SECTION 529 QUALIFIED TUITION PLAN

The 2001 Tax Act has expanded and improved upon provisions regarding tax-deferred college savings plans. IRC Section 529 provides tax-exempt status to two types of programs established and maintained by a State (or agency or instrumentality thereof) known as "qualified State tuition programs" or "QSTP's" as follows:

Savings Account Programs

- A person makes contributions to an account established and maintained by the State for the purpose of paying a designated beneficiary's qualified higher education expenses.
- Contributions are allocated to a specific account and the performance of the funds depends on how the contributions are invested by the plan. If the plan does poorly, there may not be enough in a beneficiary's account to cover educational costs.
- Most savings plans have no residency requirements.
- The full value of a savings account plan can be used at any accredited college or university in the country, along with some foreign institutions.
- There are 36 states with a savings plan in operation (30 of which have no residency requirements for entering the plan) and another 15 states either in the process of developing or proposing savings plans.

Prepaid Tuition Programs

- Under this arrangement, a person purchases tuition credits or certificates on behalf of a designated beneficiary, which entitle the beneficiary to a waiver or payment of his or her qualified higher education expenses. A specified contribution to a plan purchases a specific amount of future tuition (e.g., 12 credit hours) at in-state public institutions. Hence, a parent can obtain tomorrow's tuition at today's prices, assuring the donor that the full cost of college (albeit at a public university) is covered
- Plans are designed to eliminate the risk of tuition inflation, although some sponsoring states do not guarantee the contract. In a worst-case scenario, a poor investment climate combined with a lack of accumulated reserves could threaten the solvency of a program trust fund.
- Most state prepaid tuition plans are available only to residents or other select groups, such as children of residents or children of those who graduated from one of the state's colleges or universities.
- Some plans impose a penalty if the student uses the credits for a private or out-of-state college.
- Currently, there are 17 states with prepaid tuition plans; only one of these states does not have a residency requirement. Not available in California at this time.

At this time, the State of California does not maintain a prepaid tuition plan; however, California has created "The Golden State ScholarShare College Savings Trust" designed to help California families and others save in order to meet the increasing costs of higher education. For more information on this program, please visit their website at www.scholarshare.com. Another good website for information on college savings plans is www.savingforcollege.com.

This outline will focus on the more readily available savings account plan.

A. Typical Transaction

In 2001, Grandparent opens a savings account plan and contributes $20,000 to the account. She names her 10-year-old Granddaughter as the beneficiary. After 8 years, the account has grown to $50,000, tax-deferred. Granddaughter enters college and Grandparent withdraws $10,000 to pay her first semester tuition. Beginning in 2002, qualified withdrawals such as this will be completely exempt from federal taxes, although some states, including California, may continue to tax the earnings on the account.

If Granddaughter had decided to skip college and travel around the world instead, Grandparent could either (i) withdraw the $50,000 from the account for Grandparent's own use. The plan charges a penalty equal to 10% of the earnings ($3,000) for a non-qualified withdrawal and reports $27,000 of income to Grandparent ($30,000 earnings less $3,000 penalty); or (ii) leave the money in the account and change the designated beneficiary to a new beneficiary who is a "member of the family" of granddaughter, with no tax consequences to the Grandparent. For the definition of "member of the family", see subparagraph B.2.d. below.

B. Benefits of a 529 Plan

1. Donor Retains Control of the Account

The donor stays in control of the account. With few exceptions, the named beneficiary has no rights to the funds. The donor "calls the shots" - he or she decides when withdrawals are taken and for what purposes. Most plans even allow donors to reclaim the funds for themselves at any time, no questions asked, although there is a 10% penalty any time there is a "non-qualified" withdrawal from the plan.

2. Income Tax Benefits

a. The investment grows tax-free for as long as the money stays in the plan.

b. Beginning in 2002, "qualified distributions" will not be subject to federal income tax.

"Qualified Distributions" are defined as:
(1) Distributions used exclusively for "qualified higher education expenses". Such expenses include tuition, fees, books, supplies, equipment, and room and board (limited to a maximum of $2,500) for a student that is enrolled at least ½ half-time in an eligible educational institution. In general, these expenses include any direct costs associated with attending a degree-granting institution, whether the degree sought is an associate's, bachelor's, graduate or professional degree. In addition, these expenses include those of a special needs beneficiary which are necessary in connection with his or her enrollment or attendance at the eligible education institution.(2) Distributions made on account of death or disability of a beneficiary(3) Distributions made on account of a beneficiary

receiving a scholarship (qualified only to extent of the scholarship amount)(4) Distributions that are rolled over into another account (discussed below)

c. A 10% percent penalty is imposed on a distribution from the plan that is included in gross income (a "non-qualified distribution"). Non-qualified distributions include distributions of the account earnings for other than (i) the qualified higher education expenses of the beneficiary, (ii) the death or disability of the beneficiary, or (iii) scholarships (or allowances or payments) received by the beneficiary which do not exceed the amounts of those scholarships, amounts or payments.

Some states, including California, prohibit non-qualifying distributions from being made to anyone other than the owner of the account; however, California permits the current account owner to transfer ownership of the account to another owner, without triggering a taxable event. Thus, by transferring ownership of an account to the person who would have otherwise received the non-qualifying distribution, the restriction (and penalty) can be avoided to some degree.

d. A change in beneficiaries is not a taxable event for income tax purposes as long as the new beneficiary is a "member of the family" of the original beneficiary.

(1) "Member of the family" of the beneficiary is defined as (i) son or daughter, or a descendant of either, (ii) stepson or stepdaughter, (iii) brother, sister, stepbrother, or stepsister, (iv) father, mother or ancestor of either, (v) stepfather or stepmother, (vi) son or daughter of a brother or sister, (vii) brother or sister of mother or father, (viii) son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law, (x) first cousins and (xi) spouse of anyone listed including the spouse of the successor beneficiary.

(2) Changing the beneficiary is accomplished through a qualified rollover, which must occur within 60 days of the withdrawal and must designate a different beneficiary to qualify.

(3) If a successor beneficiary is not a member of the original beneficiary's family, the distribution is treated as a non-qualified distribution to the account owner

3. Gift Tax Benefits

a. Contributions

(1) A transfer to a 529 plan is a completed gift for transfer tax purposes and is considered a present, not a future interest. Thus, the transfer qualifies for the gift tax annual exclusion.

(2) A transfer to a 529 plan also qualifies for the generation-skipping transfer (GST) tax annual exclusion.

(3) A substantial gift tax benefit of 529 plans is that any contributions in excess of the annual exclusion amount can be prorated over the 5-year period beginning with the year of contribution. Any excess over the aggregate 5-year amount will be taxed in the year of contribution as a gift.

A special election allows a donor to treat a qualified tuition plan contribution as if it were made over five years. This enables an individual to contribute up to $50,000 to a beneficiary's account (subject to individual state limits) and have it sheltered by five years' worth of exclusions. If the donor dies during the five-year period, a pro-rated portion of the contribution is included in his or her estate.

b. Changing Beneficiaries

Generally, no gift tax liability is incurred by the donor when a change in beneficiary occurs.

4. Estate Tax Benefits

a. Generally, no portion of any 529 plan is includable in the owner's estate for federal estate tax purposes. The only exception to this rule is if the owner dies during a five-year period for prorating a gift made in a prior year. The amount prorated to years after the owner's death (but not including the year of death) is includable in the owner's estate.

b. As the tax law stands now, the amount of the 529 plan account is included in the beneficiary's gross estate for federal estate tax purposes, even though the owner/donor retains control over the account until his or her death.

5. Other Benefits

a. Contribution amounts allowed are substantial (over $200,000 in many states).

The California plan calculates the maximum contribution limit for a beneficiary based on various factors, including the beneficiary's current age, the present estimated costs of attending five years at the most expensive educational institution in California, projected increase in the costs of attending an institution of higher learning and projected earnings of the savings account. For example, the 2000 maximum contribution limit for a beneficiary born in 1986 was $158,146, while the contribution for a beneficiary born in 2000 or 2001 was $110,033.

b. There are no age restrictions for the designated beneficiary.

c. There are no income limitations on the contributor/donor/owner.

d. The savings account plan is relatively easy to establish.

e. An account owner can also be the beneficiary of the plan.

f. Multiple plans (with either one or multiple owners) are allowed for a single beneficiary as long as the total amounts of all the plans do not exceed the maximum contribution limits. This is difficult for states to monitor if there are plans for the same beneficiary in multiple states. The IRS is expected to deal this issue shortly.

g. Existing educational IRA's and savings bonds may be rolled over into a 529 plan without triggering tax, subject to certain limitations and ownership rules.

h. Existing Uniform Transfers to Minors Accounts (UTMA) are accepted by many (but not all) 529 plans subject to limitations, including but not limited to, the prohibition from making any beneficiary changes to the UTMA/529 account.

C. Caveats

1. The owner of a Section 529 savings account plan is not permitted to direct the investments. Each state controls how qualified tuition plan contributions are invested.

a. This may not be a problem for those who lack the time and expertise to adequately manage their investments.

b. Many of the newer savings plans farm out investment management, along with program administration, to large financial service companies such as Fidelity Investments, Merrill Lynch and TIAA-CREF (which California utilizes).

2. As mentioned above, a 10% penalty on the earnings portion of all non-qualified distributions will apply, and the earnings less the penalty, will be subject to income tax..

3. A contribution to an educational IRA may not be made in the same year a contribution is made to a qualified tuition program for the same beneficiary.

4. A Section 529 plan is treated as an asset of the parent or other account owner in determining eligibility for financial aid.

a. The expected contribution towards the student's college cost will include approximately 5.6%, or less, of the value of the account for each academic year, which is much better than the normal 35% assessment for assets owned in the child's name or in a custodial account.

b. The amount of income included on the child's prior year tax return will be assessed at a 50% rate on the current year's application. This will most likely change with the new law.

D. Considerations Regarding 529 Plans

A person considering a 529 plan should pay careful attention to all aspects of available programs before deciding how and where to invest. As mentioned above, all plans allow expenses to be paid at any eligible higher education institution in the United States. The contributor needs to consider the type of investment plan he or she is most comfortable with. Each state has its own investment plan and it's own investment manager and administrator. California's ScholarShare program currently offers four different investment programs.

Many states add incentives to attract investors to their programs and keep residents from investing in another state's program. Some states offer full state tax deductions for contributions and they exempt earnings used to pay for college from state taxes. Some states offer additional grants to participants who attend in-state schools, while other states operate separate endowment funds, the earnings from which are added to participant account balances. Many states protect qualified tuition assets from the claims of creditors and disregard the account value in determining eligibility for state-level financial aid.

E. State Requirements for Section 529 Savings Account Plan

1. A 529 plan must be "established and maintained" by the state or an instrumentality of the state

A program qualifies if it was initiated by statute or regulation or by an act of a state official or agency.

2. Only cash contributions permitted

Section 529 plans can only accept cash contributions. Prop. Reg. Sec. 1.529-2(d) expands this definition to include checks, money orders, credit cards and similar methods, but not all programs currently accept credit cards.

3. 10% tax on non-qualified withdrawals

Under the new law, a 10% percent tax is imposed on a distribution from the plan that is included in gross income (a "non-qualified distribution"). Non-qualified distributions include distributions of the account earnings for other than (i) the qualified higher education expenses of the beneficiary, (ii) the death or disability of the beneficiary, or (iii) scholarships (or allowances or payments) received by the beneficiary which do not exceed the amounts of those scholarships, amounts or payments.

4. Separate accounting

A 529 plan must provide a separate accounting for each beneficiary.

5. No investment direction

No owner of, contributor to or beneficiary of a Section 529 plan may direct, either directly or indirectly, the investment of the contributions. However, the contributor may select among various investment plans and investment options are becoming more varied.

6. No pledging of interest as security

A 529 plan cannot be used as security for a loan.

7. Prohibition on excess contributions

A program will not qualify as a 529 plan unless it provides adequate safeguards to prevent excess contributions on behalf of a beneficiary over and above those necessary to provide for the qualified higher education expenses of the beneficiary. Prop. Reg. Section 1.529-2(i) provides