006).



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