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Saving For Education: Creating Educational Dynasty Trusts Using 529 Plans

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I. Dynasty Trusts and 529 Accounts: A Potent Cocktail

A. Code Section 529

Internal Revenue Code ("Code") section 529 provides an income-tax advantaged way to save for higher education.[1] Code section 529 permits states to establish qualified tuition programs and provides tax benefits to taxpayers who establish savings accounts under these qualified tuition programs.[2] The principal income tax advantage of a 529 savings account is that the earnings on the investments in the account are not subject to federal income tax while retained in the account and are not subject to federal income tax when distributions are made from the account if the distributions are used for qualified higher education expenses[3] at an eligible educational institution.[4]

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* This article was based on an outline originally presented at the 40th Notre Dame Tax and Estate Planning Institute (November 2014). This article borrows liberally from Susan T. Bart, *The Best of Both Worlds: Using A Trust to Make Your 529 Savings Accounts Rock*, 34 ACTEC J. 106 (2008). The *ACTEC Journal* article was written when the author's niece, Cara, was still in her Hannah Montana phase. Cara has now graduated from Princeton and is working in Silicon Valley. Her (modest) 529 account established by the author has been distributed. This article does not reflect the changes made by the PATH Act.

1 I.R.C. § 529(a), (c). Section 529 savings accounts often also receive favorable state income tax treatment, but state income treatment varies state to state.

2 I.R.C. § 529(b)(1). Section 529 also authorizes the establishment of prepaid tuition plans, but this article addresses only 529 savings accounts. *See id.*

3 Qualified higher education expenses are "(i) tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution; and (ii) expenses for special needs services in the case of a special needs beneficiary which are incurred in connection with such enrollment or attendance." I.R.C. § 529(e)(3)(A).

4 An "eligible educational institution" means "an institution which is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) as in effect on August

B. Dynasty Trusts

Each individual has generation-skipping transfer ("GST") tax exclusion that can be assigned to gifts to trusts.[5] If GST exemption is timely allocated in an amount equal to the value of each gift to a trust, contributions to the trust will not be subject to GST tax and the trust will have a zero inclusion ratio.[6] If a trust has a zero inclusion ratio, distributions to the grantor's grandchildren and more remote descendants will not be subject to GST tax, and upon the death of each generation of beneficiaries, the trust will not be subject to GST tax.[7] Such a trust is often called a GST Exempt Trust or a GST Trust.

A GST Exempt Trust may also be designed so that it is not included in the estates of the beneficiaries at their deaths.[8] A GST Exempt Trust can last as long as the applicable rule against perpetuities period, or if governed by the law of a state that has repealed the rule against perpetuities, in perpetuity.

A GST Exempt Trust that is intended to last for multiple generations without inclusion in the beneficiaries' estates is sometimes referred to as a Dynasty Trust.

5, 1997, and which is eligible to participate in a program under title IV of such Act." I.R.C. § 529(e)(5). The defining feature of an "eligible educational institution" is that it must be eligible to participate in Department of Education student aid programs. *Id*. The proposed regulations add, "Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible institutions." Prop. Treas. Reg. § 1.529-1(c). Institutions abroad may be eligible educational institutions.

5 I.R.C. § 2031; *see* Susan T. Bart, *Planning for College Using Section 529 Savings Accounts*, 37 PRAC. TAX LAW 38 (2002).

6 I.R.C. § 2642. Certain trusts that were irrevocable on September 25, 1985 are "grandfathered" from GST tax. Treas. Reg. § 26.2601-1. In general, a grandfathered trust could invest in 529 savings accounts to the extent that the trustee anticipates that distributions may be made for qualified higher education expenses. *See* Susan T. Bart, *Code Section 529 College Savings Accounts: More Than a Decade Without Final Rules*, 42 U. MIAMI HECKERLING INST. EST. PLAN. ch. 9 (2008).

7 This article will refer to the grantor's children, grandchildren, great grandchildren, and more remote descendants. The concepts, however, also apply to any other class of beneficiaries that, under the GST tax generation assignment rules, are assigned to the same generation as the grantor's children, grandchildren, and so on. *See* I.R.C. § 2651. For example, a Dynasty Education Trust could be established for the grantor's great nieces and great nephews (who would be assigned to the same generation as the grantor's grandchildren) and their descendants.

8 *See* Susan T. Bart, *The Best of Both Worlds: Using A Trust to Make Your 529 Savings Accounts Rock*, 34 ACTEC J. 106, 111 (2008).

C. Dynasty Education Trusts

A Dynasty Education Trust is a Dynasty Trust established for the primary purpose of funding education for multiple generations of beneficiaries. While this article will use the term Dynasty Education Trust, some clients may prefer the term Legacy Education Trust, GST Exempt Education Trust or GST Education Trust.

To the extent that the Dynasty Education Trust is intended to fund post-secondary education, the Dynasty Education Trust may be invested in 529 savings accounts to avoid income tax on funds that will be used to pay qualified higher education expenses. To the extent a Dynasty Education Trust is invested in 529 savings accounts, the trust may avoid federal (and possibly state) income tax, estate tax, and GST tax, potentially for multiple generations. The initial contribution to the Dynasty Education Trust, however, will be subject to gift or estate tax (except to the extent that contributions to the trust qualify for the gift tax annual exclusion) and GST exemption must be assigned to the trust so that the trust has a zero inclusion ratio.

A Dynasty Education Trust could establish 529 savings accounts for the grantor's grandchildren who have not completed their education. If a designated beneficiary does not need all the funds in his or her 529 savings account for qualified higher education expenses, the trustee could change the beneficiary of such account to another grandchild who has not completed his or her education.[9]

If the Dynasty Education Trust is more than sufficient to provide for the grandchildren's education, then the beneficiary of any unused 529 savings account funds could be changed to one or more of the grantor's great grandchildren, possibly subject to the restriction that the new designated beneficiary of each 529 savings account must be a "member of the family" of the old beneficiary of such account.[10] Under the transfer tax analysis described below, no gift tax consequences would result because of the change of beneficiary, even if the new beneficiary is in a lower generation than the old beneficiary, because a trust is not subject to the gift tax rules.[11] Further, the change of the beneficiary to a great grandchild and any future distributions to the great grandchild should not be subject to GST tax if the trust has a zero inclusion ratio or is a grandfathered trust.[12]

Although a Dynasty Education Trust could permit distributions to the grantor's children for their education (or other purposes) distribu-

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9 *See* I.R.C. § 529(c)(3)(C)(ii).

10 *Id.*

11 *See* I.R.C. § 2501(a)(1) (imposing the gift tax on *individuals*).

12 See Chapter 13 of the Internal Revenue Code.

tions to children waste the GST exemption that was allocated to the trust and therefore should be avoided. Making a child a discretionary beneficiary could be desirable, however, to permit the trustee to establish a 529 savings account with the child as designated beneficiary with the intention of later changing the designated beneficiary to children born to or adopted by the child after the funding of the Dynasty Education Trust.

D. A Contradiction?

At first, there may appear to be a contradiction in using 529 savings accounts within a Dynasty Trust. Code section 529(b)(6) says that the qualified tuition program must establish procedures to prevent contributions beyond those reasonably necessary to pay the beneficiary's qualified higher education expenses.[13] Yet a Dynasty Education Trust is intended to pay not just for the current generation's education, but also the education of future generations.

The apparent contradiction fades as one considers that the limitation in Code section 529(b)(6) is implemented by the states establishing maximum account values, often based on a certain number of years of school at the most expensive college within the state.[14] Once an account reaches the maximum account value no additional contributions are permitted. The maximum account value exceeds $300,000 in almost all states and in at least one state exceeds $450,000.[15] Within a class of grandchildren some may incur education expenses that exceed the maximum 529 account value. It is likely, however, that not all of the grandchildren will incur education expenses exceeding the maximum 529 account value, thus leaving funds that can be used by future generations.

Even more may remain in the 529 savings accounts after the grandchildren complete their education if some of the costs of education were paid by other sources, such as by grandparents directly paying tuition. Further, a Dynasty Trust may own non-529 savings account assets as well as 529 savings accounts.

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13 I.R.C. § 529(b)(6).

14 See Prop. Treas. Reg. § 1.529-2(i)(2), establishing a safe harbor.

15 *See* 529 Plans: Compare by Features, SAVINGFORCOLLEGE.COM, http://www.savingforcollege.com/compare_529_plans/index.php?plan_question_ids[ ]=308&mode=Compare&page=compare_plan_questions&plan_type_id=1 (last visited Sept. 14, 2015).

II. Dynasty Education Trusts: One Part of an Education Legacy Plan

Some clients may view the opportunity of education as the greatest legacy they can leave to their descendants. Others may simply appreciate the additional estate and gift tax benefits of funding education for their descendants, as well as the income tax benefits of using 529 savings accounts. In either case, a Dynasty Education Trust should be just one part of the client's education funding plan. Further, 529 savings accounts may be only a portion of the investments of the Dynasty Education Trust.

A. Section 2503(e)

Section 2503(e) permits an individual to make unlimited payments for tuition as long as those payments are made directly to an educational organization described in section 170(b)(1)(A)(ii).[16]

Grandparents with large estates should pay their grandchildren's tuition directly to remove assets from their estates at no transfer tax cost. Where a beneficent grandparent, great aunt or great uncle cannot be found, a parent with a large estate should plan to pay tuition directly. Other funding for a beneficiary's education should be structured taking into account the grandparent's or parent's intent to pay tuition directly. Paying $20,000 tuition per year for kindergarten through 12th grade, and $45,000 per year for five years for an elite private college would remove almost $500,000 from a grandparent's estate. Multiply that by several grandchildren, and you have some impressive savings.

1. *Tuition*

The exclusion applies only to tuition (full or part time) and does not apply to payments for books, room and board, or supplies.[17]

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[16] *See* I.R.C. § 2503(e). Certain "qualified transfers" are not treated as gifts and therefore do not count against the gift tax annual exclusion. "Qualified transfer" means

> any amount paid on behalf of an individual —
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> (A) as tuition to an educational organization described in section 170(b)(1)(A)(ii) for the education or training of such individual, or
>
> (B) to any person who provides medical care (as defined in section 213(d)) with respect to such individual as payment for such medical care.

Id.

[17] *See* Treas. Reg. § 25.2503-6(b)(2).

2. *Educational Institution*

The educational institution must be described in Code section 170(b)(1)(A)(ii).[18]

3. *GST Exclusion*

The GST tax also does not apply to a transfer that qualifies for the section 2503(e) exclusion – the exclusion for the direct payment of tuition or medical expenses.[19] A gift at death or a distribution from a trust is not a generation-skipping transfer if the transfer, "if made inter vivos by an individual, would not be treated as a taxable gift by reason of section 2503(e)."[20]

4. *Gift to Trust Does Not Qualify*

A gift to a trust that provides that the funds are to be used for tuition expenses incurred by the beneficiaries does not qualify because the transfer to the "trust is a completed gift for Federal gift tax purposes and is not a direct transfer to an educational organization."[21]

B. Annual Exclusion Gift Trust

1. *Gift Tax Annual Exclusion*

An individual may give $14,000 per donee each year (for 2015) without incurring federal gift tax.[22] If the donor's spouse elects to split gifts under section 2513, the donor and the spouse may give a total of $28,000 per donee each year without incurring gift tax.[23] The gift tax annual exclusion was originally $10,000 and is adjusted for inflation periodically in $1,000 increments.[24] However, the gift tax annual exclusion does not apply to gifts of future interests in property.[25] An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property is a present interest in property.[26] "Future inter-

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[18] *See* I.R.C. § 2503(e)(2)(A). Code section 170(b)(1)(A)(ii) requires that the organization (1) have the primary function of the presentation of formal instruction, (2) normally maintain a regular faculty and curriculum, and (3) have a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. I.R.C. § 170(b)(1)(A)(ii).

[19] *See* I.R.C. § 2503(e).

[20] *See* I.R.C. § 2611(b)(1).

[21] *See* Treas. Reg. § 25.2503-6(c) ex. 2; PLR 9823006 (Feb. 25, 1998).

[22] *See* I.R.C. § 2503(b).

[23] *See* I.R.C. § 2513.

[24] *See* I.R.C. § 2503(b)(2).

[25] *See* I.R.C. § 2503(b)(1).

[26] *See* Treas. Reg. § 25.2503-3(b).

est" includes interests or estates that are limited to commence in use, possession, or enjoyment at some future date or time.[27]

2. *GST Tax "Annual Exclusion"*

Code section 2642(c)(1) provides that in the case of a direct skip that is a nontaxable gift[28] the inclusion ratio is zero.[29] Thus Code section 2642(c) essentially establishes a GST tax annual exclusion.

Code section 2642(c)(1), however, does not apply to a transfer to a trust unless during the life of the beneficiary, no portion of the corpus or income of the trust may be distributed to any person other than such beneficiary and the trust will be includable in the gross estate of such beneficiary.[30]

Thus the GST annual exclusion will apply to a 2503(c) trust for a grandchild or to a Crummey trust[31] established solely for such grandchild which will be included in the grandchild's estate. The GST annual exclusion will not apply to a transfer to a trust for multiple beneficiaries (e.g., all of the grantor's grandchildren) even if the grandchild is given a Crummey withdrawal right over such contribution. Giving grandchildren Crummey withdrawal rights over contributions to a Dynasty Education Trust may qualify such contributions for the gift tax annual exclusion, but GST exemption will still need to be allocated to such contributions.[32]

3. *Crummey Trusts for Single Beneficiary*

A grandparent may establish a separate Crummey trust for each grandchild so that contributions to the trust can qualify for the GST tax annual exclusion as well as the gift tax annual exclusion. A donor can establish a trust for a single beneficiary, giving the beneficiary a right to withdraw contributions to the trust when made ("Crummey powers"), at least up to the amount of the gift tax annual exclusion.[33] Typically the

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27 *See* Treas. Reg. § 25.2503-3(a).

28 A "nontaxable gift" means a transfer that is not treated as a taxable gift under Code section 2503(b) (the gift tax annual exclusion) or Code section 2503(e) (the exclusion for direct payment of tuition or medical expenses). I.R.C. § 2503(b), (e); I.R.C. § 2642(c)(3).

29 *See* I.R.C. § 2642(c)(1).

30 *See* I.R.C. § 2642(c)(2).

31 See *infra* Part II.B.3 for a discussion of Crummey trusts.

32 *See* Sharon L. Klein, *Paying for the (Grand) Kids' College*, 148 TR. & EST., Jan. 2008, at 58-59.

33 *See* Crummey v. Comm'r, 397 F.2d 82, 88 (9th Cir. 1968). (Today trusts that take advantage of the gift tax exclusion when transferring money to a child are referred to as "Crummey trusts" after the trust utilized by D. Clifford Crummey, the first taxpayer to use this kind of trust successfully.)

beneficiary has a testamentary power of appointment over the trust to prevent the lapse of the Crummey powers, to the extent the lapse in any year exceeds the greater of $5,000 or five percent of the trust assets, from being a completed gift from the beneficiary to the trust.[34] The trust may specify the purposes for which discretionary distributions can be made and may also specify when the trustee must distribute the trust principal to the beneficiary (for example, when the beneficiary attains a certain age). A Crummey trust can be used for a minor or for an adult beneficiary.[35]

Assuming that the beneficiary is the sole beneficiary during the beneficiary's life, and the trust assets will be included in the beneficiary's estate, contributions to the trust will qualify for the GST annual exclusion.[36]

If a Crummey trust for a grandchild is used to fund the grandchild's education before using the assets of the Dynasty Education Trust, more assets will remain in the Dynasty Education Trust for great grandchildren and more remote descendants.

Consider limiting the use of the Crummey trust to post-secondary education, absent exigent circumstances such as special needs or the inability of the parents to support the beneficiary. Any funds remaining can be distributed to the beneficiary at an appropriately mature age (age 30 is the new age 21!). Such a restriction can thwart any temptation the parent might have (especially if a parent is the trustee) to use the trust to pay expenses the parents should pay themselves and avoid any argument that such trust should be used for some of the beneficiary's support needs in the event the parents divorce.

4. *Equalization*

If annual exclusion gifts are made to separate trusts for grandchildren, the client may wish to have some mechanism for equalizing the gifts to such trusts at the client's death, because the trusts for the younger grandchildren may have received fewer annual gifts than the trusts for the older grandchildren. There is no single best practice for designing such equalizing gifts.

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34 *See* I.R.C. § 2514(e).

35 *See Crummey*, 397 F.2d at 88.

36 *See* I.R.C. § 2642(c)(2). Although the beneficiary would become the transferor for GST tax purposes to the extent that the lapse of the beneficiary's Crummey power in any year exceeds the greater of $5,000 or five percent of the trust assets, this does not create any problem if the trust will be included in the beneficiary's estate in any event.

5. *Other Annual Exclusion Trusts*

Although annual exclusion gifts could also be made to 2503(c) trusts or Uniform Transfers to Minors Act ("UTMA") accounts for grandchildren, such trusts and accounts generally give the beneficiary the right to withdraw at age 21, making it difficult to ensure they are used for education (or any other purpose approved by the grantor).[37]

C. Health and Education Exclusion Trusts

A grandparent may, under current law, establish a health and education exclusion trust ("HEET") to pay directly tuition expenses for descendants even after the grandparent's death.[38] GST exemption is not assigned to a HEET trust, thus preserving GST exemption for a Dynasty Education Trust or multipurpose GST Trust. In general, HEETs work well for educating grandchildren, but after the last child dies a HEET must have a charitable beneficiary.[39] If a grandparent has been directly paying tuition for grandchildren, a HEET can serve as a backstop to fund tuition for any grandchildren who have not completed their education at the time of the grandparent's death, without requiring the use of the grandparent's GST exemption. Because the payment of tuition by the HEET could carry out distributable net income to the beneficiary,[40] it may be helpful to permit the Dynasty Education Trust to make distributions to fund any income tax liability to the beneficiaries resulting from HEET distributions.[41]

D. Dynasty Education Trust

Because grandparents often will be able to fund much of their grandchildren's education by directly paying tuition (individually or through a HEET) and by paying non-tuition expenses from Crummey trusts funded with annual exclusion gifts, the Dynasty Education Trust may be used primarily for the education of great grandchildren and more remote descendants.

E. Announce the Plan

The client should formalize the education plan, preferably in writing, and share it with the client's children and, at appropriate ages, the

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37 *See* I.R.C. § 2503(c)(2)(A).

38 *See generally*, Roy M. Adams, David A. Handler & Deborah V. Dunn, *A New Twist on Sec. 2503(e): Health and Education Exclusion Trust (HEET)*, 139 TR. & EST., July 2000, at 18.

39 *See id.* at 51.

40 *See id.* at 18.

41 See *infra* Part XII for further discussion.

client's grandchildren and more remote descendants. Documenting the plan may help to crystallize the client's thoughts about the extent and terms of the plan. Sharing the plan with descendants can help avoid the sense that different individuals were treated inequitably (e.g., the grandchild who only attends community college vs. the grandchild who attends Ivy League schools for college and graduate school) by setting forth the rules ahead of time. Further, announcing the plan well ahead of time may encourage potential beneficiaries to aim higher because they will know there is a source of funding for higher education.

III. Trusts as 529 Account Owners

If a Dynasty Education Trust is invested in 529 savings accounts, the 529 savings accounts will be owned by the trust as the account owner. The trustee would open the 529 savings accounts with cash[42] already in the trust, with the trust as the account owner[43] and one of the trust beneficiaries as the 529 savings account designated beneficiary.[44] Although the trust can be the account owner, the trust itself cannot be the designated beneficiary because Code section 529 requires that an individual be the designated beneficiary.[45] The trustee, as the account

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42 Contributions to a 529 savings account may only be made in cash. I.R.C. § 529(b)(2).

43 The term "account owner" is not used in Code section 529.

"Account owner" is defined in the proposed regulations as the person who has certain rights over the section 529 account:

> *Account owner* means the person who, under the terms of the QSTP or any contract setting forth the terms under which contributions may be made to an account for the benefit of a designated beneficiary, is entitled to select or change the designated beneficiary of an account, to designate any person other than the designated beneficiary to whom funds may be paid from the account, or to receive distributions from the account if no such other person is designated.

Prop. Treas. Reg. § 1.529-1(c).

44 The "designated beneficiary" is the person who can receive qualified distributions from the 529 savings account. The designated beneficiary must be an individual. Code section 529(e)(1) defines "designated beneficiary" as follows:

> (A) the individual designated at the commencement of participation in the qualified tuition program as the beneficiary of amounts paid (or to be paid) to the program,
>
> (B) in the case of a change in beneficiaries described in subsection (c)(3)(C), the individual who is the new beneficiary, and
>
> (C) in the case of an interest in a qualified tuition program purchased by a State or local government (or agency or instrumentality thereof) or an organization described in section 501(c)(3) and exempt from taxation under section 501(a) as part of a scholarship program operated by such government or organization, the individual receiving such interest as a scholarship.

I.R.C. § 529(e)(1).

45 *Id.*

owner, would then have the power to change the designated beneficiary of the 529 savings account, to direct a qualified distribution[46] from the 529 savings account to the designated beneficiary, to take a nonqualified distribution,[47] to change the investment options (subject to the restrictions set forth in IRS Notice 2001-55),[48] and to roll over the 529 savings account to another qualified tuition program[49] (subject to the terms of the trust, the restrictions of the qualified tuition program, and the rules of Code section 529). Additional contributions to a 529 savings account could either be made by the trustee with cash already in the trust, or by a donor making a contribution directly to the trust-owned 529 savings account, when permitted by the qualified tuition program.

Code section 529 appears to permit contributions to be made to 529 savings accounts by trusts. Code section 529(b)(1)(A) provides that a qualified tuition program includes a program under which a "person" may make contributions to a 529 savings account.[50] "Person" is defined in Code section 7701(a)(1) as generally construed to mean and include an individual, trust, estate, partnership, association, company, or corporation.[51] Under Code section 7701, the only cases in which the statutory definition is not to apply are those in which the term is not "otherwise distinctly expressed or manifestly incompatible with the intent thereof."[52] Nowhere in Code section 529 is there a distinct expression that the word "person" should not have the general meaning ascribed by Code section 7701(a)(1). Nor does the legislative history of Code section 529 reveal any indication that Congress intended to restrict contributors to 529 savings accounts to individuals. Therefore, only if the general meaning of "person" is "manifestly incompatible with the intent" of Code section 529 should the word have a different meaning. The IRS, commentators, and qualified tuition programs permitting trusts as account owners unanimously accepted this construction[53] until the IRS's January 18, 2008 Advance Notice of Proposed Rulemaking on section 529 ("Advance Notice").[54]

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46 A "qualified distribution" is a distribution not subject to federal income tax by reason of Code section 529(c)(3)(B).

47 Nonqualified distributions are subject to income tax and a ten percent additional tax on the earnings, taxable to the recipient. I.R.C. § 529(c)(3)(A); § 529(c)(6).

48 *See* I.R.S. Notice 2001-55, 2001-39 I.R.B. 299.

49 *See* I.R.C. § 529(c)(3)(C).

50 I.R.C. § 529(b)(1)(A).

51 *See* I.R.C. § 7701(a)(1).

52 *See* I.R.C. § 7701(a).

53 *See* Prop. Treas. Reg. § 1.529-1(c) (issued in 1998, providing that "person" has the same meaning as under Code section 7701(a)(1)).

54 Guidance on Qualified Tuition Programs Under Section 529, 73 Fed. Reg. 3441-01, 3443 (Jan. 18, 2008).

The Advance Notice states that it expects to develop rules limiting account owners to individuals.[55] The one reason stated in the Advance Notice for limiting account owners to individuals is to limit the potential for abuse.[56] However, the Advance Notice provides no examples of the manner in which a trust-owned 529 savings account could be used abusively. In fact, a trust limits the potential for abuse because if the trust makes a nonqualified distribution to itself, the funds are refunded to the trust and not to the transferee or grantor personally.

Limiting account owners to individuals is an unnecessary restriction on the ability of trusts and estates to be account owners of 529 savings accounts. Trusts permitting distributions for the qualified higher education expenses of a beneficiary should be able to use the same tax-favored investment vehicle as individuals. Further, trust-owned 529 savings accounts permit a donor to ensure – through the trust provisions and the fiduciary duties imposed on the trustee – that the funds are used for their intended purposes.

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55 *Id.* The Advance Notice cleverly avoids direct conflict with the language of Code section 529 by distinguishing between "contributors" and "account owners." Unfortunately, the term "account owner" does not appear in Code section 529, and the Advance Notice takes the position that the IRS is thus free to limit who may act as an account owner. *Id.* However, one might think that if Code section 529 is construed to permit trusts to be contributors to 529 savings accounts that it logically must be construed to permit trusts as account owners.

This clever sleight of hand would permit a trust to make a distribution to a beneficiary by contributing to a 529 savings account (presumably with the beneficiary as account owner) but would not permit a trust to be an account owner of a 529 savings account for the benefit of one of its beneficiaries, regardless of whether the trust is investing its own assets in the account or the account will receive contributions from individuals.

In the Advance Notice, the IRS indicates that it has thought about also trying to limit contributors to individuals, but decided against such position and instead will try to develop appropriate transfer tax and income tax rules. The Advance Notice states,

> Because any contribution to a section 529 account is treated as a completed gift, and because the gift tax is imposed only on individuals, it can be argued that the definition of "person" in section 529(b)(1) should be limited to individuals. Nevertheless, the IRS and the Treasury Department believe it may be possible to interpret sections 529(b)(1) and 529(c)(2)(A) consistently without limiting the class of permissible contributors to individuals by providing special rules for contributions made by corporations, partnerships, estates, trusts, and other entities. For example, based on § 25.2511-1(h)(1), a contribution by a person other than an individual may be treated as a separate gift by each beneficiary, member, shareholder, partner, etc., in an amount representing that individual's allocable share of the contribution.

Id. at 3444. Accordingly, the forthcoming notice of proposed rulemaking will follow the 1998 proposed regulations in providing that the definition of "person," as used in Code section 529(b)(1), will have the same meaning as under Code section 7701(a)(1).

56 *Id.* at 3442-43.

Perhaps the real concern with permitting a trust as an account owner is whether it is worth the effort to work out the transfer tax and income tax rules to be applied if non-individuals are permitted as account owners.[57] This is a legitimate concern, for if such tax rules cannot be formulated and described, then trust-owned 529 savings accounts could provide a potential for abuse. The author believes that appropriate transfer tax rules can be formulated for trust-owned 529 savings account, and that existing GST tax rules already provide the necessary guidance.[58]

IV. Trust Law Issues

In most instances, a 529 savings account for a beneficiary will be a permissible trust investment.

A. Prudent Investor Rule

Under the Uniform Prudent Investor Act adopted by many states, a "trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust."[59] Individual investments are evaluated "not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust."[60] The trustee may consider, among other things, the expected tax consequences of investment decisions or strategies and an asset's special relationship or special value to the purposes of the trust or to one or more of the beneficiaries.[61] Of course the language of the trust document and the law of the governing state must be analyzed in each instance.

Under the prudent investor rule, an investment in a 529 savings account must be appropriate in light of the purposes, terms, distribution

[57] The Advance Notice asks for comments on "rules necessary to ensure appropriate transfer tax consequences in situations where persons other than individuals make contributions to section 529 accounts." *Id.* at 3444. The Advance Notice also welcomes comments "regarding potential income tax consequences when contributions are made by non-individuals, such as a trust or estate." *Id.*

[58] See the comments on the Advance Notice submitted by the American College of Trust and Estate Counsel and the Comments on the Advance Notice submitted by the American Bar Association Section of Taxation (collectively, the "Comments"), *available at* http://www.americanbar.org/content/dam/aba/publications/rpte_ereport/2008/april/section529submission.authcheckdam.pdf, discussed *infra* at note 79 and accompanying text.

[59] Unif. Prudent Investor Act § 2(a) (1994); *see also* Restatement (Third) of Trusts § 90 (2007).

[60] Unif. Prudent Investor Act § 2(b).

[61] *See* Unif. Prudent Investor Act § 2(c); Restatement (Third) of Trusts § 90 cmt k.

requirements, and other circumstances of the trust.[62] An investment in a 529 savings account would generally be appropriate where a purpose of the trust is to fund the higher education of a beneficiary or to benefit generally the beneficiary, the trust permits distributions for higher education expenses or distributions for broader purposes such as "best interests" that may include higher education, and it appears likely the beneficiary will incur such expenses.

The trustee should consider the expected tax consequences of investing in a 529 savings account. These tax consequences would include the potential of avoiding federal (and sometimes state) income tax if the 529 funds are used for qualified higher education expenses. The potential adverse tax consequences that may occur if the funds are not used for qualified higher education expenses should also be considered.[63] The trustee should consider the possibilities that (1) the beneficiary may not incur qualified higher education expenses, (2) the beneficiary may be awarded a scholarship, (3) some other source (such as a grandparent) may pay some or all of such expenses, and (4) another beneficiary of the trust could use any remaining 529 assets for qualified higher education expenses.

In addition, the trustee must examine the proposed investment in a 529 savings account program as the trustee would examine any other investment, considering a number of factors, including expectations concerning the investment's total return, the risk of the investment and how it affects the risk of the portfolio overall, and fees.

Part of the trustee's examination of the proposed 529 savings account investment should include careful consideration of fees. The trustee should "incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship."[64] Because the differences in total costs for qualified tuition program investments can be significant, it is important for the trustee to make careful cost comparisons.[65]

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[62] *See* UNIF. PRUDENT INVESTOR ACT § 2(a); RESTATEMENT (THIRD) OF TRUSTS § 90.

[63] If a nonqualified distribution is made from a 529 savings account, the earnings portion of the distribution will be taxed as ordinary income and may also be subject to a ten percent additional tax. *See supra* note 47. The ten percent additional tax applies unless the nonqualified distribution is (1) made to the beneficiary's estate after the beneficiary's death, (2) attributable to the beneficiary's disability, or (3) made on account of a scholarship, allowance, or payment described in Code section 25A(g)(2) to the extent the distribution does not exceed the amount of the scholarship, allowance or payment. *See generally* I.R.C. § 530(d)(4)(B).

[64] RESTATEMENT (THIRD) OF TRUSTS § 90(c)(3) (2007).

[65] *Id.* § 90 cmt. m.

Under the Uniform Prudent Investor Act, a trustee may invest in any kind of property or type of investment consistent with the standards in the Act.[66] Thus if the Act applies to the trust, it is not necessary to have specific authority under the trust or state law to invest in 529 savings accounts.

B. Delegation

Investing in a pooled investment vehicle such as a 529 savings account should not violate trust law rules concerning delegation because acquisition, retention, and disposition of the trust's interest in the qualified tuition program are all within the trustee's control. Further, the trustee is selecting the qualified tuition program in which the investment will be made and the particular investment option under the qualified tuition program.[67]

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[66] UNIF. PRUDENT INVESTOR ACT § 2(e) (1994).

[67] Comment m to section 90 of the Restatement (Third) of Trusts states,

> Thus, for this purpose, the relevant securities are the fund shares held by the trustee, not the corporate, government, or other securities held in the pooled fund, much as any stock investment held in trust involves the shares rather than the internal assets of the issuing corporation. Even viewed as a delegation, however, the action would be justifiable and proper as long as the investment is otherwise prudent for the trustee.

Comment j states, in part,

> With professional advice as needed, the trustee personally must define the trust's investment objectives. The trustee must also make the decisions that establish the trust's investment strategies and programs, at least to the extent of approving plans developed by agents or advisers. Beyond these generalizations, expressed in terms that are necessarily imprecise, there is no invariant formula concerning functions that are to be performed by the trustee personally.
>
> . . . .
>
> The trustee's authority to delegate is not confined to acts that might reasonably be described as "ministerial." Nor is delegation precluded because the act in question calls for the exercise of considerable judgment or discretion. The trustee's decisions with regard to delegation are themselves matters of fiduciary judgment and responsibility falling within the sound discretion of the trustee.
>
> . . . .
>
> In deciding what as well as whether to delegate and in selecting, instructing, and supervising agents, the trustee has a duty to the beneficiaries to act as a prudent investor would act under the circumstances. The trustee must exercise care, skill, and caution in establishing the scope and specific terms of any delegation, and must keep reasonably informed in order to monitor the execution of investment decisions or plans.

C. Sample Trustee Provision

The draftsperson may consider including in new trust documents explicit authority to invest in 529 savings accounts. Such a provision might read as follows:

> *The Trustee shall have the power to establish one or more 529 Accounts under any qualified tuition program described in Code section 529, of which the "account owner" (as such term is used in the applicable Regulations under Code section 529) is the trust (or the trustees thereof, in such capacity) and of which the "designated beneficiary" (as such term is used in Code section 529 and the applicable Regulations thereunder) is any beneficiary then entitled or eligible to receive income or principal of such trust or who may be entitled or eligible in the future to receive income or principal of such trust; to contribute trust assets to any such 529 Account; to change the designated beneficiary to any beneficiary then entitled or eligible to receive income or principal of such trust or who may be entitled or eligible in the future to receive income or principal of such trust; to select among investment options and to reallocate account funds among different investment options; to roll over the 529 Account to another qualified tuition program; to withdraw or direct distributions from any such 529 Account; and to take any other actions with respect to such 529 Account; provided that the foregoing powers shall not be exercised in any manner that would be inconsistent with the terms of such trust (taking into account any distributions made or expected to be made to or for the benefit of the designated beneficiary of such account and any rights of the account owner to withdraw or transfer or direct distributions from all or any portion of such account). The Trustee's investment in a 529 Account shall not be considered a delegation of investment responsibility under any applicable statute or other law. A "529 Account" is a tuition savings account or prepaid tuition plan as defined under section 529 of the Internal Revenue Code.*

D. Beneficiary

When the trustee establishes a 529 savings account, generally the trustee must designate one of the trust beneficiaries as the designated beneficiary.[68]

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[68] *See* I.R.C. § 529(b)(1)(A)(ii).

The trustee cannot designate the trust as the beneficiary.[69] Nor can the trustee designate more than one beneficiary for a single 529 savings account, although the trustee may establish more than one 529 savings account with different beneficiaries if the trust has multiple beneficiaries.[70] Further, the trustee, as account owner, would retain the right to change the designated beneficiary to a different beneficiary of the trust or to have the account paid to the trust as account owner.[71]

V. Taxation of 529 Savings Accounts owned By a Dynasty Education Trust

A. Income Tax

Code section 529(c)(3)(A) provides: "Any distribution under a qualified tuition program shall be includable in the gross income of the distributee in the manner as provided under section 72 to the extent not excluded from gross income under any other provision of this chapter."[72] One would not normally think of a change of beneficiary as a distribution. Nonetheless, Code section 529(c)(3)(C)(ii) provides: "Any change in the designated beneficiary of an interest in a qualified tuition program shall not be treated as a distribution for purposes of subparagraph (A) if the new beneficiary is a member of the family of the old beneficiary."[73]

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69 *See* I.R.C. § 529(e)(1).

70 *See* I.R.C. § 529(e)(1); Prop. Treas. Reg. § 1.529-1(c).

71 *See* I.R.C. § 529(e)(1); Prop. Treas. Reg. § 1.529-1(c).

72 I.R.C. § 529(c)(3)(A).

73 I.R.C. § 529(c)(3)(C)(ii). "Member of the family" is defined in Code section 529(e)(2) as follows:

> The term "member of the family" means, with respect to any designated beneficiary—
>
> (A) the spouse of such beneficiary;
>
> (B) an individual who bears a relationship to such beneficiary which is described in subparagraphs (A) through (G) of section 152(d)(2);
>
> (C) the spouse of any individual described in subparagraph (B); and
>
> (D) any first cousin of such beneficiary.

Code section 152(d)(2)(A)-(G) defines the term "qualified relative" (in the context of dependents for income tax purposes) as including the following:

> (A) A child or a descendant of a child.
>
> (B) A brother, sister, stepbrother, or stepsister.
>
> (C) The father or mother, or an ancestor of either.
>
> (D) A stepfather or stepmother.
>
> (E) A son or daughter of a brother or sister of the taxpayer.
>
> (F) A brother or sister of the father or mother of the taxpayer.
>
> (G) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

Code section 152(f) provides that "child" includes a stepchild, an adopted child, and certain foster children; "brother" and "sister" include a brother or sister by the half blood.

By implication, a change in a designated beneficiary to someone who is not a member of the family of the old beneficiary will be treated as a nonqualified distribution of the 529 savings account. This Code section makes sense only to the extent that if a change of beneficiary is deemed to be a gift under Code section 529, it might reasonably be viewed as also being a distribution. In the case of a 529 savings account owned by an individual, a change of beneficiary to a member of the family[74] of the old beneficiary who is in a lower generation is deemed to be a gift, but Code section 529(c)(3)(C)(ii) ensures that there are no income tax consequences.[75] Presumably, by implication, it imposes income tax consequences if a beneficiary is changed to someone who is not a member of the family of the old beneficiary. But it should not apply to a change of beneficiary of a trust-owned account if the change of beneficiary is not a gift. A trust-owned 529 savings account should produce income tax consequences only when a distribution is made from the account. A change of designated beneficiary by itself is neither a 529 savings account distribution, nor a trust distribution, and should not produce income tax consequences.

Nonetheless, if Code section 529(c)(3)(C)(ii) is construed as treating a change of beneficiary of a trust-owned 529 savings account as a nonqualified distribution, unless the new beneficiary is a member of the family of the old beneficiary, drafting a Dynasty Education Trust becomes much more challenging. Generally, there would be no problem with changing the designated beneficiary of the trust-owned 529 savings accounts among the class of grandchildren, because the definition of "member of the family" includes both siblings and cousins, and each grandchild would be either a sibling or cousin of each other grandchild.[76] A grandchild's sibling by the half blood would be included as a member of the family. A grandchild's spouse, brothers-in-law, or sisters-in-law would also be members of the family. It is unclear whether a cousin by the half blood (the child of the grandchild's parent's half-sibling) would be included.[77] It seems that a spouse of a cousin would not be included.[78]

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74 *See* I.R.C. § 529(e)(2).

75 *See* I.R.C. § 529(c)(3)(C)(ii).

76 *See* I.R.C. § 529(e)(2).

77 The provisions of Code section 152(f), which include a brother or sister by the half blood, apply to Code section 152(d)(2), but cousins are not included in Code section 152(d)(2). *See* I.R.C. § 152(f), (d)(2). First cousins are included as members of the family only because of Code § 529(e)(2)(D). *See* I.R.C. § 529(e)(2)(D).

78 Code section 529(e)(2)(C) includes the spouse of any individual described in subparagraph (B), but does not appear to include the spouses of first cousins, who are described in subparagraph (D). *See* I.R.C. § 529(e)(2)(C).

But when it came time to move the designated beneficiaries of the trust-owned 529 accounts down a generation, care would have to be taken to ensure that the new beneficiary of each account is a member of the family of the old beneficiary of such account. A grandchild's account could move down to the grandchild's descendants (or their spouses), but could not move down to the grandchild's cousin's descendants. Thus if Code section 529(c)(3)(C)(ii) applies to trust-owned 529 savings accounts and if a Dynasty Education Trust is primarily invested in 529 savings accounts, at some point in time it may be desirable to divide the trust so that there is a separate trust for the descendants of each child of the grantor. Subsequent divisions could occur each time the trust beneficiaries move down a generation.

B. Transfer Tax Rules[79]

In analyzing the transfer tax rules applicable to 529 savings accounts, it is helpful to create two categories of 529 savings accounts – 529 gift accounts and 529 investment accounts. Transfer tax rules apply to gift accounts, but should not apply to investment accounts, unless and until they become gift accounts. A 529 savings account owned and funded by an individual with someone else as the designated beneficiary is the classic example of a 529 gift account. A 529 savings account owned and funded by an individual with himself or herself as the beneficiary is the purest example of a 529 investment account. There is no gift when such account is established. However, if the beneficiary is later changed to someone else, that should be treated as a gift under Code section 529.[80]

A 529 savings account owned and funded by an irrevocable trust is an investment account. In funding such an account the trustee is making an investment choice, not a distribution to a beneficiary and certainly not a gift. However, even though the Code section 529 gift rules do not apply to accounts owned and funded by irrevocable trusts, the generation-skipping transfer ("GST") tax rules will apply.[81]

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79 Much of this analysis of the transfer tax and income tax issues related to trust-owned 529 savings accounts is based on the Comments on the Advance Notice submitted by the American College of Trust and Estate Counsel and the Comments on the Advance Notice submitted by the American Bar Association Section of Taxation (collectively, the "Comments"), *available at* http://www.americanbar.org/content/dam/aba/publications/rpte_ereport/2008/april/section529submission.authcheckdam.pdf. James V. Roberts, Robert J. Rosepink, Diana S.C. Zeydel, Julie Kwon, Christopher E. Houston and the author participated in drafting those Comments.

80 *Id.*

81 *Id.*

1. *529 Gift Accounts*

Code section 529 provides a number of significant exceptions to the transfer tax system. In general, these exceptions allow a donor a greater deal of control over the ultimate disposition of the 529 savings account funds than permitted with other gift techniques. First, Code section 529 provides that a contribution to a 529 savings account is a completed gift that qualifies for the gift and GST annual exclusions,[82] notwithstanding that the account owner can change the beneficiary or refund the account to himself or herself. If the funds are refunded to the donor, little harm is done to the transfer tax system because the funds will then be part of the donor's taxable estate. Further, the ability to change the beneficiary freely among a group of family members was a benefit clearly contemplated by Congress and intended to induce taxpayers to save for higher education by using 529 savings accounts.

Second, Code section 529 provides that the account will not generally be included in the account owner's estate.[83] Again, this does little harm to the transfer tax system because the funds in the account do not pass pursuant to the account owner's estate plan and will eventually be used for higher education, distributed to a beneficiary or account owner and thus become part of their estates to the extent not expended, or be included in the beneficiary's estate.

Code section 529 protects the fundamental integrity of the transfer tax system by providing that if the beneficiary is changed to someone in a lower generation than the old beneficiary, the "taxes imposed by chapters 12 and 13 shall apply."[84] If an individual is the transferor, the gift tax will apply if the new beneficiary is in a lower generation than the transferor and the GST tax will also apply if the new beneficiary is two or more generations below the transferor.

2. *529 Investment Accounts in Irrevocable Trusts*

Gift or estate tax applies when the donor makes a contribution to a trust, but a trust is not subject to the gift tax rules even when it makes a distribution.[85] Therefore when an irrevocable trust invests in a 529 savings account no gift to the designated beneficiary occurs. Further, a change in the designated beneficiary of a trust-owned 529 account should not result in gift taxes.

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[82] *See* I.R.C. § 529(c)(2)(A) (stating that a contribution shall be treated as a completed gift that is not a future interest and not a qualified transfer under Code section 2503(e)).

[83] *See* I.R.C. § 529(c)(4)(A).

[84] *See* I.R.C. § 529(c)(5)(B).

[85] *See* I.R.C. § 2501(a)(1) (imposing the gift tax on *individuals*).

A trust may be subject to GST tax when a taxable termination occurs. A beneficiary receiving a trust distribution may be subject to GST tax if it is a taxable distribution.

A Dynasty Education Trust, by definition, is exempt from GST tax because it either has a zero inclusion ratio or is a grandfathered trust. Therefore a distribution from a trust-owned 529 account to a beneficiary should not be subject to GST tax. Nor should a change of the designated beneficiary of a trust-owned 529 savings account result in GST tax.

3. *Code Section 529(c)(5)*

Notwithstanding the above arguments, could the IRS argue that gift or GST tax may apply when the beneficiary of a trust-owned 529 savings account is changed? Code section 529(c)(5) provides,

> For purposes of chapters 12 and 13 –
>
> (A) Treatment of distributions. – Except as provided in subparagraph (B), in no event shall a distribution from a qualified tuition program be treated as a taxable gift.
>
> (B) Treatment of designation of new beneficiary. – The taxes imposed by chapters 12 and 13 shall apply to a transfer by reason of a change in the designated beneficiary under the program (or a rollover to the account of a new beneficiary) unless the new beneficiary is –
>
> (i) assigned to the same generation as (or a higher generation than) the old beneficiary (determined in accordance with section 2651), and
>
> (ii) a member of the family of the old beneficiary.[86]

The function of Code section 529(c)(5) is to prevent a 529 gift account, over which the donor may have retained control, from being passed down generations without the application of gift, estate, or GST tax. Changes of beneficiary within the same generation are permitted without tax consequences (so long as the new beneficiary is a "member of the family" of the old beneficiary) because one of the fundamental elements of 529 accounts is the ability to change the beneficiary.

The grantor of a zero-inclusion ratio trust has already "paid for" the privilege of being able to pass the trust assets down generations without the imposition of gift or GST taxes by allocating the grantor's GST exemption to the trust. Grandfathered trusts allow for similar benefits.

Admittedly, it would be easier to apply the gift tax rules to a change of beneficiary to a lower generation under the proposed regulations,

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86 I.R.C. § 529(c)(5).

which treated such a change of beneficiary as a gift from the old beneficiary (who is necessarily an individual) to the new beneficiary. The Advance Notice, however, backs away from treating the deemed gift under Code section 529(c)(5) as a gift from the old beneficiary and instead suggests that perhaps the gift is from the account owner.[87] If any deemed gift under Code section 529(c)(5) is determined to be made by the account owner, Code section 529(c)(5) cannot apply to a trust-owned 529 savings account, because a trust cannot make a gift.[88]

Trying to apply Code section 529(c)(5) to changes of designated beneficiaries for trust-owned 529 accounts would seem patently unfair and inconsistent with existing law, particularly if Code section 529(c)(3)(A) treats a change of beneficiary as a nonqualified distribution if the new beneficiary is not a member of the family of the old beneficiary.

C. Contributions to Trust-Owned 529 Savings Accounts

Under Code section 529, persons other than the account owner may make contributions to a 529 savings account.[89] Similarly, with a trust-owned account, someone other than the trust may make a contribution to the account. For example, assume a trustee of an existing irrevocable trust is the account owner of a 529 savings account with a minor trust beneficiary as the designated beneficiary. A grandparent of the designated beneficiary wants to contribute toward the designated beneficiary's higher education. For reasons important to the grandparent (such as the grandparent's desire to avoid additional financial responsibility and paperwork), the grandparent wants the trustee (rather than the designated beneficiary's parent) to control the grandparent's contribution. Setting up another separate 529 savings account for the same designated beneficiary would not subject the account to the terms of the trust and would cause extra administrative expense. So the grandparent would like to contribute funds to the existing trust-owned 529 savings account.

If a donor contributes cash to a 529 savings account owned by an irrevocable trust, should the contribution qualify for the gift tax and GST tax annual exclusions (and the five-year election) on the same basis as a contribution to a 529 account owned by an individual, or alternatively, should the donor be treated as if the donor had made the contribution to the trust for transfer tax purposes and the trust then contributed the funds to the 529 savings account?

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[87] *See* Guidance on Qualified Tuition Programs Under Section 529, 73 Fed. Reg. 3441-01, 3443 (Jan. 18, 2008).

[88] *See* Bart, *supra* note 8, at 112.

[89] *See id.* at 117; *supra* Part III.

Under the latter alternative, the donor would only be entitled to claim the gift tax annual exclusion if the contribution to the trust itself qualifies for the gift tax annual exclusion, as would be the case for a contribution to a Code section 2503(c) trust or a Crummey trust.[90] Under the latter alternative, the donor would only be entitled to claim the GST annual exclusion if the trust qualified under Code section 2642(c)(2) for GST tax purposes.[91] In the case of a Dynasty Education Trust, the GST annual exclusion would not be available. The GST annual exclusion applies with respect to a beneficiary only if no portion of the trust may be distributed to anyone else during the life of the beneficiary and the trust is includable in the beneficiary's estate.[92] Because a Dynasty Education Trust is designed to benefit multiple generations without estate or gift tax, contributions to the Dynasty Education Trust cannot qualify for the GST annual exclusion. GST exemption must be allocated to contributions to the Dynasty Education Trust to create or maintain a zero inclusion ratio.[93]

Permitting a contribution to a trust-owned 529 savings account to qualify for the gift and GST tax annual exclusions (and the five-year election) is consistent with the language of Code section 529. Code section 529(c)(2) states that for gift and GST tax purposes, any contribution to a 529 savings account "shall be treated as a completed gift to such beneficiary which is not a future interest in property."[94] In other words, it is treated as if it were an outright gift to the beneficiary. Nonetheless, until further guidance is issued, it may be prudent to use Crummey withdrawal powers if it is important to qualify contributions for the gift tax annual exclusion and to forgo the use of the five-year election.

Although the use of Crummey powers over contributions to a Dynasty Education Trust may at first glance appear attractive because it can reduce the amount of the taxable gift to the trust, using Crummey powers can cause GST tax complications.[95]

VI. Drafting the Dynasty Education Trust

A. Who Are the Beneficiaries?

A Dynasty Education Trust generally will be established for the grantor's grandchildren and more remote descendants. It could also be established for great nieces and nephews and their descendants, or for

90 *See* Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968).
91 *See* I.R.C. § 2642(c)(2).
92 *See id.*
93 *See* Bart, *supra* note 8, at 113.
94 I.R.C. § 529(c)(2)(A)(i).
95 *See infra* Part VII.

any other class of beneficiaries who are assigned to the grandchildren's generation, and their descendants.

A Dynasty Education Trust could also permit distributions to children. However, any distributions to children would "waste" GST exemption. Therefore, if a grantor has an estate large enough to use all of the grantor's GST exemption, it might be preferable to create a non-GST exempt Education Trust for the children. On the other hand, making the grantor's children discretionary beneficiaries may be desirable if they have additional children after the creation of the Dynasty Education Trust because it would permit 529 savings accounts to be established for the children that could later be converted to 529 savings accounts for the afterborn grandchildren.

Should spouses of descendants be beneficiaries of the Dynasty Education Trust? If the spouse will be the primary income earner, it could make sense. On the other hand, grantors would not want someone marrying their grandchild for the education benefits, and then divorcing their grandchild once they have acquired their enhanced earning potential. Safeguards could be built in, such as requiring that the marriage survive a certain period of time before a spouse could benefit, requiring that the trustee believe the proposed education will enhance the spouse's earning potential, and perhaps even requiring a postnuptial agreement addressing the education benefit provided to the spouse. The postnuptial agreement might treat the spouse's earnings and the educational credential itself as marital property. Alternatively, the trust might treat any payments for the spouse's education as loans that will be forgiven over time if the marriage endures. In any event, the trustee should have discretion not to pay for a spouse's education if there is a premarital agreement that treats the spouse's earnings as separate, non-marital property.

B. What Expenses are Covered?

The Dynasty Education Trust will almost always cover undergraduate qualified higher education expenses, which include tuition, required books and supplies, and certain room and board expenses. These are expenses that can be paid with 529 savings accounts.[96] The trust may authorize distributions for qualified higher education expenses for vocational and trade schools as well as college.[97] College may not be a realistic or optimal goal for all the beneficiaries.

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96 *See* I.R.C. § 529(e)(3)(A).

97 See I.R.C. § 529(e)(5), discussed *supra* note 4 (defining eligible educational institution).

Section 529 savings accounts may also be used for qualified higher education expenses for graduate school and adult learning programs.[98] The grantor will need to specify in the trust instrument whether and to what extent such expenses should be covered. A provision defining "education" to include post-secondary education might read:

> *Definition of Education Expenses. For purposes of this Article, "Education Expenses" are expenses relating to a Beneficiary's undergraduate, post-graduate, vocational and/or professional education, including but not limited to tuition, fees, books, supplies, tutors, housing, a reasonable living allowance and a reasonable allowance for travel between school and home. Notwithstanding the preceding sentence, to the extent the Education Trust is invested in 529 Accounts, the Trustee, in the Trustee's sole and absolute discretion, may limit distributions for Education Expenses to expenses that are qualified higher education expenses as defined in section 529(e)(3) of the Code.*

In some cases the grantor may wish to require that the student be making reasonable progress towards the degree or certification, or permit the trustee to set standards for grade point average or number of credit hours taken. The trust could also require that any post-graduate education be a reasonable investment with the goal of making the beneficiary a productive member of society, to avoid the perpetual-student problem. On the other hand, some donors may wish to permit the trust to pay for adult education, at least if the beneficiary is a productive member of society.

The Dynasty Education Trust may also cover expenses for elementary and secondary education, even though such expenses are not qualified higher education expenses. The trust may use non-529 investments to cover such expenses. A more expansive definition of education would be as follows:

> *"Education" includes all expenses incurred in educating an individual including, without limitation, expenses incurred in connection with such individual's attendance at public or private elementary or secondary school, including instruction in music, performing arts, fine arts or other subjects; college, university, graduate, postgraduate and professional school; vocational or technical school; and such expenses shall include tuition, books, supplies, equipment (including a computer), fees, tutors and reasonable travel and living expenses. Education shall also be construed to include physical, occupational and speech therapy.*

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98 *See id.*

Some grantors may want to ensure that special needs beneficiaries may receive distributions from the Dynasty Education Trust even though they may not incur education expenses. A provision for special needs beneficiaries might read:

> *Distributions for Special Needs. To the extent the Trustee believes that a Beneficiary will not incur Education Expenses because such Beneficiary, in the Trustee's judgment, is incapable of pursuing an undergraduate, vocational and/or professional education because of a physical or mental disability, the Trustee, in the Trustee's sole and absolute discretion, may distribute to or for the benefit of such Beneficiary so much or all of the net income and principal of the Education Trust as the Trustee deems advisable for such Beneficiary's special support and health care needs arising from such disability, but such distributions shall not exceed the amount that the Trustee believes would have been distributed to such Beneficiary for Education Expenses in the absence of such disability.*

The Dynasty Education Trust may also cover expenses that are not qualified higher education expenses, and that therefore should not be funded through 529 savings accounts, but that are associated with higher education. These expenses may include living expenses not included within qualified higher education expenses while attending school – transportation to and from school; computers; books and supplies not required for attendance and therefore not qualified higher education expenses; child care if the beneficiary has minor children; and health care insurance. The trust may also contain non-529 investments to cover such expenses.

C. Equity

The trust instrument should address a number of issues related to what the grantor considers equitable. With respect to grandchildren, is the grantor trying to achieve a per stirpes type of equity, in which case a separate trust for the descendants of each child might be advisable, or per capita equity, in which case a single trust may work best? Is equity construed as equality of opportunity (i.e., every grandchild has the opportunity to attend the school of his or her choice, regardless of cost) or equality of distributions? If the grantor wants equality of distributions, then the trust should include some mechanism for making equalizing distributions to grandchildren who have less expensive educations.

An additional issue of equity may arise because the grandchildren may have a wide range of ages, and therefore those who are older might use up the available funds, depriving the younger grandchildren of the same opportunity. In fact, additional grandchildren may be born or adopted after the trust is established. The grantor should also consider the extent to which other resources available to the beneficiary should be considered.

The trust instrument should also address equity among different generations. Often the grantor will give priority to the grandchildren's education over the education of great grandchildren. This may require the exercise of judgment by the trustee where great grandchildren may begin to incur education expenses before all of the grandchildren have completed their education.

Here is a sample of a trust provision setting priorities among different generations:

> *Distributions for Education Expenses*
>
> *For Grandchildren - For each Beneficiary who is a grandchild of mine, the Trustee may distribute to or for the benefit of such Beneficiary so much or all of the net income and principal of the Education Trust as the Trustee deems advisable to pay for the Beneficiary's Education Expenses, considering the Beneficiary's other resources known to the Trustee (including without limitation scholarships and 529 Accounts not owned by the Education Trust of which the Beneficiary is a Designated Beneficiary, and resources of the Beneficiary's parents). Notwithstanding the preceding sentence, the Trustee may not make a distribution pursuant to this subparagraph if the Trustee, in the Trustee's sole and absolute discretion, determines that the Beneficiary is not making reasonable progress toward legitimate educational goals or, with respect to a Beneficiary who is pursuing post-graduate studies, is not diligently pursuing a course of study that is likely to lead to such Beneficiary becoming a productive member of society. In addition, if the Trustee believes that the assets of the Education Trust are insufficient to pay for the Education Expenses of all of my grandchildren who are Beneficiaries of the Education Trust, the Trustee shall limit distributions pursuant to the first sentence of this subparagraph so as to enable each such grandchild an equal opportunity to acquire a post-secondary education, giving priority to undergraduate education. Except as provided in the preceding sentence, in making distributions pursuant to this subparagraph, the Trustee shall not be required to observe any rule of equality of distributions, but shall, instead, be fully authorized and protected in making unequal distributions.*
>
> *For More Remote Descendants - If the Trustee believes that the assets of the Education Trust are sufficient to pay for (1)*

> *the Education Expenses of all of my grandchildren who are Beneficiaries of the Education Trust, then for each Beneficiary who is a descendant of a grandchild of mine, the Trustee may distribute to or for the benefit of such Beneficiary so much or all of the net income and principal of the Education Trust as the Trustee deems advisable to pay for the Beneficiary's Education Expenses, considering the Beneficiary's other resources known to the Trustee (including without limitation scholarships and 529 Accounts not owned by the Education Trust of which the Beneficiary is a Designated Beneficiary, and resources of the Beneficiary's parents). Notwithstanding the preceding sentence, the Trustee may not make a distribution pursuant to this subparagraph if the Trustee, in the Trustee's sole and absolute discretion, determines that the Beneficiary is not making reasonable progress toward legitimate educational goals or, with respect to a Beneficiary who is pursuing post-graduate studies, is not diligently pursuing a course of study that is likely to lead to such Beneficiary becoming a productive member of society. In addition, if the Trustee believes that the assets of the Education Trust are insufficient to pay for the Education Expenses of all of the other members of the same generation who are also Beneficiaries of the Education Trust, the Trustee may limit distributions so as to enable each such Beneficiary an equal opportunity to acquire a post-secondary education, giving priority to undergraduate education. Except as provided in the preceding sentence, in making distributions pursuant to this subparagraph, the Trustee shall not be required to observe any rule of equality of distribution, but shall, instead, be fully authorized and protected in making such distributions as the Trustee, in the Trustee's sole and absolute discretion, deems advisable.*

An alternative approach is to set a target ceiling for the education expenses of each beneficiary.

> *Basic Distributions - The Trustee may distribute any part or all of the net income and principal of the trust, up to a cumulative amount of $100,000 (as adjusted under this Article) for each grandchild of mine, to any one or more of my grandchildren (whenever born) in equal or unequal shares as the Trustee from time to time considers advisable for the education of such grandchildren at any level beyond secondary school. Any undistributed net income shall be added to the principal of the trust at least annually. Distributions for "education" may include:*
>
> *(a) tuition for a beneficiary's education at any level beyond secondary school at an educational institution (in-*

cluding, without limitation, any university, college, junior college, trade school or vocational school);

(b) reasonable expenses directly related to such education (including, without limitation, expenses of room and board, costs of books and supplies, and expenses of travel to and from such institution, but not including costs of other travel);

(c) reimbursement to a beneficiary for amounts such beneficiary personally paid for such beneficiary's education expenses described above; and

(d) payments to a beneficiary to reimburse or provide for any income taxes the beneficiary must pay on account of trust distributions to the beneficiary (such payments, however, shall not be considered in applying the $100,000 limit on distributions).

Supplemental Education Distributions - If and to the extent the Trustee at any time believes the primary purpose of the trust will not be jeopardized, the Trustee may distribute any part or all of the net income and principal of the trust to or for any one or more of my grandchildren as the Trustee from time to time considers advisable to provide supplemental funds for such educational purposes in excess of the $100,000 limit.

Inflation Adjustment - Notwithstanding any other provisions, the $100,000 basic limit on distributions shall be adjusted for 2015 and each subsequent calendar year by such sum as reflects increases in the cost of living since January 1, 2014. For this purpose, the increase in the cost of living shall be determined pursuant to the Consumer Price Index for Urban Consumers U.S. City Average All Items (1982-84=100), as published by the Bureau of Labor Statistics of the U.S. Department of Labor. If such index shall cease to be published, there shall be substituted such other index as the Trustee believes most nearly reflects the same information. The Trustee shall have discretion in making such adjustments to do whatever the Trustee reasonably believes carries out my intent, and shall not be accountable except for lack of good faith.

D. Loans for Education

Another possible feature of a Dynasty Education Trust that could enable it to last for additional generations is a provision authorizing the trustee to make low-interest loans to beneficiaries. For example, the trustee could be encouraged to make loans rather than distributions for education costs that exceed a certain amount per beneficiary. Such a provision might encourage beneficiaries to make cost-effective choices for their education. Alternatively, the trust could authorize or direct the trustee to make loans instead of distributions for graduate school.

E. Trust Modifications

1. *Trust Protector*

Given the uncertain tax treatment of trust-owned 529 savings accounts, and given the complexity of drafting a Dynasty Education Trust, it may be wise to name an independent person as a Trust Protector and to give the Trust Protector certain powers to amend the Dynasty Education Trust. The Trust Protector, for example, might have one or more of the following powers: (1) to modify or amend the Dynasty Education Trust to achieve favorable tax status or to adapt to changes in the Internal Revenue Code that undermine the tax benefits of the Dynasty Education Trust originally intended by the grantor; (2) to modify the financial powers of the trustee or administrative provisions of the Dynasty Education Trust; (3) to modify the trustee provisions; (4) to remove and appoint an investment advisor; (5) to change the situs or governing law of the Dynasty Education Trust; (6) to interpret the terms of the trust instrument at the request of the trustees; and (7) to amend the Dynasty Education Trust to change, eliminate or add provisions relating to the disposition of net income and principal (including the power to add or eliminate one or more beneficiaries).

A Trust Protector, however, is effective only so long as someone is named to fill such office and able and willing to act. There should be a mechanism for naming successor Trust Protectors or filling a vacancy in the office of Trust Protector.

2. *Decanting*

If the Dynasty Education Trust only permits distributions for education or other ascertainable purposes, any decanting statute that might apply may either not permit decanting or may not permit changes to the beneficial interests. If the grantor desires more flexibility in modifying the trust terms, the trust instrument might either grant such powers to a Trust Protector or might grant an independent trustee broader decanting powers than those provided under state law.

In some cases, the grantor may fear that a current or future decanting statute might permit a modification of the Dynasty Education Trust that would be inconsistent with the fundamental purposes of the trust. Therefore, it may be helpful to include in the trust instrument a purpose clause that expresses the grantor's general intent and prohibits trust modifications that are inconsistent with such purpose.

VII. Crummey Powers: Creative or Just Crummy?

As discussed above, a client's education funding plan may use the gift tax annual exclusions available for gifts to grandchildren to fund separate Crummey trusts for each grandchild, because gifts to such trusts can qualify for the GST annual exclusion and thus preserve a larger portion of the client's GST exemption for multi-generational GST trusts, including a Dynasty Education Trust.[99] In some cases, however, a client may wish to have the ability to make annual exclusion gifts to the Dynasty Education Trust.

Direct gifts to 529 savings accounts owned by the trust may qualify for the gift tax annual exclusion under the literal language of Code section 529.[100] At this point in time, however, this result is uncertain. Further, this strategy for making annual exclusion gifts to the Dynasty Education Trust would not work if the trust does not own a 529 savings account for the beneficiary, the qualified tuition program does not permit third-party gifts to the account, or the account value is in excess of the maximum allowed account value.

Thus if the client may wish to make annual exclusion gifts to the Dynasty Education Trust, the trust should grant Crummey rights of withdrawal over trust contributions to the appropriate beneficiaries.

Care must be taken to ensure that the lapse of a Crummey withdrawal right does not result in a gift from the beneficiary to the trust. If the lapse resulted in a gift from the beneficiary or the beneficiary's estate to the trust, the beneficiary would be treated as the transferor of that portion of the Dynasty Education Trust, and unless the beneficiary assigned his or her GST exemption to such portion, the trust would not be fully exempt for GST tax purposes.[101]

A Crummey power is a general power of appointment. When the power lapses, its lapse is treated as a release of the power to the extent that the amount of the release exceeds in any year the greater of (a) $5,000 or (b) five percent of the value of the trust property subject to the release.[102] A release of a general power of appointment is treated as a gift to the other trust beneficiaries.[103] To prevent the lapse of the Crummey power from being a taxable gift from the beneficiary, the trust could use "hanging powers" to prevent the lapse from exceeding the five

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99 *See supra* Part II.B.3.
100 *See* I.R.C. § 529(c)(2).
101 *See* Bart, *supra* note 8, at 116.
102 *See* I.R.C. § 2514(e).
103 *See* I.R.C. § 2514(b).

and five amount in any year.[104] Hanging powers are complicated and difficult to draft, especially if the beneficiary has lapsing withdrawal rights over other trusts.[105] The IRS has attempted to attack hanging powers in the past.[106]

Further, if the Dynasty Education Trust includes hanging powers, in the event the beneficiary dies while Crummey withdrawal rights are outstanding, the beneficiary would be considered the transferor over a portion of the trust for GST tax purposes.[107] To ensure that the Dynasty Education Trust continues to be fully GST exempt, the trust might require the distribution to the beneficiary's estate of an amount equal to the hanging right, at least to the extent that the beneficiary's estate plan does not allocate GST exemption to such portion of the trust.

VIII. Application of GST Tax to Trust-Owned 529 Savings Accounts

By definition a Dynasty Education Trust is essentially GST exempt either because it is a grandfathered trust, or it has a zero inclusion ratio.[108] Nonetheless, it may be helpful to describe how the GST tax might apply to the trust if for some reason it had an inclusion ratio greater than zero.

In order to apply either the gift tax rules (under Chapter 12 of the Code), or the GST tax rules (under Chapter 13 of the Code), we need to know who is the transferor for transfer tax purposes. If an individual is the transferor, the gift tax will apply if the new beneficiary is in a lower generation than the transferor and the GST tax will also apply if the new beneficiary is two or more generations below the transferor.[109] If the transferor is a trust, the gift tax rules will not apply, but the GST tax rules will.[110] The GST tax rules provide a way to account for the transfers down generations with trust-owned 529 savings accounts. The GST

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104 *See* Georgiana J. Slade, 807-2nd T.M. Personal Life Insurance Trusts, at III.B.2.a(3)(b); Louis S. Harrison, *Lapse of* Crummey *Power Need Not Result in Taxable Gift if Hanging Power Is Used*, 17 Est. Plan. 140 (1990).

105 *See* Harrison, *supra* note 104, at 143.

106 *See* TAM 8901004 (Jan. 6, 1989).

107 *See* Harrison, *supra* note 104, at 143.

108 *See* I.R.C. § 2652(a)(1)(A).

109 *See* I.R.C. § 529(c)(5)(B).

110 *See id.* Conceivably, if Code section 529 treated a change of beneficiary to a lower generation as a gift by the old beneficiary, who would necessarily be an individual, one could apply the Code section 529 gift tax rules to changes of beneficiaries of trust-owned 529 savings accounts instead of the GST rules applicable to trusts. On the other hand, if the account owner may be treated as the transferor making the gift when the beneficiary is changed to a lower generation, the Code section 529 gift tax rules could not apply to a trust-owned 529 savings account, because a trust cannot make a gift. Further, even if both alternative taxation schemes were possible, applying the GST tax rules applicable to

tax rules applicable to trusts will impose GST tax instead of gift tax when a distribution is made to a new beneficiary in a lower generation,

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trusts seems more consistent with the reality that the 529 savings account is a trust investment, and not a gift.

Although Code section 529 triggers the transfer tax rules when the new beneficiary is not assigned to the same or a higher generation than the old beneficiary, it does not specify who is treated as the transferor. In the Advance Notice the IRS proposes that the donor of the gift should be the account owner, thereby necessitating that the transfer tax consequences of a change of beneficiary of a trust-owned account be analyzed using the GST tax rules. Guidance on Qualified Tuition Programs Under Section 529, 73 Fed. Reg. 3441-01, 3443 (Jan. 18, 2008). The Advance Notice proposes to assign the tax liability to the account owner by treating a change of beneficiary that is subject to gift tax "as a deemed distribution to the [Account Owner] followed by a new gift." *Id.* Presumably, the deemed distribution would fall within the rollover rule exception of Code section 529(c)(3)(C)(i) and therefore would not be treated as a nonqualified distribution. *See* I.R.C. § 529(c)(3)(C)(i)-(ii).

The proposed regulations had taken the position that the old beneficiary was the transferor. *See* Prop. Treas. Reg. § 1.529-5(b)(3)(ii). The Preamble to the Proposed Regulations states,

> [B]ecause a contribution after August 5, 1997, is a completed gift from the contributor to the designated beneficiary, any subsequent transfer which occurs by reason of a change in the designated beneficiary to the account of another beneficiary is treated, to the extent it is subject to the gift and/or [sic] generation-skipping transfer tax, as a transfer from the original designated beneficiary to the new beneficiary. This is the result even though the change in beneficiary or the rollover is made at the direction of the contributor under the terms of the contract.

Qualified State Tuition Programs, 63 Fed. Reg. 45019-01, 45021 (Aug. 24, 1998). The Proposed Regulations are consistent with the Committee Reports, which state, "[A] transfer from one beneficiary to another beneficiary (or a change in the designated beneficiary) will be treated as a taxable gift from the old beneficiary to the new beneficiary to the extent it exceeds the $10,000 present-law gift tax exclusion." H.R. Rep. No. 105-148, at 328 (1997); *see also* H.R. Rep. No. 105-220, at 356, 364 (1997) (Conf. Rep.).

There are legal and practical problems with treating the old beneficiary as the account owner. First, the gift tax is an excise tax on the privilege of transferring property, and thus avoids being an unconstitutional direct tax. However, unless the beneficiary is the account owner, the beneficiary has only a mere expectancy, and does not have any property interest to transfer. Further, the old beneficiary is not directing or consenting to the transfer. Second, on the practical side, how do you impose gift tax consequences on a beneficiary who may not know that he or she has made a gift, and who may even be a minor? The Advance Notice notes that "several comments on the 1998 proposed regulations raised concerns about the imposition of tax on the former [Designated Beneficiary]. In many cases, the [Designated Beneficiaries] are minors who may not be aware of the existence of the account for that benefit." Guidance on Qualified Tuition Programs Under Section 529, 73 Fed. Reg. at 3443.

However, treating the account owner as the transferor for gift and GST tax purposes is inconsistent with the theoretical tax universe of Code section 529, in which a completed gift was made to the old beneficiary and therefore the old beneficiary should be the transferor of any subsequent gift.

even if the new beneficiary is only one generation lower than the old beneficiary, except to the extent the trust is exempt from GST tax.[111]

For example, if grandparent is the account owner of a 529 savings account for child, and then changes the beneficiary to grandchild, Code section 529 treats the change of beneficiary as a gift. If instead grandparent established a trust for her descendants, the trust becomes the account owner of a 529 savings account for child, and the trust then changes the beneficiary to grandchild and makes a distribution to the grandchild, the distribution will be subject to GST tax. Note, however, that in the case of a 529 savings account owned by an individual, the gift tax rules apply when the beneficiary is changed; with a trust-owned 529 savings account, the GST tax is triggered when a distribution is made to the new beneficiary.[112]

When an irrevocable trust invests its own funds in a 529 savings account it should be viewed as making a trust investment, not a gift and not a trust distribution. If an irrevocable trust invests funds already held in the trust in a 529 savings account, no transfer tax consequences should result because the funds in the trust already passed through the transfer tax system when contributed to the trust (or when the trust became irrevocable) and because a trust cannot make a gift. So long as the trustee remains the account owner and no distribution is made to anyone other than the account owner, nor should any transfer tax consequences result from any change in designated beneficiary. This should be the case even if the new designated beneficiary is in a lower generation than the old designated beneficiary or if the new designated beneficiary is not a member of the family of the old designated beneficiary. With a trust-owned 529 savings account, transfer tax will be imposed when a distribution is made to the new beneficiary in a lower generation.[113] So although a trust-owned 529 savings account may change the timing of transfer tax consequences, it does not provide an opportunity to avoid transfer tax consequences.

Further, so long as the trust remains the account owner and no distribution is made to anyone other than the account owner, no transfer tax consequences should result from a change in the designated beneficiary even if the new beneficiary is not a member of the family of the old beneficiary.[114] Code section 529(c)(5)(B) says the "taxes imposed by Chapters 12 and 13 shall apply to a transfer by reason of a change in the designated beneficiary," unless the new beneficiary is in the same or a higher generation as the old beneficiary and is a member of the family

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111 *See* Bart, *supra* note 8, at 112.
112 *Id.*
113 *Id.*
114 *Id.*

of the old beneficiary.[115] However, in the case of a trust-owned 529 savings account, failing the "member of the family" test in Code section 529(c)(5)(B) should be of little consequence because the gift tax (under Chapter 12 of the Code) does not apply to trusts and the GST tax (under Chapter 13 of the Code) will apply to the trust in any event when a taxable distribution is made or when a taxable termination occurs.[116]

Code section 529 departs from the traditional rules for completed gifts and estate tax inclusion by allowing a donor the flexibility to change beneficiaries, but this flexibility is limited to "members of the family."[117] However, when a donor makes a contribution to an irrevocable trust the donor does not retain the power to change beneficiaries and therefore does not depart from traditional transfer tax rules.[118] Because there is no departure from the traditional constraints of transfer tax rules, there is no need for Code section 529 to impose transfer tax on the trustee's ability to change beneficiaries. Nor should there be any gift tax consequences to a (nonqualified) distribution from a 529 savings account to the trust. The trust is only altering its investments.

The GST tax may apply to a distribution, qualified or nonqualified, from a 529 savings account owned by an irrevocable trust if the beneficiary is two or more generations below the transferor's generation.[119] When the irrevocable trust invests funds in a 529 savings account, the transferor of the trust for GST tax purposes generally will be the same as the transferor of the 529 savings account (though a different result may apply when an individual makes a contribution to a trust-owned 529 savings account[120]). In determining the generation assignment of the transferor, Code section 2653(a) provides that if there is a generation-skipping transfer of any property and immediately after such transfer such property is held in trust, for purposes of applying the GST tax rules, the trust will be treated as if the transferor of such property were assigned to the first generation above the highest generation of any person who has an interest in such trust immediately after the transfer.[121] If the original transfer to the trust was not a generation-skipping transfer, the transferor would have his or her natural generation assignment.

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115 I.R.C. § 529(c)(5)(B).

116 As discussed in Part V.A, *supra*, Code section 529(c)(3)(C)(ii) may cause such a change of beneficiary to be treated as a nonqualified distribution.

117 I.R.C. § 529(c)(5)(B).

118 Although the donor cannot retain the power to change beneficiaries, the trustee may have the power to make distributions among a class of beneficiaries, and under traditional transfer tax rules, there are no limits on who may be included in the class of beneficiaries.

119 *See* I.R.C. § 529(c)(5)(B).

120 *See* I.R.C. § 2652(a).

121 *See* I.R.C. § 2653(a).

> *Example 1.*[122] GP establishes an irrevocable trust for the education of his descendants. GP has two children and one grandchild. Because the trust is not a skip person, and therefore there is no generation-skipping transfer when funds are contributed to the trust, the transferor is assigned to GP's generation.
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> *Example 2.* GP establishes an irrevocable trust for the education of his grandchildren and more remote descendants. Assuming no non-skip person has an interest in the trust, the trust is a skip person and therefore there is a generation-skipping transfer when funds are contributed to the trust. Therefore, the transferor is assigned to the generation above the grandchildren's generation, or to GP's child's generation.

A distribution from a 529 savings account to a designated beneficiary who is two or more generations below the generation of the transferor of the trust should be treated as either a taxable distribution or a taxable termination (as the case may be, depending on the circumstances of the trust) for GST tax purposes subject to the trust's GST tax inclusion ratio. No GST tax would be due if the trust has a zero inclusion ratio or is grandfathered for GST tax purposes.[123]

> *Example 3*. P establishes an irrevocable trust for the education of his descendants. P has one child, C, and one grandchild, GC, when the trust is established. P makes a taxable gift of cash to the trust. The trust establishes a 529 savings account with C as the designated beneficiary. Distributions are made from the 529 savings account for C's qualified higher education expenses. When C completes C's education, funds remain in the 529 savings account and the trustee changes the designated beneficiary to GC. Distributions are made from the 529 savings account to GC for qualified higher education expenses. After GC completes GC's education, the trust refunds the remaining 529 savings account funds to the trust with a nonqualified distribution. There are no transfer tax consequences to the trust's investment in the 529 savings account. When distributions are made to C, P is treated as the transferor of the 529 savings account (the contribution to the trust was

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122 In all examples in this section, the following abbreviations are used:

GP	Grandparent
P	Parent
C	Child
GC	Grandchild
GGC	Great grandchild

123 *See* Bart, *supra* note 6.

> not a generation-skipping transfer) and is only one generation above C, so no GST tax or other transfer tax consequences result. Nor do any transfer tax consequences result when the trust changes the designated beneficiary from C to GC because a trust cannot make a gift. When distributions are made from the 529 savings account to GC, they are taxable distributions for GST tax purposes because GC is two generations below P, the transferor. There are no transfer tax consequences when the trust makes a nonqualified distribution to itself as account owner.

If the trustee is required to make a principal distribution to a beneficiary, for example because the beneficiary attained a certain age, and the trust owns a 529 savings account with such beneficiary as the designated beneficiary, the trustee could make the beneficiary/designated beneficiary the new account owner. If the beneficiary is a minor, many trusts would permit a distribution to a custodian under the UTMA for the minor beneficiary. When a trust owns a 529 savings account and wishes to distribute it to a minor designated beneficiary, the trustee may wish to change the account owner to a custodian under the UTMA for the designated beneficiary. In all of these cases, when the new account owner is the same as the designated beneficiary, no transfer tax consequences should result other than whatever GST tax consequences result from the trust distribution if the designated beneficiary is two or more generations below the transferor.[124]

> *Example 4*. Same as Example 3, except that when GC has completed his education the trustee, pursuant to authority in the trust, changes the account owner to GC. The change of account owner is treated as a distribution to GC. Because P is the transferor, the change of account owner is a taxable termination for GST tax purposes.
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> *Example 5*. Same as Example 3, except that when GC has completed his education P has a great grandchild, GGC, who is also a beneficiary of the trust. The trustee, pursuant to authority in the trust, changes the designated beneficiary to GGC and then changes the account owner to GC, as custodian for GGC under the UTMA. The change of account owner is treated as a distribution to GGC. Because P is the transferor, the change of account owner is a taxable termination for GST tax purposes.

124 *See* Bart, *supra* note 8, at 111.

IX. Miscellaneous Income Tax Issues

Some of the issues to consider with respect to a trust-owned 529 savings account include (1) whether a trust's contribution to a 529 savings account constitutes a trust distribution to the designated beneficiary, (2) the tax consequences of distributions from a 529 savings account to the designated beneficiary, (3) the tax consequences of a distribution from a 529 savings account to the trust, and (4) the income tax consequences of a change of designated beneficiary.[125]

The income tax consequences of a contribution to a 529 savings account by an irrevocable trust should be based on whether or not the trustee has made or should be considered to have made a distribution to a beneficiary of the trust. "Distribution," by itself, is not defined in the Internal Revenue Code or in the Treasury Regulations. But Black's Law Dictionary defines it as a "giving out."[126] In other words, the trustee must deliver property to a beneficiary to effect a distribution to such beneficiary.[127]

Although Code section 529 treats a contribution to a 529 savings account as a completed gift to the designated beneficiary, there are exceptions to this rule. For example, when an individual opens a 529 savings account for herself, the contribution to the account is not a gift. When a trust establishes a 529 savings account, the trust is establishing an investment account, not a gift account.[128] The establishment of a trust-owned account cannot be a gift because trusts cannot make gifts. Therefore, the fact that Code section 529 treats an individual who establishes a 529 savings account for another individual as having made a gift to such other individual does not imply that a trust establishing a 529 savings account for a beneficiary should be treated as a distribution to such beneficiary.

When a trust establishes a trust-owned 529 savings account for a beneficiary, the beneficiary does not receive any property or any property interest in the account.[129] The trustee can revest the contribution (as well as its earnings), will control the timing and amount of all distributions to the designated beneficiary and can change the beneficiary. Therefore, a contribution by an irrevocable trust to a 529 savings account of which the trustee is the account owner should be treated

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125 *Id.* at 118.

126 Black's Law Dictionary (10th ed. 2014).

127 *Id.*

128 *See supra* Part V.B.

129 *See* Bart, *supra* note 8, at 118.

merely as a trust investment and have no income tax consequences for the trust.[130]

If a nonqualified distribution is made to the designated beneficiary, for example, after the beneficiary has completed his or her education, the designated beneficiary will be liable for income tax and the additional ten percent tax on the earnings portion of such distribution. If a nonqualified distribution is made to the trust, for example, if the beneficiary drops out of college, the earnings portion of the distribution will be subject to income tax and, unless one of the special exceptions applies, to the additional ten percent tax payable by the trust.[131] If a qualified distribution is made to the designated beneficiary (or the school), no federal income tax consequences would result under Code section 529.[132]

However, will a distribution from a trust-owned 529 savings account to the designated beneficiary carry out distributable net income ("DNI") from other trust assets? For income tax purposes, a 529 savings account should be treated as a separate share, except in the case where the designated beneficiary is the sole beneficiary of the trust. This result is consistent with the intent of Code section 529, the separate share rules and the administration of qualified tuition programs. First, Code section 529(c) provides that except as otherwise provided in Code section 529, no amount should be includable in gross income of a designated beneficiary or contributor. It would be quite odd if, in light of the language, Congress had intended that income from a 529 savings account could be included in the gross income of someone other than the account owner, designated beneficiary or contributor, namely someone who was merely a beneficiary of a trust that owned a 529 savings account for a different beneficiary.[133]

Second, the separate share rule applies "if different beneficiaries have substantially separate and independent shares."[134] A separate share is created whenever a trust has more than one beneficiary (whether current, future or contingent) and a 529 savings account is cre-

130 *Id.* at 118-19. If the trust's contribution to a 529 savings account is treated as a distribution, then some unexpected results may follow. The contribution could carry out distribution of net income to the beneficiary if other trust assets are producing taxable income. The contribution could be treated as a transfer for generation-skipping transfer tax purposes, thus resulting in a taxable distribution if the beneficiary is two or more generations below the grantor. Further, if one takes this logic to the extreme, a trustee could not invest in a 529 savings account unless the trust currently permitted distributions to the beneficiary. *Id.* at 119 n.43

131 I.R.C. § 529(c)(3)(A); I.R.C. § 529(c)(6).

132 Bart, *supra* note 8, at 119.

133 *Id.*

134 Treas. Reg. § 1.663(c)-1(a).

ated for one of those beneficiaries, because so long as the 529 savings account remains in existence, it can only be distributed to the designated beneficiary. It can be revested by the trust, but that would terminate the separate share and trigger the adverse income tax consequences resulting from a nonqualified distribution.[135] A separate share may exist even if the share might not ultimately be received by the beneficiary or if in the future it may be recombined with other shares.[136]

As a consequence, if a trust has more than one beneficiary, DNI for all 529 savings accounts owned by an irrevocable trust for a particular designated beneficiary is determined separately from DNI for the remainder of the trust (and separately from DNI for 529 savings accounts owned by the trust for other designated beneficiaries).[137] Thus a distribution from the 529 savings account to the designated beneficiary will not carry out DNI from non-529 savings account assets, regardless of whether such 529 savings account distribution is qualified or nonqualified. Further, assuming the trust owns only one 529 savings account for the designated beneficiary, a nonqualified distribution from a 529 savings account to the designated beneficiary will only carry out income from the 529 savings account, determined as provided under Code section 529.[138]

If there is only one beneficiary of a trust, so that the separate share rule does not apply, conceivably even a qualified distribution from a trust-owned 529 savings account could carry out DNI. Practically, this should not be much of a problem if the trustee can make a distribution to the beneficiary to pay income taxes. In the case of a qualified distribution, which would not carry out any income from the 529 savings account, one could treat the distribution as any other distribution in determining DNI. In the case of a nonqualified distribution, however, would the beneficiary be liable both for the income taxes under Code section 529 and the DNI carried out with the full amount of the distribution? Perhaps the forthcoming guidance promised by the IRS could simply decide that a 529 savings account will be treated as a separate share even when a trust has only one beneficiary.[139]

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135 Bart, *supra* note 8, at 119.

136 Treas. Reg. § 1.663(c)-3(a).

137 Treas. Reg. §§ 1.613(c)-1(a), 1.613(c)-2(b).

138 Bart, *supra* note 8, at 119. Practically this must be the result. When a distribution is made from a 529 savings account, a 1099-Q is issued to the designated beneficiary of the 529 savings account. *See* I.R.S. Form 1099-Q. If a trust is the account owner, the trustee has no way of knowing the income shown on the 1099-Q and, therefore, cannot be required to use such distribution in determining trust income or DNI for other trust distributions. Bart, *supra* note 8, at 119 n.48.

139 *Id.* at 119-20; *see* Treas. Reg. § 1.663(c)-2(a).

If the trust requires that income be distributed to the beneficiary, do the earnings in the 529 savings account constitute income for trust accounting purposes when they are accrued, or only when a distribution is made from the 529 savings account? This may depend on the applicable Principal and Income Act and the terms of the trust. As an example, the Illinois Principal and Income Act provides[140]

> To the extent not otherwise provided in this instrument or this Act, receipts shall be credited when actually received by the trustee . . . except that the trustee may elect to credit receipts . . . in any other reasonable manner that [gives due regard to the respective interests of income beneficiaries and remaindermen] and is not inconsistent with the terms of the instrument.[141]

Although the trustee generally could withdraw an amount equal to the earnings of the 529 savings account at any time, for tax purposes the trustee can withdraw all the earnings only by withdrawing the entire 529 savings account. Further, a withdrawal may result in unnecessary (or accelerated) income taxes and a penalty, much like an early withdrawal from a certificate of deposit. Therefore the better view is that the trust does not have income for trust accounting purposes until a distribution is made from the 529 savings account, and then only to the extent that the distribution is deemed to carry out earnings for tax purposes.[142]

If the trustee is required to make a principal distribution to the beneficiary, for example because the beneficiary attained a certain age, and the trust owns a 529 savings account with the beneficiary as the designated beneficiary, the trustee could effectuate the trust distribution by making the beneficiary the account owner of the 529 savings account. Alternatively, the trustee could make a discretionary distribution to the beneficiary by making the beneficiary the account owner of all or a portion of a 529 savings account with the beneficiary as the designated beneficiary. If the beneficiary is a minor, many trusts would permit a distribution to a custodian under the UTMA for the minor beneficiary. Where a trust owns a 529 savings account and wishes to distribute it to a minor designated beneficiary, the trustee may wish to change the account owner to a custodian under the UTMA for the designated beneficiary. In all of these cases, where the account owner is the same as the designated beneficiary for transfer tax and income tax purposes, no in-

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140 Bart, *supra* note 8, at 122.

141 760 ILL. COMP. STAT. § 15/3(d) (2015).

142 Bart, *supra* note 8, at 122. For this purpose, a 529 savings account may be analogous to an annuity because nonqualified distributions from 529 savings accounts are taxed as if they were annuity payments under Code section 72.

come tax consequences should result from the change of account owner.[143]

If the trustee wishes to make a distribution to the beneficiary from funds held in a 529 savings account for purposes other than paying qualified higher education expenses, the trustee could direct a nonqualified withdrawal to the trust, and then make a distribution from the trust to the beneficiary. Assuming that the trust is not a grantor trust and that the withdrawal and distribution occurred in the same tax year, presumably the distribution would carry out as DNI to the beneficiary all the taxable income incurred because of the nonqualified distribution, with the result that it would ultimately be taxed at the beneficiary's income tax rate. The ten percent additional tax, however, would presumably be payable by the trust.[144]

Alternatively, if permitted by the state program, the trustee could direct a nonqualified withdrawal directly to the beneficiary, in which case the income tax and ten percent additional tax resulting from such distribution would be payable by the beneficiary.[145]

X. Dynasty Education Plan Requires a Trust

The benefits of a Dynasty Education Trust cannot be achieved by establishing 529 savings accounts owned by individuals for grandchildren. Contributions to individually-owned 529 savings accounts for grandchildren could qualify for the gift tax and GST tax annual exclusions and the donor could make the five-year election to treat up to five times the annual exclusion amount as annual exclusion gifts in one year.[146] To the extent the donor's gift exceeded the annual exclusion, the donor could apply GST exemption to the gifts to avoid GST tax.[147] When it came time to change the beneficiary of a 529 savings account to someone in a lower generation, however, the change of beneficiary would be treated as a gift even if GST exemption had been applied to the original gift.[148] While whomever is treated as making the gift (either the old beneficiary under the proposed regulations or the account owner under the Advance Notice), when the beneficiary moves down a generation could take advantage of the annual exclusion and even make a five-year election, the deemed donor of the gift would incur gift tax (and possibly GST tax consequences if the beneficiary moves down two generations) to the extent the account value exceeded the available annual

143 *Id.*
144 *Id.* at 123.
145 *Id.*
146 I.R.C. § 529(c)(2)(B).
147 *See* Bart, *supra* note 8, at 128.
148 *See id.* at 111.

exclusions.[149] Thus even assuming that the account owners unselfishly follow the original donor's instructions about changing beneficiaries, individually-owned 529 savings accounts cannot replicate the advantages of a Dynasty Education Trust.

Individually-owned 529 savings accounts also cannot replicate the advantages of a Dynasty Education Trust for another reason. The account owner of a 529 savings account has no fiduciary duties to the beneficiary of the account.[150] Thus the account owner could change the beneficiary or withdraw the funds himself or herself and the beneficiary would have no grounds for complaint, even if the account owner's actions clearly violated the donor's intent. So long as the donor is the account owner, there is, of course, no risk of the donor's intent being frustrated. But when the donor becomes incapacitated or dies, the successor individual account owner may be able to frustrate the donor's intent. For example, assume grandparent established 529 savings accounts for the child of his son and the children of his daughter, expecting to transfer any funds not used for one grandchild's education to the accounts of other grandchildren who are pursuing more expensive educations, and intending to divide any funds left over equally among the great grandchildren, regardless of any differences in the amounts the grandchildren each received for their educations. Grandparent dies and names son as successor account owner of all of the 529 savings accounts, with oral instructions to carry out his intent. Son may be unwilling to change the beneficiary of the funds remaining in a 529 savings account after his child has completed his education to his niece or nephew (the child of son's sister). Son may feel that it is unfair that his child receives less because he did not attend college or attended a less expensive school. A trust-owned 529 account may be the only mechanism to ensure that the donor's wishes are carried out. If a trust is the account owner, the trustee is bound by the terms of the trust and has a fiduciary duty to the trust beneficiaries.

In addition to allowing the grantor to express a dispositive scheme enforceable through fiduciary duties, there are a number of other advantages to having a trust, instead of an individual, own a 529 savings account for a beneficiary.

Having an irrevocable trust as the account owner of a 529 savings account solves problems that may arise if the funds in the account cannot be used for the beneficiary's higher education and it is impracticable to change the beneficiary because there is no other potential beneficiary whom the donor would like to benefit who could use the funds for higher education and who is a "member of the family" of the old benefi-

149 I.R.C. § 529(c)(2)(B).
150 *See* Bart, *supra* note 8, at 106.

ciary.[151] Under such circumstances, the account owner has two options: make a nonqualified distribution of the account to the beneficiary or refund the funds to the account owner. Often the donor may not wish to distribute the funds to the beneficiary outright because of the beneficiary's age and level of maturity (keep in mind this may be a beneficiary who decided not to attend college or who dropped out of college). If the donor is the account owner and a nonqualified distribution is made to the donor, the funds are back in the donor's estate. On the other hand, if a trust is the account owner and the donor has not retained any rights under or powers over the trust that would cause inclusion of the trust in the donor's estate, the funds would be trust assets and would not be back in the donor's estate. Further, the funds would not be distributed outright to the beneficiary and would be subject to any restrictions imposed by the trust. The trust, as the distributee of a nonqualified distribution, would be subject to income tax and to the ten percent additional tax to the same extent that a nonqualified distribution to the beneficiary would be subject to tax.

A trust-owned 529 savings account also solves the problem of providing for a successor account owner if the account owner becomes disabled or dies. Although many qualified tuition programs permit the designation of a successor account owner, the named successor may be unwilling or unable to act. A trust generally contains more elaborate provisions for ensuring that there will always be a trustee willing and able to administer the trust and to act as the account owner of any 529 savings account owned by the trust. Failure to designate a successor account owner in a non-trust-owned 529 savings account may result in the beneficiary becoming the default account owner, thereby having unrestricted access to the funds for any use.

A 529 savings account owned by an irrevocable trust may also protect the funds from the creditors of the individual who would otherwise be the account owner. Although some states provide creditor protection for 529 savings accounts, many do not.[152] A trust containing a spendthrift clause may protect the trust assets from the account owner's creditors. An irrevocable trust-owned 529 savings account may also prevent the 529 account assets from being considered assets of the donor for purposes of Medicaid qualification, although the look back rules applicable to gifts would still apply.[153]

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[151] Code section 529(c)(3)(C)(ii) provides that a change in beneficiary is not treated as a distribution if the new beneficiary is a member of the family of the old beneficiary. "Member of the family" is defined in Code section 529(e)(2).

[152] *See infra* Appendix I for a table of creditor protection statutes for 529 savings accounts.

[153] *See* Bart, *supra* note 8, at 108.

XI. Disadvantages of Trust-Owned 529 Savings Accounts

A dynasty education funding plan is unlikely to work without using a Dynasty Education Trust. Nonetheless, the client should be aware that there are some disadvantages to trust-owned 529 savings accounts in comparison to individually-owned 529 savings accounts.

A. Gift Tax Annual Exclusion

Section 529 provides that gifts to a 529 savings account qualify for the gift tax annual exclusion.[154] However, this provision would not apply to a gift to a trust, even if the trustee eventually invests the funds in a 529 savings account. Therefore, gifts to a trust must qualify for the gift tax annual exclusion under other tax rules. In order to qualify gifts to a Dynasty Education Trust for the annual exclusion, the trust should give the beneficiaries Crummey withdrawal rights over contributions.

B. No Front Loading of Trust Contributions

Code section 529 permits a donor to contribute up to five times the annual exclusion amount and to elect to treat the gift as if it were made pro rata over five years for gift tax purposes.[155] No similar election is available for gifts to a trust, even if the trustee intends to invest the assets in a 529 savings account.

C. GST Annual Exclusion

Section 529 provides that gifts to 529 savings accounts qualify for the GST annual exclusion.[156] However, this provision would not apply to a gift to a Dynasty Education Trust, even if the trustee intends to invest the assets in a 529 savings account. GST exemption must be assigned to all contributions to the Dynasty Education Trust.

D. State Income Tax Deduction

In some states a state income tax deduction is available for contributions to a 529 savings account.[157] This deduction would not be available for a gift to a trust. Whether the trust could claim a state income tax deduction for its contribution to a 529 savings account would depend on state law.

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[154] *See* I.R.C. § 529(c)(2).
[155] *See* I.R.C. § 529(c)(2)(B).
[156] *See id.*
[157] *See* Nancy Shurtz, Education Planning: Taxes, Trusts, and Techniques 111-121 (2009).

E. Income Tax Rates

In the event of a nonqualified distribution, income taxes on the earnings portion of a trust-owned 529 savings account would be paid at the trust's income tax rate if the trust is a non-grantor trust and does not make a distribution that carries out DNI, or at the grantor's rate if the trust is a grantor trust with respect to the account owner. The trust's or grantor's income tax bracket could be higher than the beneficiary's income tax bracket.

F. No Refund to Donor

The donor cannot get the funds back by taking a nonqualified distribution because the funds are owned by the trust.

G. Financial Aid

A beneficiary's interest in a trust is treated as an asset of the beneficiary for federal financial aid purposes. Thus, a 529 savings account owned by the student or the student's parent is treated as an asset of the student, if the student is an independent student, or as an asset of the parent if the student is a dependent student. Further, a 529 savings account owned by an individual other than the student or parent (e.g., owned by a grandparent) may be ignored for federal financial aid purposes.[158]

XII. Health and Education Exclusion Trusts ("HEET")

A HEET provides a way to pay for section 2503(e) expenses for grandchildren and more remote descendants after the grantor's death without using GST exemption. However, gift tax or estate tax will be imposed on assets transferred to the trust. Thus a HEET supplements ordinary GST tax planning.[159]

A. Taxable Gift

The gift to the trust is subject to gift tax or estate tax.

B. Non-Skip Person

The trust must not be a skip person in order to avoid a GST direct skip upon funding the trust. So long as the trust has at least one beneficiary who is not a skip person, the transfer to the trust will not be a direct skip. The non-skip beneficiary could be a child or a charity.

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[158] *See id.* at 431.

[159] *See* Adams et al., *supra* note 38; *see also* Michael Delgass & Deborah S. Gordon, *HEET Wave*, 144 Tr. & Est., Mar. 2005, at 20, 22-23.

C. Distributions

The trust must make tuition payments directly to the school to avoid having a distribution to a grandchild treated as a GST taxable distribution. The grantor may also wish to include provisions regarding equality or inequality of distributions and priority among generations.

D. Avoid Taxable Termination

A taxable termination will occur when the trust no longer has a non-skip person as a beneficiary. Thus if the HEET is intended to be a long-term trust for more than one generation, a charity should be a beneficiary.

1. *Significant Interest*

Section 2652(d)(2) provides that an interest that is "used primarily to postpone or avoid" GST tax will be disregarded.[160] Thus the charitable interest should be to some extent mandatory and significant. The mandatory interest might be a unitrust amount (e.g., three percent of the value of the trust each year) or a percent of income (e.g., fifty percent of the trust's annual income).

2. *Not a Separate Share*

The separate share rules will treat as a separate trust the interest of any beneficiary that is substantially separate and independent and that exists from and at all times after the creation of the trust.[161] If the separate share rules apply, the initial gift to the trust would be treated as (1) a gift of some portion to an entirely charitable trust and (2) a gift of some portion to a trust for the individual beneficiaries, which would either be a direct skip immediately (if there were no non-skip individual beneficiaries) or a taxable termination upon the death of the last non-skip individual beneficiary.

To avoid the application of the separate share rule, the trust could give the charity an indefinite interest, for example, by layering a discretionary interest on top of the mandatory interest. Alternatively, the trust might provide that the charity's interest does not exist "from and at all times after the creation of the trust," for example, by only giving the charity a mandatory interest upon the death of the last non-skip individual beneficiary.

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160 I.R.C. § 2652(d)(2).
161 Treas. Reg. § 26.2654-1(a).

E. Avoid Taxable Distributions

Under section 2642(c)(3), any distribution that would have qualified under section 2503(e) will not be treated as a taxable distribution.[162] Thus the trust can directly pay medical expenses and tuition for grandchildren and more remote descendants without GST tax.[163] The trust could permit other distributions to the beneficiaries, but any non 2503(e) distributions to skip persons would be subject to GST tax.[164]

F. Funding of Trust

The HEET may be funded during the grantor's life with annual exclusion gifts and Crummey powers, or by making a taxable gift to the trust, which could be sheltered by the grantor's $1,000,000 lifetime exclusion amount. Alternatively, the HEET may be funded at the donor's death with a gift from the donor's estate.

G. Private Foundation Rules

For a discussion of why the private foundation self-dealing rules should not apply to a HEET, even though the HEET permits distributions to charity, see Michael Delgass and Deborah Gordon, "HEET Wave."[165]

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162 *See* I.R.C. §§ 2503(e), 2642(c)(3).
163 *See* PLR 9109032 (Nov. 30, 1990).
164 Delgass & Gordon, *supra* note 159, at 21.
165 *See id.* at 22-23.

CREDITOR PROTECTION FOR 529 SAVINGS ACCOUNTS

Updated September 14, 2015

Any comments on this table or new developments that should be reflected on the table should be sent to sbart@sidley.com.

State	Statutory Exemption	Limited to State's Own Program	Statute Expressly Specifies Protection from Creditors of Account			Exemption Inapplicable		Other Limitations	Comments
			Donor	Owner	Beneficiary	Child Support	Divorce		
Alaska	Alaska Stat. §§ 14.40.802; 34.40.110(b)(4) (2015)	Y		√	√	√			
Arizona	Ariz. Rev. Stat. Ann. § 33-1126(A)(10) (2015)	N		√	√			Exemption does not include contributions within two years of bankruptcy.	
Arkansas	Ark. Code Ann. § 6-84-110(b)(2) (2015)	Y		√	√				
Colorado	Colo. Rev. Stat. § 23-3.1-307.4 (2015)	Y	√	√	√				
Florida	Fla. Stat. § 222.22 (West 2015)	N	√	√	√				
Idaho[1]	Idaho Code Ann. § 11-604A (2015)	Y				√	√		
Illinois[2]	15 Ill. Comp. Stat. 505/16.5 (2015) 735 Ill. Comp. Stat. 5/12-1001(j) (2015)	Y	√	√	√			Exemption limited to amount of gift tax annual exclusion for contributions during 365-day period prior to filing bankruptcy; same limit applies to contributions made 366-730 days prior to filing bankruptcy.	

1 *In re* McFarland, No. 04-01623, 2004 WL 4960367 (Bankr. D. Idaho, Sept. 3, 2004) (holding that the statutory exemption for employee benefit plans expressly includes the state's 529 college savings accounts).

2 PNC Bank. N.A. v. Dubin, No. 11 C 2126, 2013 U.S. Dist. Lexis 48070 (N.D. Ill. Jun. 13, 2013) (permitting non-bankruptcy creditor to enforce judgment against 529 accounts).

State	Statutory Exemption	Limited to State's Own Program	Statute Expressly Specifies Protection from Creditors of Account Donor	Owner	Beneficiary	Exemption Inapplicable Child Support	Divorce	Other Limitations	Comments
Kansas[3]	KAN. STAT. ANN. § 60-2308(f)(2)-(4) (2015)	Y		√	√			Beneficiary must be lineal descendant of account owner. No protection for contributions made within one year before bankruptcy petition or judgment for claims. Contributions made between one year and two years prior to bankruptcy petition or judgment for claims only protected up to $5,000 per account owner.	
Kentucky	KY. REV. STAT. ANN. § 164A.350 (West 2015)	Y		√	√				
Louisiana	LA. REV. STAT. ANN. § 17:3096(G) (2015)	N	√	√	√			Protection of beneficiary's right to account assets applies only to accounts established under the state's own program.	
Maine	ME. REV. STAT. tit. 20-A, § 11478 (2015)	Y		√	√				
Maryland	MD. CODE ANN., EDUC. § 18-1913 (LexisNexis 2015)	Y						No protection from the State as a creditor.	
Michigan	MICH. COMP. LAWS § 600.6023(1)(l) (2015)	N							
Nebraska	NEB. REV. STAT. § 85-1809 (2015)	Y		√	√				
Nevada[4]	NEV. REV. STAT. § 21.090 (2015)	Y						Exemption amount may not exceed $500,000. Exemption is inapplicable if "the money will not be used by any beneficiary to attend a college or university" or the money was deposited after entry of a judgment against the owner.	

3 *In re* Werth, 468 B.R. 412 (Bankr. D. Kan. 2012) (holding that contributions to 529 accounts made within the year preceding the filing of a bankruptcy petition are not exempt).

4 VFS Fin., Inc. v. Specialty Fin. Corp., No. 3:09–cv–00266–RCJ–VPC, 2014 U.S. Dist. Lexis 100341 (D. Nev. Jul. 23, 2014) (permitting enforcement of judgment against all funds deposited in 529 account owned by debtor after entry of judgment, including funds contributed by third parties).

State	Statutory Exemption	Limited to State's Own Program	Statute Expressly Specifies Protection from Creditors of Account: Donor	Owner	Beneficiary	Exemption Inapplicable: Child Support	Divorce	Other Limitations	Comments
New Jersey	N.J. Stat. Ann. § 18A:71B-41.1 (West 2015)	Y	√		√			Provides exemption for moneys paid into or out of an account for qualified higher education expenses.	
New York	N.Y. C.P.L.R. § 5205 (McKinney 2015)	Y						Exemption is very limited. See the statute.	
North Carolina	N.C. Gen. Stat. § 1C-1601 (2015)	N				√	√	Exemption limited to $25,000. Excludes funds contributed during prior 12 months unless contributions were made in the ordinary course of the debtor's financial affairs and were consistent with the debtor's past pattern of contributions. Exemption is also limited to the extent that the funds are used to fund college for a child of the debtor.	
North Dakota	N.D. Admin. Code 12.5-02-01-06 (2015)	Y		√	√				
Ohio	Ohio Rev. Code Ann. § 2329.66(A)(10)(c),(e) (LexisNexis 2015)	N		√	√	√		Exemption does not apply to amounts "deposited for the purpose of evading the payment of any debt."	See Ohio Rev. Code Ann. § 3334.15(A) re: Ohio prepaid 529 accounts.
Oklahoma	Okla. Stat. tit. 31 § 1(A)(24) (2015)	Y							
Oregon	Or. Rev. Stat. § 348.863(2) (2015)	Y		√	√				
Pennsylvania	24 Pa. Cons. Stat. § 6901.309.2 (2015)	Y		√	√				
Rhode Island	R.I. Gen. Laws § 9-26-4(15) (2015)	Y				√	√		
South Carolina	S.C. Code Ann. § 59-2-140 (2015)	Y							Protects "contributions," the "right of a person to a refund of contributions" and "any other right."

State	Statutory Exemption	Limited to State's Own Program	Statute Expressly Specifies Protection from Creditors of Account			Exemption Inapplicable		Other Limitations	Comments
			Donor	Owner	Beneficiary	Child Support	Divorce		
South Dakota	S.D. Codified Laws § 13-63-20 (2015)	Y	√	√	√			No exemption for funds contributed by account owner or contributor within one year of filing bankruptcy petition.	
Tennessee	Tenn. Code Ann. § 49-7-822 (2015)	N							
Texas	Tex. Prop. Code Ann. § 42.0022 (West 2015)	N							Protects "a person's right to the assets held in or to receive payments or benefits under."
Virginia	Va. Code Ann. § 23-38.81 (2015)	Y	√	√	√				
West Virginia	W. Va. Code § 18-30-7(i) (2015)	Y		√	√				
Wisconsin[5]	Wis. Stat. § 16.641 (2015)	Y			√				

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5 Cirilli v. Bronk (*In re* Bronk), 444 B.R. 902 (Bankr. W.D. Wis. 2011) (holding that Wisconsin's exemption statute protects only the beneficiary's right to qualified withdrawals from a college savings account).