529 Plan Myths Debunked:
The Facts About the Estate Planning Benefits of 529s

Sponsored by Legg Mason's Scholars Choice

LEGG MASON
GLOBAL ASSET MANAGEMENT

Presented By

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Myth:

529 Plans are inflexible, and must be used to pay for college expenses

FACT:

529 Plans were designed by Congress for maximum flexibility, with unique gifting, estate planning and control benefits

Our Objectives

Explain how to:

- reduce current and future tax liability
- pass wealth onto children, grandchildren and future generations
- fully control assets even though assets are outside the estate
- reduce expenses associated with Trusts
- protect assets from creditors.

What is a 529 Plan?

A gift from Congress

- Created by Congress in 1996, 529 "Qualified State Tuition Plans" are *tax-advantaged programs with special estate planning, gifting and creditor protection provisions.*
- Many Congressional leaders, staff and tax experts view Section 529 as *one of the most generous tax provisions ever passed by Congress for the benefit of American families.*

What is a 529 Plan?

Even IRS Acknowledges Special Treatment

"In addition, *the estate planning and gift tax treatment* of contributions to a Qualified State Tuition Plan (QSTP) and interests in a QSTP *is generally different from the treatment that would otherwise apply* under generally applicable estate and gift tax principles."

Preamble to Proposed IRS 529 Regulations

Myth:

The money in a 529 Plan account must be used to pay for college expenses for the benefit of the designated Beneficiary

FACT:

The Account Owner maintains full control of the assets in a 529 Plan account at all times

Account Owner Control

The Owner retains full control and has the ability to:

- change investment options (twice per calendar year)
- change the Beneficiary (unlimited times)
- transfer account ownership
- rollover assets to another 529 plan (1x per 12 months)
- decide when – and even – whether to distribute assets
- make withdrawals – Qualified or Non-Qualified.

Myth:

The Beneficiary of a 529 Plan account may only be changed to a blood relative in the same generation

FACT:

The Beneficiary of a 529 Plan account may be changed to anyone related by blood, marriage or adoption – of any age – in any generation

Flexibility

Beneficiary Changes: Member of the Family Defined

The prior Beneficiary's:

- Son or daughter or descendant of either
- Stepson or stepdaughter
- Brother, sister, stepbrother or stepsister
- Father or mother or ancestor of either
- Stepfather or stepmother
- Niece or nephew
- Aunt or uncle
- Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law
- Spouse of any of the above
- First cousin
- Child includes legally-adopted child
- Brother or sister includes brother or sister by the half-blood

Myth:

The money in a 529 Plan account must be distributed before the Beneficiary reaches age 30

FACT:
529 Plans have no time or age restriction*

Time Restrictions

Most 529 Plans have no time restrictions:

- 49 States – and DC – *no* time restrictions
- 1 State with time restriction: Virginia*

*For beneficiaries who have not graduated from high school at the time a CollegeAmerica Account is opened, the Account Owner has 30 years after the projected date of the Beneficiary's high school graduation to use all assets in their CollegeAmerica Account. For beneficiaries who have graduated from high school at the time an Account is opened, the Account Owner has 30 years after the date the CollegeAmerica Account was opened to use all assets in their CollegeAmerica Account. Any time spent by a Beneficiary as an active-duty member of any branch of the U.S. Armed Services will be added to the 30-year period. If an Account is rolled over to a new Beneficiary, the applicable 30-year time limit will begin again, based on the new Beneficiary's age and date of Account inception. Requests for extensions of this Account duration limit will be considered by the Program Manager on a case-by-case basis.

If the CollegeAmerica Account is not depleted within the 30-year Account duration limit, the Program Manager will contact the Account Owner regarding the status of the CollegeAmerica Account. If neither the Virginia529 Board nor the Program Manager, after diligent commercial efforts, is able to locate the Account Owner, the Beneficiary or any designee of survivorship rights, the Board shall report the unclaimed amounts to the Virginia State Treasurer as unclaimed property pursuant to Section 55–210.12 of the Code of Virginia (1950), as amended.

Myth:
The Account Owner of a 529 Plan account is subject to income limits

FACT:
529 Plans have no income limits

Myth:

A withdrawal from a 529 Plan account must be used for college expenses or will be subject to tax and penalty

FACT:

Only the earnings portion of a Non-Qualified withdrawal from a 529 Plan account is subject to tax and penalty

Tax Treatment of Withdrawals

The Owner may take two types of withdrawals:

- Qualified Withdrawals – in which the money *is* used for Higher Educational Expenses
  - Free from federal and state tax.
- Non-Qualified Withdrawals – in which the money *is not* used for Higher Educational Expenses
  - subject to ordinary income tax, plus a 10% federal penalty -- on the *earnings* portion of the withdrawal *only.*

The federal Tax Cuts and Jobs Act (TCJA), which was signed into law in December 2017 and became effective January 1, 2018, expanded the definition of a qualified higher education expense to include up to $10,000 (federal tax-free withdrawals) per year in tuition expenses at private, public and religious elementary and secondary schools (K–12).

The state tax consequences of using 529 plans for elementary or secondary education tuition expenses will vary depending on state law and may include recapture of tax deductions received from the original state and may also include taxes and penalties. Some states (such as Colorado) do not offer state tax deductions or tax credits for K–12 tuition, and other restrictions may apply.

Myth:

When making a Non-Qualified withdrawal from a 529 Plan account, earnings come out first

FACT:

Withdrawals from a 529 Plan account come out Pro-Rata

EXAMPLE

Tax treatment of Non-Qualified withdrawals

- withdrawal amount is $30,000
- from an account which grew to $150,000 on $100,000 in contributions
- the earnings portion of the withdrawal would be 1/3 or $10,000
- 2/3rds of the withdrawal is return of principal – free from any tax or penalty
- Only 1/3 or $10,000 of the withdrawal is subject to tax – and the 10% federal penalty.

Ideal Prospects:

- Clients with needs other than college expenses.

Myth:

When making a Non-Qualified withdrawal from a 529 Plan account, the Account Owner is taxed

FACT:

Non-Qualified withdrawals from a 529 Plan account are taxed at the ordinary income tax rate of the Distributee – either the Beneficiary, the current Owner or a new Owner

EXAMPLE

Tax treatment of Non-Qualified withdrawals

- withdrawal amount is $30,000
- from an account which grew to $150,000 on $100,000 in contributions
- the earnings portion of the withdrawal would be 1/3 or $10,000
  - Account Owner is in the highest tax bracket
  - if the Bene's income tax rate is 10%, then the federal tax would be $1,000, and the 10% federal penalty would be an additional $1,000, for a total of $2,000.*

Ideal Prospects:

- Clients with a Beneficiary in a much lower tax bracket.

*State income tax may apply.

Myth:

A Non-Qualified withdrawal, such as one used for medical expenses, is always subject to tax and penalty

FACT:

A 529 Plan account withdrawal, used to pay medical expenses of a disabled Beneficiary, are exempt from the normal 10% federal penalty

Reference: IRS Publication 970 – Tax Benefits for Education.

EXAMPLE

Tax treatment of Non-Qualified withdrawals

- Beneficiary is changed from Owner's child to Owner's mother, who is disabled
- $30,000 is withdrawn to pay for medical mother's expenses
- from an account which grew to $150,000 on $100,000 in contributions
- the earnings portion of the withdrawal would be 1/3 or $10,000
  - Ordinary Income Tax at Distributee's rate on $10k, but
  - *no* 10% federal penalty.

Ideal Prospects:

- Clients with disabled family members.

Myth:
All 529 Plans have balance limits

FACT:
No 529 Plans have balance limits; an account can grow in perpetuity to any amount

EXAMPLE

Setting up a Legacy College Fund

Investors can fund a 529 that can benefit multiple generations:

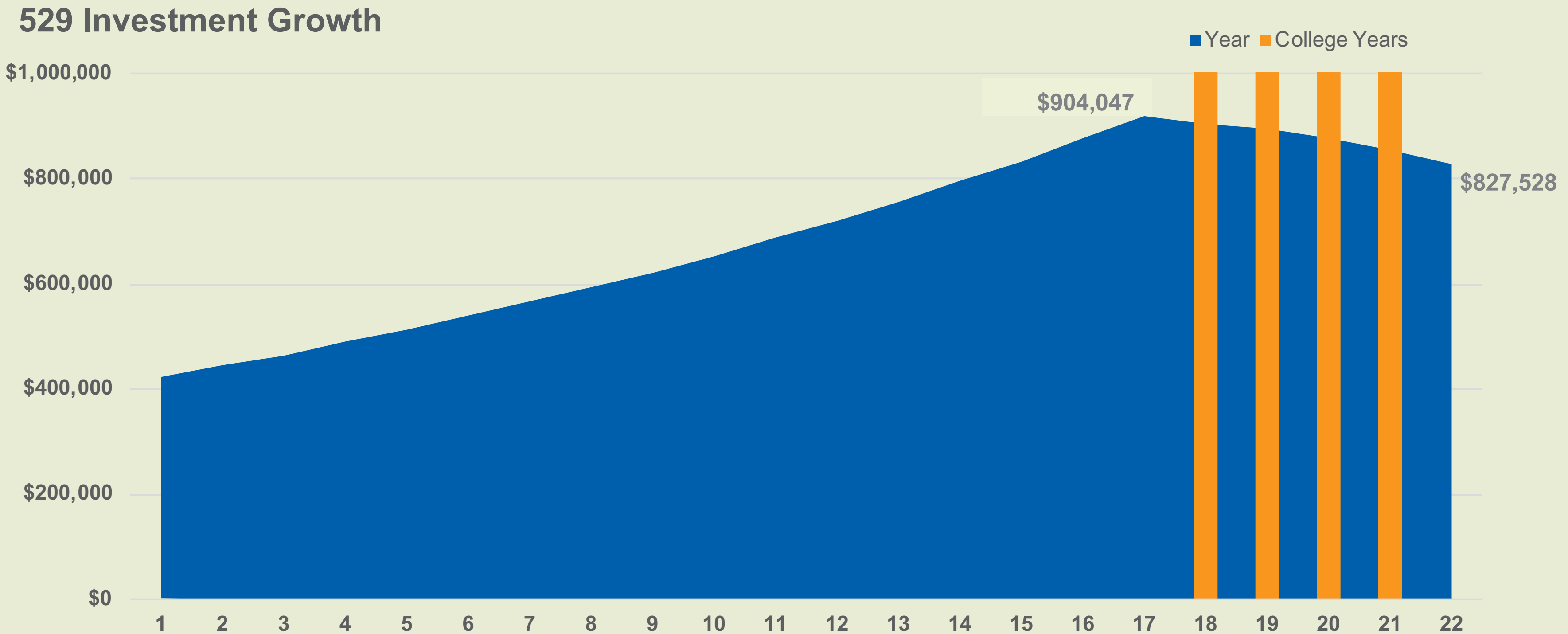
- **Step 1.** Fund a single account with $400k for a grandchild.[1] In 18 years, the account grows to approximately $904,047.[2]
- **Step 2.** In years 18-21, Account Owner withdraws $240,546 for college tuition and expenses for the grandchild – the original Beneficiary.[3]
- **Step 3.** In subsequent years, Account Owner changes the Beneficiary to great grandchildren and future generations.

Ideal For:

- Clients who wish to provide education for generations to come.

1. Contributions in excess of the annual Gift Tax Exclusion ($15,000 for individuals; $30,000 for joint filers) – or the Section 529 5-year “Forward-Gifting” provision limits ($75,000 for individuals; $150,000 for joint filers) – would be deducted from the Giftor’s Lifetime Unified Credit.
2. For illustration purposes only; assumes an average annual growth rate of 5%; does not represent the returns of any Scholars Choice 529 Plan Portfolio.
3. The Cost of Attendance in Year 18 represents the national average of a 4-year degree from a public (in-state) college, adjusted for a hypothetical 5.0% rate of tuition inflation over 18 years; source: “Trends in College Pricing 2019,” the College Board, 2019.

EXAMPLE



Source: https://leggmason.wealthmsi.com/collcost/

Contributions in excess of the annual Gift Tax Exclusion ($15,000 for individuals; $30,000 for joint filers) – or the Section 529 5-year "Forward-Gifting" provision limits ($75,000 for individuals; $150,000 for joint filers) – would be deducted from the Giftor's Lifetime Unified Credit.

For illustration purposes only; assumes an average annual growth rate of 6%; does not represent the returns of any Scholars Choice 529 Plan Portfolio.

The Cost of Attendance in Year 18 represents the national average of a 4-year degree from a public (in-state) college, adjusted for a hypothetical 5.0% rate of tuition inflation over 18 years; source: "Trends in College Pricing 2019," the College Board, 2019.

Assumes no adverse changes to the current legislation pertaining to Section 529 of the Internal Revenue Code.

Changes to tax rates and laws as well as the impact of inflation may have an impact on the comparative results.

Myth:

A 529 Plan Account Owner can gift only $15,000 per year – $30,000, if filing jointly

FACT:
A 529 Plan Account Owner can gift $150,000 or more per Beneficiary*

*Contributions in excess of the annual Gift Tax Exclusion ($15,000 for individuals; $30,000 for joint filers) – or the Section 529 5-year "Forward-Gifting" provision limits ($75,000 for individuals; $150,000 for joint filers) – would be deducted from the Giftor's Lifetime Unified Credit.

Gift Tax Exclusion

- **Annual Exclusion.** Any individual may give up to $15,000/yr – *per Beneficiary* – without paying federal gift tax; $30,000/yr (joint).*
- **"Accelerated- or Forward-Gifting."** Through a special Section 529 provision, Owners may effectively use five years of their annual gift tax exclusion all at once:
  - $75,000 for individual filers
  - $150,000 for joint filers.**

*The current (2019) Annual Gift Tax Exclusion amount is $15,000.
**In any year during which your 529 contributions for a particular beneficiary exceed the Annual Gift Tax Exclusion amount, you may make an election on Form 709 to spread the contributions ratably over five years (20% per year) for gift-tax purposes. This permits frontloading of up to $75,000 (in 2018) per beneficiary (or $150,000 for a married couple) into a 529 plan without generating a taxable gift, assuming no other gifts to that beneficiary are made during the five calendar-year period. If you make the five-year election and die before the fifth calendar year, the contributions allocated to the years after your death are included in your taxable estate.

Gift Tax: Caveat

"Accelerated-" or "Forward-Gifted" contributions are outside the Owner's taxable Estate, unless...

- the Contributor passes away within the 5-year timeframe, in which case Forward-Gifted contribution amounts – excluding any earnings – will be added back to the taxable estate.*
- Beneficiary still has no access to the monies; Ownership is dictated by a previously designated Successor Owner or the Executor of the Owner's Estate.

*Source: Internal Revenue Code 529(c)(2)(B).

Myth:

Using one's 529 5-year forward-gifting provision will reduce the Lifetime Unified Credit

FACT:

Investors can take advantage of the 529 5-year forward-gifting provision and keep their Unified Credit intact.

EXAMPLE

Gifting After a Liquidity Event

Irving and Rhonda: 81 years old – who have 7 children (some married), 15 grandchildren (some married), and 6 great-grandchildren – sold their business for $25 million.

Ideal Prospects:

- Clients with $20 – 30 million in net worth.

- They contribute $150,000 to a 529 account for each child, grandchild, great-grandchild – and the spouses of each, if married -- 34 accounts for total of $5.1 million.
- They remove $5.1 million from their estate using the 5-year forward-gifting provision.
- They keep their Unified Credit intact.
- No gift tax consequence for Irving and Rhonda, so long as they do not make additional gifts to the same beneficiaries over the 5-year period and live into the fifth year.

Myth:

The maximum a 529 Plan Account Owner can gift to a single Beneficiary is $150,000

FACT:

A 529 Plan Account Owner can gift $400,000 – or more – to each Beneficiary*

*The Maximum Contribution Limit for the Colorado-sponsored 529 Plans. Contributions in excess of the annual Gift Tax Exclusion ($15,000 for individuals; $30,000 for joint filers) – or the Section 529 5-year "Forward-Gifting" provision limits ($75,000 for individuals; $150,000 for joint filers) – would be deducted from the Giftor's Lifetime Unified Credit.

Estate Tax: 2018 Rule Change

Lifetime exemption ("Unified Credit") was increased

- 2018 lifetime exemption doubled to:
  - *over $11 million (individual)*
  - *over $22 million (joint).[1]*
- Note: An annual gift tax exclusion taken does *not* count against an individual's Lifetime Unified Credit.

1. Original $5MM amount was indexed for inflation occurring after 2011; was $5.49MM in 2017. Effective date – the provision is effective for estates of decedents dying and gifts made after December 31, 2017 and before January 1, 2026.

EXAMPLE

Using the Lifetime Unified Credit

George and Helen, a married couple with three adult children, contribute $400,000 to a 529 plan account – for each of their 6 teenage grandchildren – soon to attend college.

- They immediately removed $2.4 million from their taxable estate.
- Their accountant makes a “Note to File” that their Unified Credit is to be reduced by $2.4MM.
- George and Helen – while they are still alive – get to see their grandchildren benefit from their gift.

Ideal Prospects:

- ❑ Clients whose adult children have not saved for their children’s education.
- ❑ Clients with net worth under $20 million.

Myth:
Transferring Ownership of a 529 Plan account is a taxable event

FACT:
Transferring Ownership of a 529 Plan account is not a taxable event

Note: Federal law does not specifically address the tax treatment of a transfer of ownership of a 529 account. You may want to consult a tax adviser to fully understand any potential tax consequences.

EXAMPLE

Transferring Account Ownership

Margaret – 65-year-old grandmother of a newborn granddaughter, Sophia.

- Margaret opens a 529 plan account for Sophia, and funds the account with $75,000, using the 5-year forward-gifting provision.
- 18 years later, before Sophia enters college, Margaret transfers ownership of the account to Sophia's mother, Angela.
- Angela – now "Owner" – controls Sophia's account; can change investments and take distributions.
- No tax consequence for Margaret.
- No tax consequences for Angela.

Ideal For:

- Clients who, years later, do not want the administrative burden of taking withdrawals to pay for tuition, etc.

Myth:
An Account Owner is bound by the Contribution Limit of the 529 Plan

FACT:

The Contribution Limit aggregated by Beneficiary applies only to accounts sponsored by the same state

Contribution Limits

529 Plans are required to have Contribution Limits:

- Contribution Limits are generally $300,000 or higher
- When an account reaches the Plan's Contribution Limit, no further purchases may be made.
    - All accounts for the benefit of the same Beneficiary – regardless of Owner – are aggregated for the purpose of limiting contributions
    - Additional accounts in Plans – sponsored by *other* States – are not aggregated.

EXAMPLE

Multiple Accounts for the Same Beneficiary

Clients can exceed the Contribution Limit of a single state by funding 529 Plan accounts – for the same Beneficiary – in *multiple states:*

- **Account #1 / State A.** Fund an account with $400,000 – the Contribution Limit for State A – for a grandchild.*
- **Account #2 / State B.** Fund a second account with $300,000 – the Contribution Limit for State B – for the same grandchild.*

Ideal Prospects:

- Clients whose grandchildren may need more money than a single Plan's maximum.

*Contributions in excess of the annual Gift Tax Exclusion ($15,000 for individuals; $30,000 for joint filers) – or the Section 529 5-year "Forward-Gifting" provision limits ($75,000 for individuals; $150,000 for joint filers) – would be deducted from the Giftor's Lifetime Unified Credit.

Myth:
A 529 Plan account can only be established by an individual

FACT:
529 Plan Accounts can be Owned by Entities such as Trusts

Trust-Owned 529 Plans

Leveraging a 529's tax advantage

- Eliminates any year-over-year taxes on earnings.
- Maximizes the after-tax return on assets in Trust intended for education.
- Potentially simplifies the Trust's investment policy.
- Potentially helps offset expenses of the Trust (administrative fees, accounting costs, attorney fees, custody charges, court fees, etc.).
- Helps to ensure assets are ultimately used for higher education or for the benefit of the child who receives tax-deferred growth.

Ideal Prospects:

- Clients who already have a Trust

Myth:
Assets in a 529 Plan account can be seized by Creditors

FACT:

529 Plan account assets are protected from Creditors and Bankruptcy*

*For contributions made more than a year, but less than two years, the first $5,000 contributed is kept out of the estate, and any contributions made during the last year will be included in the estate. The exclusions also depend on the beneficiary having specific familial relationships to the settlor and the contributions being within the allowed 529 limits.

Creditor and Bankruptcy Protection

Two Forms of Protection

- If the contributions were *made more than two years prior* – and neither the Account Owner or the Account Owner's spouse are not the named beneficiaries – *all* assets in the 529 accounts are protected from creditors:
  - at the *State* level, for *Colorado residents* in the Legg Mason Scholars Choice 529 Plan*
  - for all – *regardless of residency* – under the *Federal* Bankruptcy Protection Act of 2005.**

*Colorado law is intended to exempt Accounts and Account assets from all claims by creditors of the Account Owner or Beneficiary. However, Colorado law does not exempt Accounts and Account assets from tax levy, garnishment, attachment or similar orders from the IRS. It is important to note that whether a non-Colorado resident can rely on the creditor protection laws of Colorado, is an issue that has yet to be tested in the courts.

**For contributions made more than a year, but less than two years, the first $5,000 contributed is kept out of the estate, and any contributions made during the last year will be included in the estate. The exclusions also depend on the beneficiary having specific familial relationships to the settlor and the contributions being within the allowed 529 limits.

EXAMPLE

Bankruptcy Protection

- When a married couple, Peter and Cynthia, who are real estate developers, contributed $150,000 to a 529 plan for each of their 5 young children – a total of $750,000 from their Estate.
- Unfortunately, two years later, one of their developments failed and they were sued and were forced to file for bankruptcy.
- Under the Federal Bankruptcy Protection Act, all the assets in their children's 529 Plan accounts were protected from creditors.

Ideal Prospects:

- ❑ Clients who are in businesses at risk of being sued, such as doctors, real estate developers, etc.

Myth:

A 529 Plan account hurts the Beneficiary's chances of receiving federal student aid

FACT:

Only the assets and income of the Parent and the Student are expected to be contributed to the cost of attendance

Financial Aid Impact of 529 Plans

FAFSA's "EFC" calculation

	Assets[1]	Income[2]
Student	20%	50%
Parents	Up to 5.6%	22% - 47%

Ideal Prospects:

- Clients whose adult children may qualify for Federal Student Aid.

- Third-party-owned 529 plans (e.g., grandparents) are treated differently:
  - Assets are not considered at all in the EFC calculation
  - Distributions are considered income of the student.

Owner	Assets[1]	Distributions
Parent	Up to 5.6%	0%
Third Party	0%	50%

1. Total current balance of cash, savings and checking accounts; net worth of investments, including real estate, excluding the home in which parents and student live; net worth of parent and student current businesses and/or investment farms, excluding family farms or businesses with 100 or fewer full-time or full-time equivalent employees. Net worth means current value minus debt. Source: FAFSA, 2019.
2. Income includes the adjusted gross income from the parents' and students' Forms 1040 along with certain other items representing untaxed income and benefits (e.g., untaxed portions of IRA distributions and veteran on-education benefits, such as disability). Source: FAFSA, 2019.

Re-Cap:
Estate Planning Benefits of 529 Plans

Estate Planning Benefits of 529 Plans

- **Reduce Exposure to Estate Tax**
  - Contributions are considered Completed Gifts – not subject to estate tax.
- **Retain Control**
  - Ensure assets are spent on education as distributions are controlled by the Account Owner, not the Beneficiary – even once 18 and/or in school.
  - Changes in Beneficiary – including to self — can be made easily without tax consequences.
  - Daily access and liquidity — can take the money back if needed (e.g., for unforeseen medical expenses).
  - Similar benefits of revocable Trust.
- **No Expiration Date**
  - In most 529 Plans, there is no distribution requirement date, so accounts can grow tax-deferred – for generations.

Estate Planning Benefits of 529 Plans (cont'd)

- **Substantial contributions can be made at any time**
  - Can use not only annual exclusion – also Forward-Gifting and Unified Credit.
  - No need to wait until the child is in college – or even born yet – thus, *removes mortality risk,* generate tax-free/deferred income.
- **Money can be used to pay medical expenses**
  - Not subject to 10% federal penalty in the event Beneficiary is disabled.
- **Wealth can be transferred**
  - Change of ownership and subsequent withdrawals can be done in a manner resulting in little or no tax or penalty.
- **Mitigate tax paid by Trust**
  - Make the Trust an Owner of a 529 to lower or eliminate taxes.

Estate Planning Benefits of 529 Plans (cont'd)

- **Money can be protected from Creditors**
  - All assets in the account for two years or more are protected.
- **Tax-deferred growth**
  - Regardless of the eventual use of the funds.
  - No cap gains tax, net investment income tax or AMT.
- **No income limit**
  - Useful for clients of all net worth values.
- **No time limit**
  - In all but the Virginia-sponsored Plans.
  - Never a Required Minimum Distribution.

Why Consider
Legg Mason Scholars Choice® 529 Plan?

Why Scholars Choice?

Estate Planning-related Features

- **No time restrictions.** One State – VA – has a 30-yr hold limit, a potential concern for our clients using a 529 Plan for wealth transfer, or with accounts with significant balances left after the current beneficiary graduates/drops out/never attends college.
- **High contribution limit.** $400k.
- **Ability to transfer account ownership.** With no tax implications – regardless of relationship to current Owner – ever.
- **Ability to have distributions made payable to either the Account Owner or the Beneficiary.** Allows for any tax on the earnings of a Non-Qualified distribution to be paid at the lower rate.[1]

1. See Plan Disclosure Statement for details.

Why Scholars Choice?

Other Features

- **Multi-Manager.** The Plan features both funds managed by Legg Mason affiliates – Western, ClearBridge, Brandywine and QS Investors – plus non-proprietary fund managers, Franklin Templeton and Thornburg.[1]
- **Active-Management.** The Plan utilizes actively-managed funds exclusively.
- **Asset Allocation Expertise.** The Plan's Investment Manager – QS Investors – performs ongoing asset allocation adjustments, underlying fund selection and performance monitoring.[2]
- **Low Fees & Competitive Pricing.** The Plan has:
  - 2nd-lowest asset-based fees of all actively-managed, advisor-sold plans[3]
  - Class A - Maximum Sales Charge: 3.5%; $500k NAV breakpoint
  - Class C - No CDSC; plus NOW -- "Convertible C" available.[4]

1. Franklin Templeton Investments and Thornburg Investment Management are not affiliates of Legg Mason. 2. QS Investors is the Investment Manager and Legg Mason Investor Services, LLC is the primary distributor of interests in the Program; together they serve as Manager of the Program. 3. As of 9/30/19. Source: Strategic Insight "529 College Savings Quarterly Fee Analysis – Second Quarter 2019." 4. See Plan Disclosure Statement for details.

Questions?

Contact us

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