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May 2023 IN THIS ISSUE

TAX LAW UPDATE

PHILANTHROPY: President Biden's Budget Proposal and Its Impact on Philanthropy

TIPS FROM THE PROS: Powers of Appointment And Fiduciary Duties

PRACTICAL PRACTICE SOLUTIONS: Income Taxes and Grantor Trust Angst

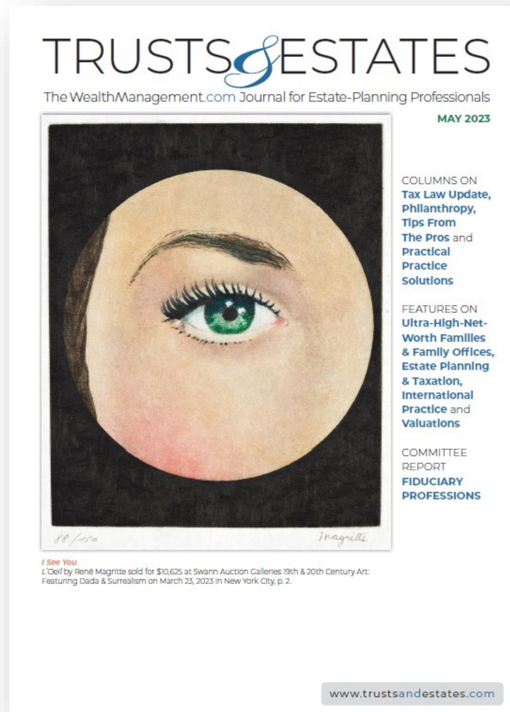
ULTRA-HIGH-NET-WORTH FAMILIES & FAMILY OFFICES
- The Inheritance Experience

ESTATE PLANNING & TAXATION
- Deeds and Discounts:
- Estate Planning With Real Estate

INTERNATIONAL PRACTICE
- This U.S. Trust Has a Foreign Beneficiary!
- Cecil v. Commissioner Provides New Insights on Tax-Affecting

VALUATIONS
- Cecil v. Commissioner Provides New Insights on Tax-Affecting

FIDUCIARY PROFESSIONS
- Fiduciary Law Trends
- Choosing a Professional Trustee
- The Entrepreneur's Trust
- Trustee Considerations in Owning a 529 Plan



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COMMITTEE REPORT:
FIDUCIARY PROFESSIONS

By **Gail E. Cohen**

Trustee Considerations in Owning a 529 Plan

Potential pitfalls and drafting guidelines

In the September 2022 issue of *Trusts & Estates,*[1] I described the benefits of having a trust-owned Internal Revenue Code Section 529 plan (529 plan). If a trust owns a 529 plan, donors can maximize their annual exclusion gifts without the need to provide *Crummey* powers and continue to decide how the 529 plan can benefit the current and future beneficiaries.[2] Additionally, a directed trust allows the donor to continue to make all investment decisions within the 529 plan's framework. An additional benefit in having the trust own the 529 plan is the ability to pass on the unused funds in the 529 plan without paying any gift, estate or generation-skipping transfer taxes.

Let's explore the potential pitfalls confronting the trustee when the trust owns the 529 plan and drafting guidelines to assist the trustee in avoiding these pitfalls.

Some Basics

The Internal Revenue Code and proposed regulations provide definitions for terms that are specific to the 529 plans, which assist in understanding the issues confronting trustees of trust-owned 529 plans.

Account owner. The most important role is that of the account owner.[3] The account owner has the power to: (1) select the designated beneficiary; (2) change the designated beneficiary; (3) decide how the funds are to be used; and (4) receive distributions if there's no designated beneficiary. An account owner can be an individual, trust or entity. For trust-owned 529 plans, the trustee is the account owner.

Contributor. The contributor is the person who contributes cash to a 529 plan. The contributor isn't necessarily the account owner. A contributor can be an individual, a trust or an entity. With respect to trust-owned 529 plans, often the person who creates the trust is the contributor, but any individual or the trust may also be a contributor.[4]

Designated beneficiary.[5] The designated beneficiary is the individual whose qualified expenses are covered by the 529 plan. There's no requirement that the designated beneficiary be a family member. The designated beneficiary must be a U.S. individual; therefore, trust-owned 529 plans may not be appropriate for trusts with non-U.S. beneficiaries.

Qualified expenses.[6] When distributions are made from a 529 plan to the designated beneficiary, there's no income tax if those distributions of income are used to pay for qualified expenses. Qualified expenses include tuition, fees, books, supplies and equipment. For special needs students, they also include services connected to enrollment or attendance. Supplies and equipment include computers, peripheral equipment, software and internet access. Room and board also constitute qualified higher education expenses if the student is enrolled with at least a one-half course load. Notably, travel expenses aren't included.

Member of the family.[7] Many of the transfer tax implications of 529 plans depend on the relationship between the current designated beneficiary and the successor designated beneficiary. These implications hinge on whether the successor designated beneficiary is a member of the current designated beneficiary's family. Members of the family of a designated beneficiary include: child or a descendant of a child;

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a sibling or a stepsibling; a parent or ancestor; a stepparent; a brother or sister of the father or mother; a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law; and a first cousin.

General Observations

The following general observations assist in understanding the potential pitfalls facing trustees of trust-owned 529 plans.

Designated beneficiaries have no right to distributions. The decision regarding whether and to what extent a designated beneficiary receives any distribution from a 529 plan lies solely with the account owner who can be the trustee for trust-owned 529 plans.

Once the cash is donated to the 529 plan, the account owner can't invest in specific stocks or bonds. Nevertheless, an account owner can analyze the various state's plans to determine which state has the most favorable mutual fund investment options. The account owner does have the ability to change the asset allocation among the mutual funds the plan offers.

All states have limits on contributions to their 529 plans. Additional contributions can't be made once the value of the plan exceeds a certain amount, ranging from $235,000 in Georgia and Mississippi, to $529,000 in California; these levels are set generally based on the cost of education in the state. These limits pertain to the value of the plan, not the value of the contributions. Typically, once the plan reaches that value, no additional contributions can be made to the plan. There's no penalty if a plan grows to levels above the limit. If a state's maximum value is $529,000, the contributor can fund a new 529 plan immediately with $529,000.

Contributors can contribute to a plan in any state, but beware of home state income tax rules regarding out-of-state 529 plans. For example, Alabama will tax Alabama residents who receive distributions from out-of-state plans but not distributions from in-state plans. In considering which state's plan to use, contributors should also determine whether a state income tax deduction is available for contributions to their resident state's 529 plan. For example, New York state allows for a limited income tax deduction for contributions by New York taxpayers into the New York 529 savings plan.

The account owner is responsible for making distributions. If those distributions are made for qualified education expenses,[8] no federal income tax will be payable with respect to those distributions. While payments may be made directly to eligible educational institutions, several other distribution strategies are available. For example, a check may be made payable to both the designated beneficiary and the educational institution. Or, the account owner may make distributions directly to the designated beneficiary as a reimbursement after substantiation is provided for the expenses. Additionally, the account owner can release funds directly to the designated beneficiary after they certify that they'll use it for qualified higher education expenses within a reasonable time. The beneficiary must provide substantiation that they've used the funds for education expenses within 30 days of receiving the distribution in anticipation of those expenses.

If distributions aren't made towards qualified education expenses, the earnings portion of the withdrawal are subject to income tax as ordinary income along with a 10% penalty.

If distributions aren't made towards qualified education expenses, the earnings portion of the withdrawal are subject to income tax as ordinary income[9] along with a 10% penalty.[10] If a 529 savings plan was funded for a designated beneficiary who doesn't attend college or has excess funds remaining, the account owner may change the beneficiary to a "member of the family" of the original designated beneficiary. The Setting Every Community Up for Retirement Act 2.0. adds a new strategy for the use of any excess funds remaining in a 529 plan. Account owners of 529 plans now have the limited ability to roll over these funds into a Roth individual retirement account for the benefit of the designated beneficiary without incurring income tax on that rollover, up to a maximum of $35,000.[11]

> If a trust owns a 529 plan, the trust agreement needs to contain certain provisions to assure that the trustee has the power to make appropriate decisions surrounding the 529 plan.

Selecting the Plan

Each of the 50 states and the District of Columbia maintains at least one 529 plan option. Ideally, the person who creates the plan will seed the trust with a minimal amount of assets to allow the trustee to open the 529 plan account. Then the donor maximizes the gift directly into the newly opened plan account.[12] Unless the trust is a directed trust, the trustee has the responsibility to select a 529 plan from the myriad of options available. The following is a checklist of factors for a trustee to consider in selecting a plan.

1. **Fees.** Section 7 of the Uniform Prudent Investor Act requires a trustee to "only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust and the skills of the trustee."[13] A trustee has a duty to investigate the fees charged by the 529 plan—both for administration and for the underlying investment options. And while fees shouldn't be the determinative factor, it's an element of the decision making that should be addressed and documented. Be sure to look at the fees charged by the plan administrators in different states.

2. **State income tax**. Several of the states that have an income tax provide a tax deduction to the person who contributes assets to the 529 plan.[14] Other states provide no income tax deduction. The availability of a state income tax deduction to the donor shouldn't be a consideration of the trustee because the trustee's duty of loyalty lies with the beneficiaries, not the person who funded the 529 plan. Nevertheless, if other factors weigh in favor of a particular state's plan, the fact that the donor receives a state income tax deduction for contributing to that plan shouldn't create any liability for the trustee. More importantly, the state income tax implications to the beneficiaries is a factor that the trustee must consider. As mentioned above, some states tax residents on receipts of distributions from out-of-state plans.
3. **Duration of state's plan**. Some states' plans have limits on how many years the plan can continue, while other states' plans have no limit, thus allowing the plan to remain open long after the designated beneficiary completes their education. This is an important factor to consider for a trustee, and the decision about this factor should be aligned with the duration of the trust.
4. **Maximum value**. As mentioned above, each state has a limit on the maximum value a plan can attain after which contributions may no longer be made. This is a factor to consider and should be weighed when taking into account the goals of the trust and the grantor.
5. **Qualifying educational expense.** There are some variations in what constitutes a "qualifying educational expense," even though the IRC and regulations define the term.[15]
6. **Available investments.** Investment strategies vary from state to state and often depend on the outside investment company managing the program. The trustee should review the available investment options and assure that they're suitable for the trust's objectives.

Powers to Include

If a trust owns a 529 plan, the trust agreement needs to contain certain provisions to assure that the trustee has the power to make appropriate decisions surrounding the 529 plan. Additionally, trustees should be exonerated for making these decisions, because in some instances the decisions may benefit one beneficiary differently from another. Ideally, the agreement should contain a separate powers section

concerning 529 plan ownership. Here are some suggested powers and basic language to include:

Authorization to invest in a 529 plan. In the first instance, the trustee must have the power to invest in a 529 plan. *Suggested language:*

> The trustee is authorized to invest and reinvest in a Education Savings Account created pursuant to IRC Section 529, without regard to the proportion that such 529 plan may bear to the value of the trust; the trustee is authorized to select the state 529 plan it determines in its sole and absolute discretion and shall have no liability for having selected one state's 529 plan rather than another.

Authorization to hold. In addition, the trustee should have the ability to hold any 529 plan it receives as a successor owner from another account holder. *Suggested language:*

> The trustee is authorized to receive a 529 plan as a successor owner under any successor owner designation made and to continue to hold that 529 plan with no duty to review such plan.

Designated beneficiaries. The trustee must have the ability to select the designated beneficiary and to change the designated beneficiary. *Suggested language:*

> The trustee is authorized to designate a designated beneficiary for any 529 plan owned by the trust from among a class of beneficiaries consisting of the individuals who are then currently eligible to receive distributions of principal and/or income from the trust (trust beneficiaries); the trustee is additionally authorized to change a designated beneficiary at any time and for any reason, with no liability for having selected one of the trust beneficiaries as the designated beneficiary over another.

Rollovers. The trustee must have the ability to roll over any 529 plan for successor generations. *Suggested language:*

> The trustee is authorized to roll over any 529 plan for successor generations who are trust beneficiaries, with no liability for having made such a rollover; the trustee is additionally authorized to roll over any balance in a 529 plan into a Roth IRA or other vehicle authorized by law with no liability on the trustee for having made such rollover.[16]

Authorization to manage investments. The trustee should have the ability—unless the trust is directed—to make the selection among the various investment options in a 529 plan. *Suggested language:*

> The trustee is authorized to select any investment strategy or investment option offered by the 529 plan as it determines in its absolute discretion, and to change any such

SPOTLIGHT

Checkmate

The Chess Players by Marcel Duchamp sold for $7,800 at Swann Auction Galleries 19th & 20th Century Art: Featuring Dada & Surrealism on March 23, 2023 in New York City. Both an artist and a chess player, Duchamp saw a correlation between art and chess and actively sought opportunities to combine the two seemingly unrelated disciplines. He was part of the Cubism, Dada and conceptual art movements.

investment selection in the manner allowed by the 529 plan.

Distributions. The trustee must have the ability to make distributions to the designated beneficiary. *Suggested language:*

> The trustee is authorized to make any distributions from the 529 plan, including both qualified and non-qualified distributions, with no liability for having made any such distribution; the trustee is authorized to determine the manner in which any such distribution is made, either directly to an educational institution, directly to a designated beneficiary, or both; and the trustee has the power to require appropriate substantiation for any expense as it determines in its absolute discretion, with no liability for having selected one method of substantiation rather than another.

Key to Success

Trust-owned 529 plans can supercharge an estate plan by providing all of the benefits of trust planning plus income tax savings. Assuring that the trustee has the broadest powers to own and manage the plan is key to the trust's success. And if there are excess funds in the 529 plan after the current beneficiary completes their education, those funds can be rolled over to the next generation.

Endnotes

1. Gail E. Cohen, "Tips From the Pros: Having it All—Flexibility Protection and Tax Mitigation—Using a 529 Dynasty Trust," *Trust & Estates* (September 2022).
2. Typically, the donor would be the account owner to maintain direct control.
3. Proposed Regulations Section 1.529-1(c).
4. *Ibid.*
5. An existing trust with cash can create an Internal Revenue Code Section 529 plan (529 plan).
6. IRC Section 529(e)(3).
7. IRC Section 529(e)(2).
8. Prop. Regs. Section 1.529-2(e)(4)(ii)(A).
9. IRC Section 529(c)(3)(A).
10. Section 529(c)(6).
11. The new rule allows a maximum of $35,000 to be rolled over per designated beneficiary. More importantly, the 529 plan must have been in existence for 15 year prior to the rollover.
12. By making the largest gift directly to the trust-owned 529 plan, the donor avoids the need to provide *Crummey* notices to any beneficiary and can use the 5-year prefunding rule, which isn't available for gifts made directly to the trust.
13. Uniform Prudent Investor Act, drafted by the National Conference of Commissioners on Uniform State Laws, Section 7.
14. More than 30 states offer a deduction or credit to their residents for contributions to their own state's 529 plan. A few states give a deduction for contributions to any state's 529 plan (Arizona, Arkansas, Kansas, Minnesota, Missouri, Montana and Pennsylvania). Caution: A rollover from one state to another may result in a recapture of deductions.
15. Some states view student loan debt as a "qualifying educational expense," others don't.
16. While current law allows rollovers into a Roth individual retirement account, that law may change or may be expanded to allow rollovers into other vehicles; this language is intended to capture that possibility.

AD INDEX

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