

Public Finance Alert: IRS Previews New Section 529 Qualified Tuition Program Regulations

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On January 17, 2008, the IRS released an advance notice (the "Advance Notice") of proposed rulemaking for the long-awaited final regulations relating to qualified tuition programs under Section 529 of the Internal Revenue Code ("Section 529"). The Advance Notice indicates that the rulemaking notice, when published, will repropose most of the initial Section 529 regulations proposed in 1998, with adjustments reflecting statutory changes and comments received to date. The Advance Notice focuses on the expected content of new regulations primarily designed to prevent what Treasury officials perceive as a risk of abusive gift tax avoidance through the funding of Section 529 accounts. The Advance Notice also addresses certain income tax and recordkeeping requirements under Section 529. The Advance Notice invites comments on its description of the proposed rules prior to the release of the actual proposed rules. **Any comments must be submitted to the IRS by March 18, 2008.**

There are no major bombshells in the Advance Notice for typical participants in Section 529 programs. However, certain account funding structures or uses that currently are permissible may be restricted or taxed out of existence. For example, it appears that the actual regulations, when promulgated, may contain provisions that:

- in certain circumstances result in additional income taxation of account owners who receive distributions from accounts funded by contributors other than the account owner;
- treat the funding of a Section 529 account by an entity (as opposed to a natural person) as a *pro rata* gift by each shareholder, member, partner or beneficiary of a corporation, limited liability company, partnership or trust that funds the Section 529 account;
- require that an individual serve as the account owner of a Section 529 account, precluding account ownership by entities; and
- alter the gift and estate tax treatment of accounts that are not fully applied to pay the qualified higher education expenses of the designated beneficiary.

In addition, the Advance Notice warns that the actual regulations, when promulgated, may contain new recordkeeping and reporting requirements for Section 529 programs and may require changes in the administrative procedures of Section 529 programs and in program documentation. The Advance Notice indicates that the new regulations, when promulgated, will generally apply prospectively and will provide a grace period of no less than 15 months for programs to implement "most changes."

The Advance Notice provides the following previews of coming regulatory attractions:

Income Tax Provisions

Reimbursement of Prior Year Qualified Higher Education Expenses

Section 529 and the 1998 proposed regulations provide no guidance on whether a qualified distribution from a Section 529 account must occur in the same tax year as the qualified higher education expense to which the distribution relates. The Advance Notice states that the new proposed regulations will provide that a qualified distribution must correspond to the amount of qualified higher education expenses incurred in the same calendar year as the distribution or by March 31 of the following year. Accordingly, the contemplated regulations will permit limited withdrawals in advance of expenditures, but apparently will not allow qualified distributions to reimburse any prior calendar year expenditures.

Deduction of Losses in Section 529 Accounts

The Advance Notice indicates that the new regulations will confirm that investment losses in Section 529 may be deducted only as miscellaneous itemized deductions, which are deductible only if in excess of 2% of adjusted gross income.

Taxation of Distributions to Account Owner of Third Party Donations

The Advance Notice asserts that Treasury expects to develop additional rules that will tax as income, rather than treating as a return of the investment, amounts withdrawn by an account owner that correspond to contributions to the account by a person other than the account owner. According to the Advance Notice, such rules would make the account owner liable for income tax on the entire amount of the funds distributed for the account owner's benefit "except to the extent that the [account owner] can substantiate that the [account owner] made contributions to the section 529 account...." Although this is an income tax provision, it is designed to discourage perceived gift tax circumvention when a donor contributes funds to a Section 529 account controlled by a different account owner or when an account owner transfers a Section 529 account to a new account owner.

Gift and Estate Tax Provisions

General Anti-Abuse Rule

Responding to Treasury's perception that the unique transfer tax provisions of Section 529 make it possible for large amounts to be transferred from one individual to another in circumvention of otherwise applicable gift or estate taxes, the Advance Notice describes an upcoming anti-abuse regulation that "will deny the favorable transfer tax treatment under section 529 if contributions to those accounts are *intended or used* for purposes other than providing the [qualified higher education expenses] of the [designated beneficiary]" (emphasis added). While it is not surprising that intentional funding of Section 529 accounts for purposes other than the eventual payment of higher education expenses would be considered abusive by Treasury, the "intended or used" phrasing suggests that the new regulations may result in the imposition of non-Section 529 gift or estate taxes in as yet undefined circumstances when substantial amounts are invested in Section 529 accounts and subsequently distributed to a party other than the contributor for nonqualified purposes, irrespective of the contributor's original intent.

The Advance Notice warns that the IRS and the Treasury Department will monitor whether the general anti-abuse rule is sufficient to curtail the perceived abuses of Section 529 accounts to avoid transfer taxes, and that if concerns persist, broader rules may be adopted that might limit the circumstances under which account owners may withdraw funds from a Section 529 account, change the designated beneficiary or transfer account ownership.

Funding of Section 529 Accounts by Persons Other Than Natural Individuals

The Advance Notice suggests that it is arguable that the term "person" as used in Section 529 should be limited to natural individuals, so that corporations, limited liability companies, partnerships and trusts could not fund Section 529 accounts. However, it confirms that the proposed regulations will include entities within the definition of "person" and therefore as permissible contributors to Section 529 accounts, although it mentions that the regulations may not permit entities to be account owners. The Advance Notice hints that the proposed regulations may include special rules for contributions by entities that would look through to the individuals that control such entities for transfer tax purposes. The Advance Notice solicits comments "as to whether the complexity of any special rules would outweigh the benefit of allowing non-individual contributors."

Taxation of Transfer to Lower Generation Beneficiary

The Advance Notice indicates that under the new proposed regulations, liability for payment of gift tax due upon an account owner's designation of a new beneficiary of a lower generation than the prior beneficiary will be shifted from the prior beneficiary to the account owner. This will be achieved by treating the transaction as a deemed distribution of the account to the account owner and the opening of a new account, and the making of a new gift, by the account owner for the new beneficiary.

Taxation upon Change of Beneficiary of Account with Same Account Owner and Beneficiary

The Advance Notice states that, in the case of Section 529 accounts for which the contributor is also the designated beneficiary, any subsequent change in the designated beneficiary will be treated as a distribution to the contributor and a gift by the contributor to the new beneficiary. This eliminates a potential gift tax loophole arising from the fact that under current law there is no gift, and therefore no gift tax, when a contributor funds an account for himself or herself, and likewise no gift upon a subsequent change of the beneficiary to another member of the contributor's family who is of the same or a higher generation as the contributor.

Inclusion of Account in the Estate of a Deceased Beneficiary

According to the Advance Notice, the proposed new rules will clarify that if the designated beneficiary of an account dies, the value of the account will be included in that beneficiary's estate for federal estate tax purposes only if the account owner causes the entire account to be distributed to such estate within six months of the beneficiary's death. It is unclear what the estate tax consequences will be of a distribution of less than the entire account to the beneficiary's estate, or the distribution of the account to the beneficiary's estate more than six months after the beneficiary's death.

Spreading of Gifts over Five-Year Period

The Advance Notice indicates that the proposed rules will clarify that, to take advantage of the Section 529 provision permitting the spreading of a contribution made in a particular year over a five-year period for purposes of the annual gift tax exclusion, the election must be made irrevocably on the last federal gift tax return filed on or before the due date of the gift tax return for the applicable contribution (or, if a timely gift tax return is not filed, on the first gift tax return filed after the due date). The rules also will clarify that the spreading election applies only to contributions that do not exceed five times the applicable annual exclusion amount, and that the entire amount of any contributions over such limit is subject to gift tax in the year contributed to the account.

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