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The Pension Protection Act and the 529 Plan

On August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 ("PPA"). Among other things, the PPA made permanent several attractive provisions regarding Qualified State Tuition Programs, also known as "529 Plans," which were scheduled to expire on December 31, 2010. These Plans provide a terrific vehicle to save for college and graduate education.

Although 529 Plans are offered in all fifty states and there is no residency requirement for the establishment of a Plan, if a New York resident establishes a New York 529 Plan, the first $5,000 of contributions each year may be deducted on the donor's New York State income tax return ($10,000 for a married couple filing jointly). The earnings are also exempt from New York State income taxation when used for qualified higher education expenses. Income tax considerations aside, it is important to consider the best plan for your family as there are major differences among the various states' Plans.

Funds in a 529 Plan grow free from federal income tax and may be withdrawn at any time to pay for higher education expenses such as tuition, fees, supplies, room and board (if certain requirements are met), books and equipment. Under the old law, income on funds withdrawn from a 529 Plan was taxed to the beneficiary at the federal level. Under the PPA, however, if funds are withdrawn to pay for higher education, including undergraduate or graduate school and approved trade, technical or other occupational training, they are not subject to federal income tax. If the funds withdrawn from a 529 Plan are not used for qualified educational expenses, the earnings will not only be subject to both federal and state income tax, but also a 10% penalty. This penalty will be waived if the withdrawal is occasioned by the death or disability of the designated beneficiary or, subject to certain limitations, if the designated beneficiary receives a scholarship.

If the named beneficiary decides not to pursue higher education or does not fully utilize the 529 funds, the account owner can name another member of the beneficiary's family as a beneficiary to avoid income tax and the imposition of penalties. In fact, the account owner can change the beneficiary *at any time* and for *any reason* as long as the new beneficiary is a "member of the family" of the current beneficiary, a term which is very broadly defined and includes: the mother or stepmother, father or stepfather, grandparents, son, daughter, stepchildren, siblings or step-siblings, nieces or nephews, spouse or spouses of any of the above. The PPA permanently added first cousins to the list of eligible family members.

The PPA also made permanent the account owner's ability to roll an existing 529 Plan into a different 529 Plan every 12 months. Thus, the fund owner has the ability to change the way in which the funds are invested without actually being able to select individual investments. The rules

regarding rollovers vary from state to state. A rollover from a New York Plan to another state's Plan could cause earnings and contributions to be subject to New York State income tax.

From an estate planning standpoint, the funds contributed to a 529 Plan are generally not includible in the estate of either the donor or the beneficiary for federal estate tax purposes. Moreover, contributions qualify for the gift tax annual exclusion ($12,000 in 2007). For a discussion of the gift tax annual exclusion, see the Fall 2006 issue of **A Step Ahead**, page 3. As a incentive to establish 529 Plans, and to maximize the potential growth of the account, the donor can "pre-fund" the 529 Plan by immediately utilizing five years of annual exclusion amounts ($12,000 x 5=$60,000, $120,000 for a married couple) in any one year provided that no further gift is made to that same beneficiary during the next four years. However, if the account owner dies before the year he could have utilized an annual exclusion, the "unearned" annual exclusions are brought back into his taxable estate.

It is very important to coordinate gifts to a 529 Plan with other annual gifting. Thus, for instance, in addition to annual exclusion gifts, you are entitled to pay tuition expenses for your loved ones if the payment is made directly to an educational institution. Unlike annual exclusion gifts, in order to qualify for this "non-taxable" gift, these payments can not be made directly to the student. Payments for fees, supplies, room and board, books and equipment also do not qualify for this treatment, although they may be paid directly to the student and qualify as an annual exclusion gift. Therefore, you may consider utilizing a 529 Plan to pay for non-tuition type expenses and paying tuition bills directly to the educational institution to take advantage of both types of non-taxable gifts.

The changes promulgated by the PPA make 529 Plans an attractive way to save for your loved one's higher education expenses. When you consider establishing a 529 Plan, please do not forget to take into account its overall impact on your existing estate and asset protection plans.