QUALIFIED STATE TUITION PROGRAMS (§529 PLANS)

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In 1997 Congress established a method to make it easier to save for college education when it passed IRC §529. That section provides a framework under which States can set up college savings plans with certain tax benefits. Connecticut's version of the §529 plan appears in PA 97-224.

Under §529 Plans, an individual (the "Depositor") contributes cash to the state-sponsored plan for the benefit of a "Designated Beneficiary". The state is responsible for the investments. However the state must provide separate accounting for each Designated Beneficiary. State plans vary as to how the investments are handled, but most contract with professional financial managers or investment companies to manage the investments.

In Connecticut the Treasurer is responsible for the program (known as the "Connecticut Higher Education Trust" or "CHET"), and the Treasurer has contracted with TIAA-CREF Tuition Financing, Inc. (TFI) to manage the funds. Connecticut has set up several investment options. Once the option is selected, the funds may be moved to another option only once per year.

<u>Some of the major features of Connecticut's plan follow:</u>

1. The investments grow on a tax-deferred basis (federal and state).

2. When the funds are withdrawn, the portion of the withdrawal attributable to income is taxed to the Beneficiary, rather than to the Depositor, for federal income tax purposes. (Withdrawals are taxed like annuities for federal income tax purposes.)

3. There is no federal or Connecticut income tax on the distributions if the distributions are used for post-secondary educational expenses. (Note: Freedom from state taxes may vary from state to state.)

4. In addition, for Connecticut residents, a state income tax deduction is available for the amount of a contribution to the CHET plan up to $5,000 per year for a single file or $10,000 for married filers.

5. Under the federal law, a Depositor may contribute the amount of the annual exclusion from gift tax ($13,000 per person year in 2009), without needing to file a gift tax return (assuming no other gifts are made to the same person). In addition amounts in excess of the annual exclusion may be contributed with the gifts spread

ratably over 5 years for annual exclusion purposes, for both gift tax and generation skipping tax ("GST"). Using this device, a single person could contribute up to $65,000/year and a married couple could contribute up to $130,000 in one year and qualify the entire gift for the annual exclusion. (However, if the Depositor dies prior to the end of the 5-year period, the gifts allocated to the tax years after his death are brought back into his estate. For example, if the Depositor dies in the third year after making a $65,000 gift, $26,000 would be included in his estate.) The ability to front-load a gift is a significant advantage, since the earnings are immediately removed from the Depositor's income, and begin to accrue on a tax deferred/free basis. Since Conn. Gen. Stat. §12-643 defines "taxable gifts" as "transfers by gift which are included in taxable gifts for federal gift tax purposes", the ability to spread a gift over a five-year period will also apply to the Connecticut gift tax. (This benefit may not be available in all states.)

6. It is also possible to make small contributions and to make contributions as automatic withdrawals from a bank account or as a payroll deduction (if the employer agrees to participate).

7. The Depositor is able to retain significant control over the funds, in that he can name a substitute Designated Beneficiary, as long as that substitute is a family member of the original Beneficiary. The definition of "family member" has been expanded over the original definition and now includes first cousins of the original beneficiary. This is an important change since if a grandparent made the original gift, the logical substitute beneficiary would be another grandchild, who may not be a sibling of the original beneficiary.

Note: If a beneficiary of a younger generation is substituted, both the gift tax rules and GST rules will apply.

8. If the beneficiary does not utilize the funds and the Depositor does not transfer the account to another beneficiary, the funds will be refunded to the Depositor. If the amount of the unused funds is no greater than the amount of scholarships received by the Beneficiary, or if the Beneficiary dies or becomes disabled, there will be no penalty due to the refund. Otherwise refunds are subject to a 15% penalty on earnings.

9. In spite of the control the Depositor retains, if he dies prior to distribution of all of the funds, the balance is not included in his estate for tax purposes (other than the inclusion in the Depositor's estate due to his death prior to utilizing any deferred annual exclusions, as discussed above).

10. Funds can be withdrawn for tuition, books, supplies, fees and room and board at any eligible public or private post secondary educational institution.

Web sites:

More specific information regarding Connecticut's CHET, including an application form, can be obtained from Connecticut's web site at www.aboutchet.com. Information about other State's §529 plans also is often found on the Web.

Conclusion:

A §529 Plan can be very beneficial in the right circumstances. It is most useful if contributions to the Plan are made when the Designated Beneficiary is young, so that it will have time to grow on a tax deferred/tax free basis. It is also particularly useful for the contributor who would like to make a gift in excess of the annual contribution, since the funds will start to grow sooner and that additional growth can be removed from the contributor's estate.

The provisions for contributions through payroll deductions are helpful for the contributor who does not have the ability to make large contributions, since the built-in discipline will encourage the contributor to actually start saving for college.

However, due to restrictions on the plans, it is not a good idea to contribute more than is likely to be utilized by the original Designated Beneficiary, especially if that beneficiary has no siblings or first cousins.

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