Abandoning Principles: Qualified Tuition Programs and Wealth Transfer Taxation Doctrine

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ARTICLE

ABANDONING PRINCIPLES: QUALIFIED TUITION PROGRAMS AND WEALTH TRANSFER TAXATION DOCTRINE

Wayne M. Gazur

In 1996 Congress gave its imprimatur to a modest qualified tuition program provision. Over the course of the next five years the provision was expanded, providing additional wealth transfer taxation and income taxation benefits. This essay proposes that unless limited, such benefits are inconsistent with established taxation principles and also have the potential to undermine the integrity of the wealth transfer tax structure and the progressive nature of the income tax.

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I. INTRODUCTION

The Small Business Job Protection Act of 1996 (the "1996 Act") introduced the § 529 prepaid tuition plan as a new tax-advantaged savings vehicle for education expenses. The prepaid tuition concept was not altogether new because the statute was in part enacted to clarify the treatment of prepaid tuition plans that had been already created by several states without specific guidance in the Internal Revenue Code (the "Code"). Congress subsequently refined both the income tax and wealth transfer tax aspects of the statute on repeated occasions, including changes enacted with the

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The promising tax and estate planning aspects of the provision received a lot of attention in planning literature, particularly after the 2001 Act expanded the tax benefits to include an income tax exemption for plan earnings used to pay qualified higher education expenses. Several accounts suggest that taxpayers are also increasingly embracing the new savings vehicle, with some predicting total investment in § 529 plans of $200 billion by 2007.

107-22, § 1(b)(3)(C), 115 Stat. 196, 197 (changing the references to "education individual retirement accounts" to references to "Coverdell education savings accounts").


An essay addressing the federal wealth transfer taxation considerations of § 529 plans could at first blush promise to be an essay about little because the statute is designed to be extremely forgiving in terms of wealth transfer taxes. Section 529 plans benefit from very favorable gift tax rules coupled with an exemption from estate taxation that is very broad and generally inconsistent with established wealth transfer taxation principles. This essay explores the nature of those inconsistencies and the broader implications for the federal wealth transfer taxation system.

Like many of the provisions liberalized by the 2001 Act, § 529 will sunset for taxable years beginning after December 31, 2010.\(^\text{10}\) The potential extension of § 529 should provide an opportunity for Congress to reassess the appropriateness of its structure. In that regard, this essay argues that in its current form, § 529 provides an education subsidy in the form of wealth transfer tax and income tax exemptions that is most attractive and helpful to the wealthiest taxpayers, but who probably need financial aid for higher education the least. This is inconsistent with other education tax incentives that impose limits on amounts and eligibility for contributions, reserving the provisions for taxpayers who have greater need of financial assistance. Furthermore, the § 529 plan tax exemptions detract from the integrity of the wealth transfer tax system and the progressive nature of the income tax structure.

Part II presents an overview of the income taxation of § 529 plans. Part III discusses how the wealth transfer taxation of § 529 plans is inconsistent with longstanding wealth transfer taxation principles. Part IV addresses the broader implications of § 529 plans and Part V recommends some changes. Part VI concludes the essay.

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II. An Overview of the Income Tax Treatment of § 529 Plans

A. The Rise and Refinement of the § 529 Plan

Section 529 permits state governments (and private educational institutions) to sponsor "qualified tuition programs." Although § 529 prescribes overall requirements for a qualified plan, the plan sponsors are free to craft their own variations within those guidelines. All 50 states and the District of Columbia now sponsor some form of qualified tuition program. In many cases a private, for-profit money management firm operates the plan. Section 529 plans can be complex financial products, raising issues about the level of fees and the quality of disclosures.

There are two distinct types of § 529 plans, although the statute refers to both as "qualified tuition programs." In a prepaid tuition program, a person purchases tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses. Generally, the purchaser pays a current, discounted
price for an amount of future tuition, and that future amount is guaranteed and not dependent on investment returns. A prepaid tuition program is generally viewed as a more conservative investment approach. Private universities can sponsor only prepaid tuition programs.19 Alternatively, in an education savings account structure, a person makes contributions to an account20 and the contributions are invested, with the ultimate distributions dependent on the account’s investment returns.21 By most accounts, the education savings account is the more popular structure.22

The income tax treatment of investment returns during the § 529 plan’s accumulation phase has remained substantially intact since the statute’s inception in the 1996 Act.23 No person, whether the purchaser or the designated beneficiary, recognizes taxable income from any growth of the account.24 However, under the 1996 Act, the investment returns were taxable when distributed.25 To discourage improper use of this income tax deferral privilege, a qualified tuition program was required to impose “a more than de minimis penalty on any refund of earnings from the account”26 that was used for other than “qualified higher education expenses.”27 For this purpose, “qualified higher education expenses” included tuition, fees, books, supplies, and equipment required for the enrollment of the designated beneficiary, but no living expenses.28 Consequently, the principal benefit offered by § 529

19. See id. § 529(b)(1). In addition, the income tax exemption for growth or earnings of the qualified tuition program did not apply to distributions from a plan sponsored by an educational institution for any taxable year beginning before January 1, 2004. Id. § 529(c)(3)(B)(iii).
20. Id. § 529(b)(1)(A)(ii).
21. A program will not be treated as qualified unless it provides that a contributor or designated beneficiary “may not directly or indirectly direct the investment of any contributions to the program (or any earnings thereon).” Id. § 529(b)(4). However, the proposed regulations permit an account owner to select among different investment strategies at the time the initial contribution is made to the account. Prop. Treas. Reg. § 1.529-2(g), 63 Fed. Reg. 45,019, 45,028 (Aug. 24, 1998). In addition, the Service permits the account owner to change the plan investments once a year. I.R.S. Notice 2001-55, 2001-2 C.B. 299.
22. See, e.g., Susan T. Bart & Lauren J. Wolven, College Savings Accounts: Why All the Buzz?, 14 CBA Rec. 46 (2000) (stating that college savings accounts are more popular than prepaid tuition plans); David M. Pfefferkorn, The Investment of Custodial Funds in Section 529 Qualified Tuition Programs: Tax Advantages and Fiduciary Concerns, 30 Est. Plan. 571, 573 (2003) (stating that savings plans are more popular than prepaid tuition plans); Steven B. Boehm, The Regulation of 529 Plans, S/J026 ALI-ABA 105, 110 (ALI-ABA Continuing Leg. Educ. Oct. 16–17, 2003) (Although prepaid tuition plans regained some popularity with a poor overall stock market, the savings account structure remains more popular.).
24. I.R.C. § 529(c)(1).
27. Id.
plans was the deferral of income tax on investment earnings and a shifting of the ultimate tax burden to the designated beneficiary who usually would be in a lower income tax bracket than the contributor at the time the funds were distributed. 29

Congress revisited the statute in the 1997 Act and sweetened the provisions by expanding the definition of qualified higher education expenses to include an allowance for room and board. 30 Nevertheless, the plans continued to serve as only income tax deferral and shifting structures.

The election of a Republican administration in 2000 that was committed to "tax relief" as a policy imperative produced the 2001 Act. With respect to § 529 plans, the 2001 Act established the plans' highly attractive income tax benefit—permanent exemption from income tax. If distributions are used to pay only qualified higher education expenses, no income taxes will ever be imposed on the increase in value of the account or earnings on the account. 31 "Qualified higher education expenses" for this purpose include tuition, fees, supplies and equipment, and room and board. 32 To the extent distributions are not used for higher education expenses, 33 the allocable share of investment earnings is included in taxable income and a ten percent penalty is also imposed on such earnings. 34 However, excess funds can be redirected to a new designated beneficiary without penalty, and for that purpose the statute permits the designation from a broad class of family members. 35

29. See id., 110 Stat. at 1896–97 (current version at I.R.C. § 529(c)(3)(A)) ("Any distribution ... shall be includible in the gross income of the distributee .... "). Most students entering college would be older than 14, which would preclude application of the "kiddie tax" prescribed by I.R.C. § 1(g).


32. Id. § 402(f), 115 Stat. at 63 (codified at I.R.C. § 529(e)(3)(A)(I)).

33. Under the 1996 Act’s version of § 529(b)(3), the plan sponsor had responsibility to impose penalties for refunds of earnings not used for qualified higher education expenses. 1996 Act, Pub. L. No. 104-188, § 1806, 110 Stat. 1755, 1896 (current version at I.R.C. § 529(b)(3)). The proposed regulations permitted several alternative ways to verify payment of the qualified higher education expenses such as direct payment, a joint check to the designated beneficiary and the education institution, the submission of proof of expenditures prior to the distribution, and certification prior to the distribution of intent to make such expenditures, followed by substantiation of the expenditures following the distribution. Prop. Treas. Reg. § 1.529-2(e)(4), 63 Fed. Reg. 45,019, 45,027–28 (Aug. 24, 1998). With the 2001 Act’s elimination of the plan-imposed penalty, the Service announced that the final regulations will not require the policing of distributions as originally proposed. I.R.S. Notice 2001-81, 2001-2 C.B. 617.

34. I.R.C. §§ 529(c)(6), 530(d)(4).

35. Section 529(c)(3)(C)(i)(II) permits a rollover to "another designated beneficiary under a qualified tuition program who is a member of the family of the designated beneficiary with respect to which the distribution was made." Section 529(e)(2) in turn defines "family" for this purpose, and designated beneficiaries may be drawn from the class composed of the spouse of the beneficiary; a son or daughter (or
The tax benefits of § 529 plans are not confined to the federal level because many states allow a state income tax deduction or credit for contributions made to the state’s qualified tuition program.36

The income tax benefit of the § 529 plan is not unqualified because “double benefit” prohibitions generally preclude the student from claiming other deductions or credits for tuition expenses to the extent that they are paid with the tax-exempt earnings from the plan.37 However, that drawback is confined to the payment of tuition and related fees, as there generally is no deduction or credit for room and board. In addition, the deductions or credits are generally subject to limits in amount,38 plus eligibility limits based on the income of the student.39 Accordingly, as tuition costs increase (or the income of the student increases) the residual benefits of the § 529 plan increase. A student at a community college might be more interested in the benefits of the Hope Scholarship Credit40 than in § 529 benefits, but a student at an expensive private university might be more interested in the § 529 plan benefits.

36. According to one source, 23 states plus the District of Columbia allow a state income tax deduction or credit for all or some portion of § 529 plan contributions. See The Internet Guide to Funding College: State Tax Benefits and Other Enhancements, at http://www.savingforcollege.com/529_plans/the_529_evaluator/index.php (access document by selecting “State Tax Benefits and Other Enhancements” from the “Compare by Question” drop down menu) (last visited Aug. 1, 2004). Generally speaking, states that adopt a federal definition of gross income usually recognize a correlative state income tax exemption for § 529 plan earnings, but the exceptions defy a coast-to-coast summary. The website cited above summarizes the state-by-state variations.

37. See, e.g., I.R.C. § 222(c)(2) (no deduction for tuition and fees paid with an amount of earnings excluded under a § 529 plan); id. § 259(c)(3)(B)(v) (qualified higher education expenses for the § 529 plan are reduced by tuition costs taken into account in computing a Hope Scholarship Credit or Lifetime Learning Credit).

38. See, e.g., id. § 222(b)(2) ($2,000 or $4,000 limit on the deduction); id. § 254(b)(1) (maximum credit of $2,000 for Hope Scholarship Credit); id. § 254(d) (maximum credit of $2,000 for Lifetime Learning Credit).

39. See, e.g., id. § 222(b)(2) (income limitation for tuition deduction); id. § 254(d) (income limitation for Hope Scholarship Credit).

40. Id. § 254(b).
B. The Coverdell Education Savings Account Comparison

The education provisions of the 1997 Act were the product of a compromise between President Clinton's agenda of deductions or credits for tuition costs and a Republican vision of permanently tax-exempt savings vehicles. The 1997 Act introduced two new education incentives, the Hope Scholarship Credit and Lifetime Learning Credit, which reflected President Clinton's proposals. The 1997 Act also introduced an above-the-line deduction for student loan interest, and the "education individual retirement account," which was generally a Republican proposal. "Education individual retirement account" was an inappropriate title because the account had nothing to do with retirement. It was later renamed the "Coverdell Education Savings Account."5

The "Roth IRA" and its model of nondeductible contributions but potentially tax-exempt distributions was also introduced by the 1997 Act. The Roth IRA and the Coverdell Education Savings Account both reflect, to varying degrees, the fundamental precepts of earlier savings proposals such as the "American Dream Savings account" proposed by the House of

41. The path to enactment of the 1997 Act was full of turns and compromises, but the overall convictions of the parties were reflected in a comparison of proposed tax incentives prepared by the staff of the Joint Committee on Taxation in March 1997. See generally STAFF OF JOINT COMMITTEE ON TAXATION, COMPARISON OF CERTAIN PROPOSED TAX INCENTIVES FOR HIGHER EDUCATION (Comm. Print 1997). President Clinton's fiscal 1998 budget proposal included a Hope Scholarship tuition tax credit and a deduction for other tuition and fees, id. at 2-5, and an exclusion from income for loan forgiveness by tax-exempt charitable organizations, id. at 7-8. The Safe and Affordable Schools Act of 1997, S.1, 105th Cong., and the Balanced Budget Act of 1995, H.R. 2530, 104th Cong. (vetoed by President Clinton), contained none of these provisions. On the other hand, the two latter bills included a deduction for student loan interest, STAFF OF JOINT COMMITTEE ON TAXATION, supra, at 5-6, and "Bob Dole education investment accounts" and "American Dream Savings Accounts," respectively, id. at 9-11, that would permit tax-free distributions from savings accounts to pay for higher education costs.

43. Id. § 202, 111 Stat. at 806-09 (current version at I.R.C. § 221).
44. Id. § 213, 111 Stat. at 813-18 (current version at I.R.C. § 530).
45. The name change was made on July 26, 2001, to honor Senator Paul D. Coverdell (R-Ga.), who passed away on July 18, 2000. Craig D. Bell & Maureen C. Ackerly, A Primer: Section 529 Plans, Coverdell Education Savings Accounts (Education IRAs), and Other Tax-Smart Ways to Save for College, ARMY LAW., Apr. 2004, at 38 n.94; see also Act of July 26, 2001, Pub. L. No. 107-22, 115 Stat. 196. Senator Coverdell was a vigorous proponent of tax-exempt savings accounts for education expenses, including expenses for elementary and secondary education. Bell & Ackerly, supra, at 38 n.94.
46. I.R.C. § 408A(d) (In general, distributions are tax exempt if the distributee is at least age 59½ and the account has been established for at least five years.).
Representatives' Republican majority in its "Contract with America." The American Dream Savings account concept employed nondeductible contributions, but distributions were tax-free so long as a five year holding period was satisfied and the withdrawals were used to pay for tuition and fees of family members or certain first-time homebuyer expenses and medical expenses.

The Coverdell Education Savings Account, like the § 529 plan, allows the invested amounts to accumulate free of any current income taxes. However, from its inception in the 1997 Act, the Coverdell Education Savings Account also offered a complete income tax exemption for investment earnings to the extent the distributee expended all of the funds on qualified higher education expenses. As discussed in the previous section, a similar exemption was not extended to § 529 plans until the 2001 Act, although such an exemption was proposed earlier during the consideration of the 1997 Act.

The Roth IRA and the Coverdell Education Savings Account both remain much more highly circumscribed savings vehicles in comparison with the § 529 plan. For example, both the Roth IRA and the Coverdell Education Savings Account impose quite modest annual contribution limits as well as phase-outs of eligibility for contributions based on adjusted gross income levels. In comparison, § 529 only requires that plans impose a limit on the


49. Id.

50. I.R.C. §§ 530(a), 529(a).


53. Title III of Senate Bill 1 would have made distributions from a § 529 plan tax exempt if used for qualified higher education expenses. Affordable College Act, S. 1, 105th Cong. § 303(a) (1996).

54. Although the Roth IRA is primarily a retirement savings vehicle, the provisions do permit tax-free withdrawals for qualified higher education expenses, medical expenses, and a limited amount for the acquisition of a home by first-time homebuyers. I.R.C. § 408A(d)(2)(B)(iv); see also id. § 72(t)(2) (defining qualified special purpose distribution).

55. Id. §§ 219(b)(5), 408A(c)(2) (Roth IRA annual contribution limits of $3,000 or $3,500 in 2004); id. § 530(b)(1)(A) (Coverdell Education Savings Account annual contribution limit of $2,000).

56. Id. § 408A(c)(3) (Roth IRA limits on the contributor's income); id. § 530(c)(1) (Coverdell
overall amount of contributions so they are not "in excess of those necessary to provide for the qualified higher education expenses of the beneficiary." One state plan interprets this provision as allowing as much as a stunning $315,270 in accumulated plan assets per designated beneficiary and limits in the $250,000 range are quite common. The limitation is apparently interpreted as a state-by-state limit that could be possibly circumvented by establishing multiple § 529 plan accounts for the same designated beneficiary in different states. Furthermore, § 529 imposes no limits on the tax exemption based on the income levels of the contributor or the distributee. If he desired, Bill Gates could establish § 529 plans for his children to help defray the costs of their education. And, with Mr. Gates presumably being taxed at the highest marginal income tax rates, that income tax exemption would be of greatest benefit to him and other similarly situated high-income taxpayers.

Contributions may not be made to a Coverdell Education Savings Account after the beneficiary reaches age 18, and generally must be distributed within 30 days after the beneficiary reaches age 30. Section 529 Education Savings Account limits on the contributor's income).

57. *Id.* § 529(b)(6).

58. Rhode Island's plan adopts the $315,270 limit. The Louisiana plan's $205,175 cap is the lowest and went into effect on August 1, 2004, bringing every states' plan limit above $200,000. *See* The Internet Guide to Funding College: Maximum Contributions, at http://www.savingforcollege.com/529_plans/the_529_evaluator/index.php (access document by selecting "Maximum Contributions" from the "Compare by Question" drop down menu) (last visited Oct. 16, 2004).

59. The operative language of § 529 states: "A program shall not be treated as a qualified tuition program unless it provides adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the qualified higher education expenses of the beneficiary." I.R.C. § 529(b)(6). One could read that provision to apply only to the program in question or alternatively to require consideration of all programs. Another provision states: "For purposes of applying [§ 72 . . . to the extent provided by the Secretary, all qualified tuition programs of which an individual is a designated beneficiary shall be treated as one program." *Id.* § 529(c)(3)(D)(I). Section 72, however, deals with the taxability of distributions, not with the amount of contributions. *Id.* § 72(e)(9). Indeed, the proposed regulations adopt aggregation in the context of "calculating the earnings portion of any distribution." Prop. Treas. Reg. § 1.529-3(d), 63 Fed. Reg. 45,019, 45,030 (Aug. 24, 1998). The Service has announced that it will aggregate all plans sponsored by a state for purposes of the contribution limit, but that apparently does not extend to plans sponsored by multiple states for the same beneficiary. *See* I.R.S. Notice 2001-81, 2001-2 C.B. 617. In comparison, the Roth IRA provisions clearly announce an "all plans" aggregation rule: "The aggregate amount of contributions for any taxable year to all Roth IRAs maintained for the benefit of an individual . . . ." I.R.C. § 408A(c)(2).

60. In an analysis of the impact of marginal income tax rates on § 529 plan investments, one commentator found that "[t]he largest increases in returns accrue to the highest income group, both in dollar terms and relative terms." Dynarski, *supra* note 16, at 370.


62. *Id.* § 530(b)(1)(E), (d)(7).
imposes no age limitations of this type, although the state plan sponsor may impose them.63

C. The Retirement Savings Account and Lifetime Savings Account Initiative

This essay will later propose that restrictions resembling those applicable to the Roth IRA and Coverdell Education Savings Account be extended to § 529 plans to discourage abuse of the § 529 plan advantages to preserve the integrity of the wealth transfer tax system and to promote progressivity of the federal income tax structure.64 However, the existing limits on the Roth IRA and Coverdell Education Savings Account may be eliminated to some degree by proposals for broader savings incentives.

For example, in February of 2004, President Bush's 2005 Budget proposed the creation of four new savings accounts: the Retirement Savings Account ("RSA"); the Lifetime Savings Account ("LSA"); the Employer Retirement Savings Account; and the Individual Development Account.65 The Roth IRA would be renamed the RSA.66 Unlike the current Roth IRA, the RSA would include no income limits.67 Nondeductible annual contributions of $5,000 (indexed for inflation) would be allowed.68 Earnings would accumulate tax-free, and qualified distributions after age 58 would be tax-free.69

The LSA would provide for nondeductible $5,000 annual contributions (indexed for inflation), and would contain no income limits or age limits.70 Earnings would accumulate tax-free and all distributions would be excluded from gross income with no minimum holding requirement.71 While individuals could continue to contribute to Coverdell Education Savings Accounts and § 529 plans, they could elect to convert balances from Coverdell

63. See, e.g., Taylor & Cipparone, supra note 8, at 142–43 (referring to Iowa’s limit on contributions for beneficiaries 18 years old or younger and provision that the account must be used by age 30 and Indiana’s 25 year limit on account duration).
64. See infra Part V.
66. Id.
67. Id.
68. Id.
69. Id.
70. Id.
71. Office of Public Affairs, supra note 65.
Education Savings Accounts and § 529 plans to LSAs. In early 2004, bills were introduced in the House of Representatives and Senate to create LSAs patterned after the President’s budget proposal.

While proposals of this nature may not be adopted immediately, such developments may determine the future of § 529 plans. First, the direction of tax legislation might be toward fewer limits on these types of accounts, so looking to the current Roth IRA or Coverdell Education Savings Account as models for reform may be misplaced. Second, although difficult to predict, an LSA that permits annual contributions of $5,000 that can be withdrawn, tax-free, for any purpose would seem to be a strong competitor for the education-focused § 529 plan, except for taxpayers who wish to contribute more than $5,000 annually. The enactment of LSA legislation would probably make § 529 plans attractive almost exclusively to a wealthy clientele. Third, the RSA and LSA proposals do not include estate tax exemptions so the accounts are apparently includible in the gross estate of the account owner. Accordingly, the special estate tax exemption extended to § 529 plan assets would become even more attractive to wealthy individuals as compared to LSAs, again suggesting the need for greater scrutiny of the appropriateness of the § 529 plan exemption.

III. SECTION 529 PLAN INCONSISTENCIES WITH ESTABLISHED FEDERAL WEALTH TRANSFER TAX PRINCIPLES

A. Alternative § 529 Plan Ownership Structures

The primary focus of the language and structure of § 529 is on two parties: the contributor of the funds to the plan (the “contributor” or “donor”) and the future student who is the beneficiary of the plan (the “designated

72. Id.
74. The proposed LSA would apply the contribution limit to the owner of the account, not to the contributor, and one may make contributions to the accounts of other individuals. Office of Public Affairs, supra note 65. Accordingly, parents could create LSAs for themselves, as well as separate LSAs for each of their children. Several commentators speculate that the LSA proposal would greatly reduce taxpayer interest in § 529 plans. See, e.g., Rick Miller, LSAs Could Threaten the Existence of 529s: Proponents of College Savings Plans Express Concern to Government, INVESTMENT NEWS, Feb. 16, 2004, at 19, available at 2004 WL 65581658; Ellen Uzelac, College Rivals: Keep Funding Your 529 Accounts, But Watch Out for Proposed New LSAs, Which Could Give College Savings Plans a Run for Their Money, RESEARCH, Apr. 1, 2004, at 19, available at 2004 WL 66371013.
75. See Office of Public Affairs, supra note 65.
76. I.R.C. § 529(c)(4).
beneficiary” or “distributee”).

There can be a third party (the “account owner”) who establishes the account and exercises discretion with respect to a number of matters such as the designation of the initial beneficiary and new beneficiaries and choices of plan investments. In many situations, such as a parent contributing to a plan on behalf of a child, the contributor and the account owner will be the same person. However, in other cases, if the terms of the plan permit this, one could have multiple contributors, such as grandparents, uncles, and aunts, with the child’s parent as the account owner. Certainly, most contributors expect that, barring unforeseen circumstances such as the death of the child or the failure to pursue post-secondary education, the funds will be applied to the education expenses of the designated beneficiary. Nevertheless, assuming the inapplicability of trust doctrine, or the express creation of a trust or custodial account as discussed below, the account owner may have the power to apply those funds for other purposes and for the benefit of other persons, albeit incurring an income tax.

77. Designated Beneficiary is defined as:
(1) The individual designated as the beneficiary of the account at the time an account is established with the [qualified state tuition program]; (2) The individual who is designated as the new beneficiary when beneficiaries are changed; and (3) The individual receiving the benefits accumulated in the account as a scholarship in the case of a [qualified state tuition program] account established by a State or local government or an organization described in §501(c)(3) and exempt from taxation under §501(a) as part of a scholarship program operated by such government or organization.


78. “Distributee means the designated beneficiary or the account owner who receives or is treated as receiving a distribution from a [qualified state tuition program].” Id., 63 Fed. Reg. at 45,025–26 (emphasis in original).

79. I.R.C. § 529.

80. Account owner is defined as:
the person who, under the terms of the [qualified state tuition program] 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.


81. The ability to choose investments, however, is limited by the statute. See supra note 21.

82. Section 529 plans provide only for post-secondary education. In comparison, Coverdell Education Savings Accounts can be used to fund elementary and secondary education expenses. I.R.C. § 530(b)(4). The expansion of the Coverdell Education Savings Account provisions to include elementary and secondary education expenses was a politically charged issue, and the amendment was belatedly enacted with the 2001 Act. See supra note 51.

83. The account owner would typically argue that an expression of such intent by the contributor is precatory language not rising to the level of a legal obligation. See William M. McGovern, Jr. & Sheldon F. Kurtz, Wills, Trusts and Estates 218–20 (3d ed. 2004).
and a ten percent penalty on the distributions not used for higher education expenses. Indeed, the planning literature frequently refers to the power of the account owner to request a refund of the account balance at any time.\textsuperscript{84}

As discussed below, the existence of such powers of revocation, whether or not exercised, would usually render a gift incomplete at the outset if the contributor and the account owner are the same person. Furthermore, the existence of such power on the part of the account owner, whether or not the account owner is the contributor, would otherwise invoke application of the estate tax under established wealth transfer taxation doctrine.\textsuperscript{85} In response to such concerns, the statute creates broad divergences from established wealth transfer taxation principles.\textsuperscript{86} These inconsistencies are discussed in the next section.

The power of revocation enjoyed by the account owner is apparently a valued aspect of §529 accounts because it provides a degree of flexibility not otherwise achievable with irrevocable gifts.\textsuperscript{87} However, from the standpoint of a contributor who is not also the account owner, the possible misapplication of the §529 plan funds could be a concern.\textsuperscript{88} Furthermore, even if the contributor is also the account owner for now, the contributor could have well-founded concerns about the future of the account ownership if the contributor were to pass away or otherwise become incapacitated. It is beyond the scope of this essay to deal with these issues in any depth. However, a promising solution is the creation of a custodianship under statutes such as the Uniform Habilitation Act.
Transfers to Minors Act\textsuperscript{89} or Uniform Gifts to Minors Act,\textsuperscript{90} or the express creation of a trust.\textsuperscript{91} The contributor would transfer the funds to the custodianship or trust. The custodian or trustee, as the case may be, would in turn invest in the § 529 plan if permitted by the terms of the plan. If the trust was irrevocable, and the contributor did not serve as trustee, some of the wealth transfer tax doctrine inconsistencies discussed in the next section would be addressed.

B. Section 529's Inconsistencies with Wealth Transfer Tax Doctrine

1. The 1996 Act's Approach to § 529

As originally enacted in the 1996 Act, the federal wealth transfer taxation aspects of § 529 plans were roughly consistent with established doctrine, but there were some significant contradictions.

\textsuperscript{89} UNIF. TRANSFERS TO MINORS ACT § 3, 8C U.L.A. 25 (2001). The custodial account is a simple and less expensive alternative to create because the terms of the arrangement are dictated by statute. No custodial agreement is required beyond a document identifying the beneficiary and the custodian. See id. §§ 9 & 11, 8C U.L.A. 36–38, 46–47. Furthermore, the income is generally reported directly on the federal income tax return of the beneficiary so no separate federal income tax return is required. See Rev. Rul. 59-357, 1959-2 C.B. 212. Finally, for federal wealth transfer tax purposes, transfers to the custodian qualify as gifts for which the annual gift exclusion can be claimed. I.R.C. § 2503(b), (c). However, the custodial account suffers from inflexibility (as compared with a trust), particularly with respect to the common requirement that the account be distributed when the beneficiary reaches a statutorily imposed age, generally 18 or 21. See UNIF. TRANSFERS TO MINORS ACT § 20, 8C U.L.A. 72–73 (2001). In a handful of states, the distribution of the custodial funds can be delayed until the beneficiary reaches age 25. See, e.g., ALASKA STAT. § 13.46.195(c) (2002); CAL. PROB. CODE § 3920.5 (West 1991 & Supp. 2004); NEV. STAT. § 167.034 (2003). For an article discussing the implications of § 529 plan ownership by custodial accounts, see Pfefferkorn, supra note 22.

\textsuperscript{90} UNIF. GIFTS TO MINORS ACT (1966), 8A U.L.A. 297 (2003). The cited page in the Uniform Laws Annotated volume no longer contains the text of the Uniform Gifts to Minors Act because the National Conference of Commissioners on Uniform State Laws no longer recommends adoption of that model act, preferring the more modern Uniform Transfers to Minors Act as a substitute. Indeed, by referring to the list of jurisdictions that have adopted the Uniform Transfers to Minors Act, one can infer that South Carolina and Vermont are the two remaining states that still follow statutes patterned after the Uniform Gifts to Minors Act. See Table of Jurisdictions Wherein Act Has Been Adopted, 8C U.L.A. 1–2 (2001); see also S.C. CODE ANN. §§ 20-7-140 to -240 (Law. Co-op. 1985 & Supp. 2003); VT. STAT. ANN. tit. 14 §§ 3201–3209 (2002).

\textsuperscript{91} A trust of any sophistication will require a written trust agreement and possibly the filing of a federal trust income tax return, Form 1041. Also, gifts to a typical discretionary trust generally do not qualify for the annual gift exclusion afforded by § 2503(b) of the Code unless a so-called "Crummey clause" is utilized. See infra notes 129–30 and accompanying text.
First, the statute provided that a contribution to a § 529 plan was not treated as a taxable gift. As discussed below, this was appropriate if the donor was the account owner, because the revocable nature of § 529 transfers, as well as the ability to shift designated beneficiaries, would normally render the gift incomplete. However, if the donor was not the account owner and therefore lacked continuing control over the § 529 plan, the statute was inconsistent with established principles that would generally dictate completed gift treatment.

Second, consistent with established doctrine, when a distribution was actually made to or for the benefit of a designated beneficiary, it was treated as a gift at that time. However, if the distribution was made directly to the educational institution, the statute provided that it was to be treated as a qualified transfer under § 2503(e) of the Code, ultimately producing no taxable gift. This was a bit of a stretch of the doctrine of § 2503(e) in the sense of treating the tuition plan as a proxy for the original donor to the § 529 plan. However, for generation-skipping transfer tax ("GSTT") purposes at least, the Code already permitted a trust to claim the § 2503(e) exclusion for transfers made by it to educational institutions. In addition, to the extent that the original donor is the account owner and retains the power to revoke the beneficiary designation or demand a refund of the account balance, it could be argued that any payments of plan assets to third parties for education expenses are in substance a completed transfer at that time by the donor/account owner. It is much as if that person had written a check directly

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92. "In no event shall a contribution to a qualified State tuition program on behalf of a designated beneficiary be treated as a taxable gift for purposes of chapter 12." 1996 Act, Pub. L. No. 104-188, § 1806, 110 Stat. 1755, 1896 (current version at I.R.C. § 529(c)(2)).
93. See infra Part III.B.2.a.
94. See infra Part III.B.2.a.
96. "For purposes of [§] 2503(e), the waiver (or payment to an educational institution) of qualified higher education expenses of a designated beneficiary under a qualified State tuition program shall be treated as a qualified transfer." Id., 110 Stat. at 1897 (current version at I.R.C. § 529(c)(5)).
97. Taxpayers who sought to qualify payments to the prepaid tuition fund itself under § 2503(e) received generally positive responses from the Service with respect to the treatment of the payments made directly to the prepaid tuition authority. See Priv. Ltr. Rul. 88-25-027 (Mar. 29, 1988) (§ 2503(e) did not apply to shelter the gift to a trust which in turn purchased a prepaid tuition contract); Priv. Ltr. Rul. 89-010-027 (Sept. 30, 1988) (§ 2503(e) did not apply to shelter the gift to a trust which in turn purchased a prepaid tuition contract); Priv. Ltr. Rul. 91-09-032 (Nov. 30, 1990) (§ 2503(e) applied to payments made by a trust to the prepaid tuition authority); Tech. Adv. Mem. 1999-41-013 (July 9, 1999) (§ 2503(e) applied to payments made by a grandparent to the prepaid tuition authority).
98. I.R.C. § 2611(b)(1).
to the third party from resources outside the § 529 plan, or at the time of contribution to the § 529 plan, had written a post-dated check.

Third, the value of any interest in a qualified tuition program attributable to contributions made by an individual to such program was includible in the gross estate of the contributor for estate tax purposes.\(^9\)

The gift tax provisions produced a benign result because they did not require the utilization of the annual gift exclusion at any time or the filing of a gift tax return.\(^{10}\) The postponed "gift" on distribution would be completely absorbed by the § 2503(e) exclusion. Certainly, this tidy result would have been disturbed as § 529 evolved to include room and board as qualified higher education expenses—§ 2503(e) is confined to tuition\(^{101}\)—but § 2503(e) could have been amended for this narrow purpose to track the room and board requirements of § 529.

The estate tax treatment was surely considered to be a negative for taxpayers, but, of course, only for the relatively few taxpayers for whom the estate tax matters. It would be no impediment for other contributors. The estate tax treatment could be faulted for the complexities involved in tracing the accumulations from contributions by multiple donors to a § 529 plan. Furthermore, the 1996 Act’s solution was flawed from the standpoint of established principles because the estate tax inclusion apparently could not be avoided even if the donor relinquished all ownership or other control over the account.\(^{102}\) The statute simply stated that contributions by a donor were includible in the donor’s estate.\(^{103}\) As discussed below, the focus should be on the person who holds powers over the § 529 plan, usually the account owner. Like many simple solutions, the 1996 Act in this respect was overbroad in its potential application.

2. The 1997 Act’s Change of Direction

The 1997 Act changed the wealth transfer taxation aspects of the § 529 plan to their current state. In describing the amendments, the staff of the Joint Committee on Taxation engaged in what might be considered an

\(^{9}\) The 1996 Act broadly stated: "The value of any interest in any qualified State tuition program which is attributable to contributions made by an individual to such program on behalf of any designated beneficiary shall be includible in the gross estate of the contributor for purposes of chapter 11." 1996 Act, Pub. L. No. 104-188, § 1806, 110 Stat. 1755, 1897 (current version at I.R.C. § 529(c)(4)).

\(^{10}\) I.R.C. § 6019(1).

\(^{101}\) Id. § 2503(e)(2)(A).

\(^{102}\) See 1996 Act § 1806, 110 Stat. at 1897 (current version at I.R.C. § 529(c)(4)).

\(^{103}\) Id.
understatement, at best, or disingenuous misinformation, at worst, by describing the substantial changes as simply "clarifying the estate and gift tax treatment of contributions to qualified State tuition programs or education IRAs." Still, if the degree of significance of tax legislation is measured in part by the budget effects, these amendments did not warrant a separate line revenue cost projection.

The Conference Committee for the 1997 Act had to weigh different approaches to modifying the wealth transfer taxation aspects of §529 plans. Both the House bill and the Senate amendment were in agreement that, for estate tax purposes, the value of any interest in a qualified tuition program or Coverdell Education Savings Account would be includible in the estate of the beneficiary and not in the estate of the contributor. This made little sense from the standpoint of established wealth transfer taxation principles if the account owner retained the power to revoke the beneficiary designation or demand a refund of the plan assets. Despite that, or perhaps because of that, shifting the imposition of estate taxes to the beneficiary, usually a young adult with few assets, would generally be a favorable development for taxpayers. Moreover, the proposal would apply an estate tax to the beneficiary’s estate only if he or she passed away before the account assets were consumed by education expenses and only if the account assets were paid to the designated beneficiary’s estate. This proposal would, as a practical matter, eliminate the estate taxation of §529 plans in most cases. As discussed below in greater detail, the final compromise did exempt all persons from estate tax on §529 plan assets except to the extent of amounts distributed to a designated beneficiary on account of the beneficiary’s death—a 180 degree turn from the prior law.

The competing proposals differed with respect to the gift taxation treatment of contributions to §529 plans. In its bill, the House proposed that


105. The estimated budget effects document does not mention the §529 plan estate and gift tax changes anywhere. However, the 1997 Act expanded the definition of qualified higher education expenses to include room and board and the revenue loss was projected at $1.491 billion for fiscal years 1997–2007. STAFF OF JOINT COMM. ON TAX’N, 105TH CONG., ESTIMATED BUDGET EFFECTS OF THE CONFERENCE AGREEMENT ON THE REVENUE PROVISIONS OF H.R. 2014, THE “TAXPAYER RELIEF ACT OF 1997” 1 (Comm. Print 1997). This “estimate includes interaction with estate and gift taxes.” Id.


contributions be treated as completed gifts of present interests, qualifying the contributions for the annual gift exclusion. In its amendment, the Senate proposed that neither contributions nor distributions would be considered taxable gifts for federal gift tax purposes. The Senate approach retained the no taxable gift approach of the 1996 Act but eliminated the symmetry of the 1996 Act that included plan balances in the donor's estate. As a practical matter, the Senate amendment essentially eliminated all wealth transfer taxation of § 529 plans.

The Conference Committee compromise in part followed the House bill in terms of gift tax consequences, treating the contributions as completed gifts. The Conference Committee also created a special five year election that permits the tax-free front loading of contributions for gift tax purposes.

Notably, both the House bill and the Senate amendment included limits on amounts contributed to § 529 plans sponsored by private educational institutions, as well as a prohibition on further contributions once a designated beneficiary reached age eighteen. While these concepts were included in the Coverdell Education Savings Account provisions, none of them were adopted in § 529.

This essay will now examine in depth the current wealth transfer taxation provisions that were introduced by the 1997 Act.

a. The Deemed Completed Gift

The statute now provides that "any contribution to a qualified tuition program on behalf of any designated beneficiary shall be treated as a completed gift to such beneficiary." The language overrules long established doctrine that a gift is rendered incomplete if the donor has the reserved power to name new beneficiaries, even if the donor cannot revest the beneficial title to the property in himself or herself. This appears to be a response to the possibility of subsequent changes in the designated beneficiary

108. 1997 Revenue Comparison, supra note 106, at 32–33.
109. Id.
111. Id.
112. Id. at 355–59, reprinted in 1997-4 C.B. 1824–49 (comparing the House and Senate proposals for qualified tuition programs).
113. Id.
115. See, e.g., Treas. Reg. § 25.2511-2(c) (as amended in 1999) (adopting the rule announced in Estate of Sanford v. Comm'r, 308 U.S. 39 (1939)).
by a contributor/owner of the § 529 plan. This would not be a concern if the
ccontributor and owner were different persons. The language also identifies
the designated beneficiary, rather than the § 529 plan itself, as the donee.\textsuperscript{116} This is analogous to the judicial characterization of trusts as being transparent,
focusing on the beneficiary for gifts in trust.\textsuperscript{117}

Under established doctrine, a completed gift can occur if the beneficiary
subsequently receives income from the property or other enjoyment, with the
amount of the taxable gift limited to the value of such income or enjoyment.\textsuperscript{118} Although that result probably does not follow under current § 529 because the
gift is considered complete upon the contribution to the plan, the statute
nevertheless cautiously confirms that, except for a special rule for shifts in the
generation of the designated beneficiary, “in no event shall a distribution from
a qualified tuition program be treated as a taxable gift.”\textsuperscript{119}

The statutory language apparently overrules a more fundamental gift
taxation principle: A gift is incomplete if the “donor reserves the power to
revest the beneficial title to the property in himself or herself.”\textsuperscript{120} Under this
principle, the gift is considered incomplete unless and until the donor
relinquishes the power or the power otherwise terminates. Absent the deemed
completed gift, this doctrine would apply to a § 529 plan if the same person
was both the contributor and the owner. Nevertheless, the statute deems the
transfer to be a completed gift in all cases.\textsuperscript{121} This “easy to complete”
approach is meritorious from the standpoint of simplifying matters. A
contributor, whether or not an owner of the account, knows at the outset that
he or she always has made a completed gift. Although some contributors
might wish to postpone the completion of the gift until a later date,
particularly if it were taxable, the statute shelters future appreciation in the
§ 529 plan from later application of the gift tax by accelerating the timing of
the gift.

\textit{b. The Future Interest Exemption}

The designated beneficiary’s enjoyment of the property in the § 529 plan
would commence “in use, possession, or enjoyment at some future date or

\begin{itemize}
  \item \textsuperscript{116} I.R.C. § 529(c)(2)(A)(I).
  \item \textsuperscript{117} See, e.g., Comm’r v. Hutchings, 312 U.S. 393, 396 (1941).
  \item \textsuperscript{118} See, e.g., Treas. Reg. § 25.2511-2(f) (as amended in 1999).
  \item \textsuperscript{119} I.R.C. § 529(c)(5)(A).
  \item \textsuperscript{120} Treas. Reg. § 25.2511-2(c) (as amended in 1999).
  \item \textsuperscript{121} I.R.C. § 529(c)(2)(A)(I). 
\end{itemize}
time" and under established principles would otherwise constitute a future interest in property ineligible for the annual gift exclusion. However, by statutory fiat, a contribution on behalf of a designated beneficiary of a § 529 plan is treated as a gift "which is not a future interest in property." It consequently qualifies for the annual gift exclusion.

As a practical matter, this exemption from the future interest rule ensures that modest contributions (i.e., currently $11,000 or less) to § 529 plans will be sheltered by the annual gift exclusion and exempt from gift taxation and the GSTT. The future interest rule was originally enacted to deal with remote or contingent trust interests for which the ultimate beneficiaries could be difficult to identify. As discussed above, § 529 plans demonstrate uncertainty as to ultimate beneficiaries, probably to a greater degree than a long-term multigenerational trust if one considers the power of the account owner to demand a refund. It is outside the scope of this essay to offer an analytical defense of the gift tax's future interest rule, a rule that has produced more than its fair share of litigation and formalistic maneuvering, including the development of the Crummey clause. However, it is fair to say that

123. The § 529 plan is a contract and the gift tax regulations state that a future interest does not include "such contractual rights as exist in a bond, note (though bearing no interest until maturity), or in a policy of life insurance, the obligations of which are to be discharged by payments in the future. But a future interest or interests in such contractual obligations may be created by the limitations created in a trust or other instrument of transfer used in effecting a gift." Id. Example six of the regulation finds that the payment of premiums by L on a policy of insurance on L's life is a gift of a present interest of property if all the incidents of ownership in the policy are vested in M. Id., Ex. (6). It would seem that a § 529 plan in which the designated beneficiary's interest is subject to change and divestment is not comparable to the insurance policy in the example.
125. See id. § 2503(b)(1).
127. Gifts that qualify for the annual gift exclusion are generally granted a correlative exclusion from the GSTT. See I.R.C. § 2642(c).
129. The clause takes its name from the influential Ninth Circuit Court of Appeals decision Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968), which approved a somewhat hollow, formalistic device to circumvent the future interest rule. The Service adopted the result in Crummey in Revenue Ruling 73-405, 1973-2 C.B. 321, but that did not foreclose subsequent revenue rulings, private letter rulings, and judicial decisions to further define the contours of the doctrine. Thousands of pages of commentary have been devoted to the doctrine. For some of the more recent commentary, see David Pratt & Elaine M. Bucher, Updated Practical Planning with Crummey Powers, 29 EST. PLAN. 73 (2002); Walter D. Schwidetzky, Estate Planning: Hyperlexis and the Annual Exclusion Rule, 32 SUFFOLK U. L. REV. 211 (1998).
exempting § 529 plans from the rule is highly inconsistent with longstanding doctrine and its only redemption is the new "simplicity" for the donor.\textsuperscript{130}

Congress dispensed with the future interest rule on at least one prior occasion when it enacted the cumbersome provisions of § 2503(c) of the Code. However, reflecting the origins of the future interest rule, that section very carefully requires that the identity of the donee be limited to one individual (barring death), mandates distributions at age 21, and is much more circumscribed overall than the open-ended approach permitted by § 529.\textsuperscript{131} Perhaps the future interest rule is an anachronism and should be abolished, but § 529 plans, with their open-ended ownership structures, are not the appropriate vehicle for that reform.\textsuperscript{132}

c. The Special Five-Year Election

At the election of the donor, annual contributions to a § 529 plan in excess of the annual gift exclusion may be ratably spread over a five year period beginning with the calendar year of contribution for purposes of applying the annual exclusion.\textsuperscript{133} According to the Service instructions for the gift tax return (Form 709), in the absence of other gifts, the donor need not file a Form 709 for the following four years.\textsuperscript{134}

The statutory language—"be taken into account for purposes of [§ 2503(b)]"\textsuperscript{135}—implies that if the contribution were to exceed the product of the annual exclusion amount multiplied by five, the application of the applicable exclusion amount or payment of an actual gift tax would be made in the year of contribution with respect to the taxable excess. The proposed

\textsuperscript{130} Even without the § 529 exemptions, more sophisticated taxpayers could create a completed gift of a present interest by creating an irrevocable trust with a Crummey clause for gifts to the trust under which an independent trustee would invest in § 529 plan accounts on behalf of the trust. \textit{See Crummey}, 397 F.2d at 83, 88; Pratt & Bucher, \textit{supra} note 129, at 73; Schwidetzky, \textit{supra} note 129, at 216–22; see also \textit{supra} note 91 and accompanying text.

\textsuperscript{131} I.R.C. § 2503(c).

\textsuperscript{132} \textit{Compare} Harry L. Gutman, Reforming Federal Wealth Transfer Taxes After ERTA, 69 VA. L. REV. 1183, 1245–46 (1983) (suggesting that the future interest exception should not extend to gifts to trusts), with Jeffrey G. Sherman, \textit{‘Tis a Gift to be Simple: The Need for a New Definition of “Future Interest” for Gift Tax Purposes}, 55 U. CIN. L. REV. 585, 666–67 (1987) (arguing that the future interest test should be satisfied only by gifts satisfying a “fee simple absolute” test).

\textsuperscript{133} I.R.C. § 529(c)(2)(B).


\textsuperscript{135} I.R.C. § 529(c)(2)(B).
regulations and Service instructions for Form 709 adopt this interpretation.

If the donor makes the five year election discussed above, but dies before the end of the five year period, the contributions allocable to periods after the date of death of the donor are treated as additions to the donor’s gross estate. Only the amounts of the original contributions are treated as additions, not their current value. This also is inconsistent with prevailing estate tax principles that include an asset brought back into the gross estate at its fair market value on the decedent’s date of death (or alternate valuation date, if applicable).

The five year election is quite generous, permitting the donor to frontload contributions to the § 529 plan. While it is true that it streamlines the gift tax reporting for large contributions to § 529 plans, only individuals of some wealth have the resources available to make gifts of $55,000 to $110,000 per donee. To the author’s knowledge, this type of election has never before been allowed for wealth transfer taxation purposes and is quite extraordinary. In other contexts, donors have been left to rely on self-help spreading measures such as sales of property to the donee with serial forgiveness of the obligation and retained interest structures.

139. Id.
140. I.R.C. § 2031(a).
141. Id. § 2032(a).
142. The annual gift exclusion as of 2004 is $11,000 per donee. See supra note 126. With gift splitting, a married couple could in one year gift $110,000 to an account for a single designated beneficiary. I.R.C. § 2513(a)(1).
143. Commentators have advanced a number of proposals to refine the annual gift exclusion. See, e.g., Robert B. Smith, Should We Give Away the Annual Exclusion?, 1 FLA. TAX REV. 361 (1993) (proposing additional restrictions on the annual exclusion); John G. Steinkamp, Common Sense and the Gift Tax Annual Exclusion, 72 Neb. L. Rev. 106 (1993) (proposing additional restrictions on the annual exclusion).
144. Compare Estate of Maxwell v. Comm’r, 3 F.3d 591 (2d Cir. 1993) (treating installment sale of property with serial forgiveness of the purchase money indebtedness as a gift with a retained life estate), with Haygood v. Comm’r, 42 T.C. 936 (1964) (respecting installment sale of property with serial forgiveness of the purchase money indebtedness).
145. Assorted strategies can be used to reduce the immediate taxable amount of a gift, but they can entail recapturing the deduction over future years. For example, grantor retained unitrusts and grantor retained annuity trusts governed by § 2702 of the Code require payments to the grantor in satisfaction of the retained interest, I.R.C. § 2702(b)(1), (2), and those amounts to some extent replenish the amount of the donor’s taxable estate. However, some techniques governed by § 2702, such as the qualified personal residence trust, id. § 2702(a)(3)(A)(ii), reduce the amount of the gift but do not replenish the donor’s
**d. The Shift of Generations Rule**

Section 529 imposes some safeguards to prevent contributions in excess of those necessary to provide for the higher education of a designated beneficiary. In addition, the imposition of an income tax and a ten percent penalty on the amounts not used for qualified higher education expenses is an additional disincentive for overfunding the plan. On the other hand, the limitation on accumulations of funds has been interpreted to permit accumulations as great as $315,270 per designated beneficiary. Any excess funds can be redirected to a new designated beneficiary without penalty, and the statute permits the designation of a broad class of family members. In fact, from an income tax standpoint, the designation of lineal descendants as new beneficiaries is unlimited and could include children, their children, the great-grandchildren, and so forth. Consequently, by rolling forward the generations as designated beneficiaries, a large family could accumulate significant § 529 plan assets that could be retained generation to generation free of the imposition of federal income taxes.

To seemingly discourage large multigenerational accumulations of § 529 plan assets, the statute provides that a change in the designated beneficiary or rollover to the account of a new beneficiary can require the imposition of a gift tax if the new beneficiary is a generation below the generation of the old beneficiary under GSTT principles. However, the proposed regulations treat the gift as being made by the old beneficiary. Such treatment is peculiar from the standpoint of established wealth transfer tax principles, because the new designation was probably made by the account owner, not by the old beneficiary. In that regard, the lone example in the proposed regulations of a taxable change of beneficiary involves a parent as a donor/account owner who does just that:

taxable estate.

146. I.R.C. § 529(b)(6).
147. Id. § 529(c)(3)(A), (c)(6).
148. See supra note 58 and accompanying text.
150. Id. § 529(c)(2).
151. See supra note 35.
152. I.R.C. § 529(c)(5)(B).
In Year [one], P makes a contribution to a [qualified tuition program] on behalf of P's child, C. In Year [four], P directs that a distribution from the account for the benefit of C be made to an account for the benefit of P's grandchild, G. The rollover distribution is treated as a taxable gift by C to G, because, under [§] 2651, G is assigned to a generation below the generation assignment of C.154

This would usually be favorable from a wealth transfer taxation standpoint because the old beneficiary is likely younger and less wealthy than the donor or account owner. This result, however, is not supported by the language of the statute or by established wealth transfer taxation principles. It apparently is based on a supporting statement from the House Report.155

The statute further provides that a change of beneficiary will also be subject to the GSTT "if the new beneficiary is a generation below the generation of the old beneficiary."156 That statement is consistent with a view that the GSTT transferor is the original donor, because the GSTT generally treats a natural person as a "skip person" only if that person is assigned to a generation which is two or more generations below the generation assignment of the transferor.157 For example, if a grandparent was the contributor to the § 529 plan and a grandchild or great-grandchild was the original designated beneficiary, that could produce a direct skip for GSTT purposes for the original contribution.158 A designation of a beneficiary even one generation lower would produce a direct skip. Likewise, if the parent was the contributor to the § 529 plan and a child was the original beneficiary, the designation of a new beneficiary one generation lower, a grandchild, would also produce a direct skip. The one lower generation rule of the statute seems to assume that the contributor or account owner will always be at least one generation higher than the original beneficiary. This assumption probably works in most cases, but not all.159

155. "In all other cases, 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..." H.R. REP. No. 105-148, at 328 (1997), reprinted in 1997-4 C.B. 319, 650. In fairness, because the statute treats the original contributions as a completed gift and ignores the powers of the account owner for estate tax purposes, the designated beneficiary is in some respects the only person without an express statutory immunity. I.R.C. § 529(c)(2)(A).
156. I.R.C. § 529(c)(5)(B).
157. Id. § 2613(a)(1).
158. However, to the extent the contribution qualifies for the annual gift exclusion, it will also be exempt from the GSTT. See I.R.C. § 2642(c).
159. Of course, if the contributor names himself or herself as the original designated beneficiary, the wheels fall off the statute. Furthermore, at least one article suggests strategies such as adult attorneys establishing § 529 plans for themselves, so this is not that farfetched. See Helen W. Gunnarsson, Law Pulse, 90 ILL. B.J. 168, 174 (2002).
The proposed regulations attempt to rescue the statute from the interpretative mess created by its own language by stating that the GSTT will apply only "if the new beneficiary is assigned to a generation which is two or more levels lower than the generation assignment of the old beneficiary."\(^6\) Of course, this clearly contradicts the language of the statute. But it is consistent with the gift rule discussed above that focuses on the original beneficiary as the donor, and consequently also as the GSTT transferor.

If a gift or generation-skipping transfer is produced by the change of a designated beneficiary, it is unclear from the statute if it qualifies for the annual gift exclusion.\(^6\) However, the proposed regulation provides that if there is a taxable transfer, the five year averaging rule may be applied.\(^6\) This draws support from a statement in the House Conference Committee Report that a taxable gift would be produced only if it exceeded the annual gift exclusion\(^6\) and from a statement expressly approving use of the five year averaging rule in this instance.\(^6\)

These rules do offer planning options, as discussed previously. First, if a gift or GSTT transfer arises, it is considered to be made by the original beneficiary, who is more likely less wealthy at the time, has no other outstanding gifts, and so forth.\(^6\) Second, the original beneficiary can use the annual gift exclusion, plus the five year averaging rule.\(^6\) Third, if the gift transfer is exempt by reason of the annual gift exclusion, it will be also an exempt transfer for GSTT purposes.\(^6\) Fourth, the proposed regulations focus on the original beneficiary as the transferor for GSTT purposes, so if the original beneficiary were a grandchild, the plan remains GSTT exempt through the level of great-great grandchildren.\(^6\) As with most GSTT transfers that are exempt from tax, the strategy is to name the youngest

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161. The deemed completed gift rule and present interest rule apply to "any contribution to a qualified tuition program on behalf of any designated beneficiary." I.R.C. § 529(c)(2)(A).
163. "Thus, a transfer of an account from a brother to his sister will not be treated as a taxable gift, whereas a transfer from a father to his son will be treated as a taxable gift (to the extent it exceeds the $10,000 present-law gift tax exclusion)." H.R. CONF. REP. No. 105-220, at 356 (1997), reprinted in 1997-4 C.B. 1835.
164. "If a beneficiary’s interest is rolled over to a beneficiary in a lower generation (e.g., parent to child or uncle to niece), the five-year averaging rule described above may be applied to exempt up to $50,000 of the transfer from gift tax.” Id. at 365, reprinted in 1997-4 C.B. 1835.
166. See I.R.C. § 529(c)(5)(B).
167. See I.R.C. § 2642(c).
designated beneficiary possible at the outset. Fifth, even if a gift tax or GSTT is produced by a designation of beneficiary, an income tax will not be due if the new designated beneficiary qualifies as a family member.\textsuperscript{169}

The shift of generations rule seems to have few teeth. Furthermore, some commentators have observed that the account owner's power to shift designated beneficiaries of the same generation without the imposition of gift tax or GSTT could lead to other abuses.\textsuperscript{170} For example, an account owner could contribute funds to plans initially established for different beneficiaries of the same generation, such as her daughter, a niece, and a nephew.\textsuperscript{171} Later the account owner could change the designated beneficiary of the latter two accounts to be her daughter, all ostensibly without the imposition of wealth transfer taxes.\textsuperscript{172}

e. The Broad Estate Tax Exemption

Subject to two exceptions, \$ 529 offers a broad exemption from estate taxation, stating that "no amount shall be includible in the gross estate of any individual for purposes of [the estate tax] by reason of an interest in a qualified tuition program."\textsuperscript{173} One exception to this rule was previously discussed, and deals with the recapture of gifts for which the five year election was made and the donor did not survive for five years.\textsuperscript{174} The other exception provides that the exemption "shall not apply to amounts distributed on account of the death of a beneficiary."\textsuperscript{175}

If the contributor and the owner are the same person, the astonishing breadth of the exemption begins to emerge. For example, if the plan permits

\begin{footnotes}
\item[169] See I.R.C. \$ 529(c)(3)(C)(I), (c)(2).
\item[170] See Merrick, supra note 9, at 319–20. The courts have generally rejected schemes to multiply the annual exclusion amount through transitory gifts to third parties. See, e.g., Schultz v. United States, 493 F.2d 1225 (4th Cir. 1974); Heyen v. United States, 945 F.2d 359 (10th Cir. 1991). However, those arrangements generally require the cooperation of the third party as \$ 529 plans do not and could support the claim of a simple change of heart on the part of the donor.
\item[171] See Merrick, supra note 9, at 320.
\item[172] Id.
\item[173] I.R.C. \$ 529(c)(4)(A).
\item[174] See supra text accompanying notes 138–41.
\item[175] I.R.C. \$ 529(c)(4)(B). The operative language is prefaced with the subtitle "amounts includible in estate of designated beneficiary in certain cases," which suggests that the drafters envisioned the treatment of payments received by the estate of a designated beneficiary who passes away. However, notwithstanding that prefatory language, the operative language is arguably broad enough to insure that if the owner of the account receives a distribution of the plan assets by reason of the death of the designated beneficiary (and no new beneficiary is designated) those funds are subject to estate tax in the estate of the owner.
\end{footnotes}
the contributor/owner to distribute the plan assets to himself or herself, shutting out the designated beneficiary, that would give rise to inclusion under several provisions of the estate tax. For example, § 2038 of the Code imposes an estate tax on interests for which the donor has retained the power to "alter, amend, revoke, or terminate."[176] An account owner's power to revoke the § 529 plan account and demand a refund would surely satisfy this requirement. Moreover, aside from permitting distributions of plan assets to the contributor/owner himself or herself,[177] the power to change the designated beneficiary would probably constitute a power to "alter, amend, revoke, or terminate" the interest under § 2038, as well as the power "to designate the persons who shall possess or enjoy the property or the income therefrom"[178] for § 2036. This type of retained power to determine who may enjoy the property has an inherently testamentary character, a character that traditionally would invoke application of the estate tax.

If the contributor is not the same person as the owner, the contributor generally would have no continuing estate tax concerns.[179] Grandparents contributing funds for the education of their grandchildren could fall into this group if another person serves as the account owner, including a custodian or trustee.[180] However, if the transfer satisfies a legal obligation of support, established doctrine might produce a taxable inclusion of the plan assets in the contributor's estate by application of § 2036(a)(1) of the Code as retained "possession or enjoyment of, or the right to the income from, the property."[181]
If the owner is not the contributor, but wields broad powers over the plan, including the power to distribute the assets to himself or herself, the owner should be considered to possess a general power of appointment, and the appointable assets would be included in the owner’s gross estate by § 2041 of the Code. If the owner is subject to the imposition of a trust on the proceeds of the plan, the power may constitute only a nontaxable “special” power of appointment.

All of this discusses what would have been the estate tax result but for the application of the § 529 exemption. It appears that the § 529 estate tax exemption answers all of these questions simply and conclusively, producing estate tax inclusion only on account of the two narrow statutory exceptions discussed at the beginning of this section.

IV. Assessing § 529’s Favored Status

This part of the essay is an attempt to explain and, if possible, reconcile the special status of § 529 plans that is so inconsistent with established wealth transfer taxation principles.

A. Incremental Repeal of the Wealth Transfer Taxes or Simply Another Loophole?

It might be claimed that the wealth transfer taxation aspects of § 529 were simply an incrementalist, partial repeal of the wealth transfer taxes by a Congress and Presidential administration that were generally antagonistic toward “death taxes.” In that respect, the 2001 Act provided for the temporary repeal of the estate tax and GSTT, and it clearly was the work of such a Congress and President. However, as discussed below, the forces that shaped § 529 are less clear cut. Nevertheless, at the outset one must assume that the wealth transfer taxation system merits concern about its internal coherence.

182. See supra Part III.A for a discussion of constructive trust doctrine, custodianships, and express trusts.

183. The exercise of a so called “special” power of appointment which cannot be exercised for the benefit of the holder, the holder’s creditors, or the holder’s estate, is not treated as a gift or included in the holder’s estate. I.R.C. §§ 2514, 2041.

184. 2001 Act, Pub. L. No. 107-16, § 501, 115 Stat. 38, 69–70 (codified at I.R.C. §§ 2210, 2664) (providing for termination of the estate tax and the GSTT, respectively, for years after 2009). However, section 901 of the 2001 Act provides that its provisions, including the terminations, shall not apply after 2010. Id. § 901(a), 115 Stat. at 150. The gift tax is retained primarily as a backstop for income tax avoidance and also to anticipate the revival of the other taxes for years after 2010.
If the wealth transfer taxation system will or should be eliminated altogether, then why the fuss about polishing the rough edges of legislation such as § 529?

It is beyond the scope of this essay to address the merits of a repeal or substantial revision of the wealth transfer taxation system. For this discussion, it is assumed that the current system will be retained, and therefore the role of § 529 in that overall scheme remains the principal issue. Nevertheless, even if the estate tax and GSTT were abolished, the gift tax would almost certainly be retained, so many of these issues would remain relevant even then.

Section 529 was introduced as part of the 1996 Act enacted on August 20, 1996 near the end of President Bill Clinton's first term and during his bid for re-election. During the November 1994 elections, the Republican Party had gained majorities in both the House of Representatives and the Senate, contributing to a high degree of partisan bickering, stalemate, and vetoes over budgetary matters and implementation of the tax cuts that were the focus of the House Republicans' "Contract with America." The resulting 1996 Act was a mixed bag for both political parties, balancing an increase in the minimum wage as a centerpiece for the Democrats and President Clinton, with a broad assortment of tax relief such as liberalized home office deduction and retirement plan rules, expensing of business property, and S corporation rules. Section 529 was not included in the House Bill and it was introduced in the Senate amendments. It probably was not seen as a significant part of the 1996 Act.

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186. See Brian McGrory, President's Party Basks As He Signs Wage Bill, BOSTON GLOBE, Aug. 21, 1996, at A18, available at 1996 WL 6874102 (suggesting that signing the bill was important to the President's perceived ability in an election year to get things done).


190. President Clinton's statement issued with respect to the 1996 Act did not mention § 529 plans.
The inconsistent wealth transfer taxation rules were enacted later with the 1997 Act amendments. The 1997 Act was, by most accounts, another compromise between Congress and President Clinton, and the wealth transfer taxation changes could have again been considered an immaterial detail in the context of the overall legislative package.

Much of this essay has been spent in explaining § 529's dramatic departure from longstanding principles of wealth transfer taxation. It is clear, of course, that this is within the power of Congress. However, the legitimacy of the overall wealth transfer taxation system could be called into question if fundamental principles can be so readily discarded. At least from the standpoint of taxpayers and their advisors, one would usually place some value on the predictability, and protection of reliance interests, that follow from continuity and adherence to custom. However, that may not be a forceful objection in this situation because § 529 is an almost unqualified pro-taxpayer provision, without much of a hint of an adverse result. In addition, § 529 plans are a new creation, so taxpayers and their advisors will necessarily need to learn about their tax consequences as a matter of first impression; the new statute does not uproot an existing provision dealing with the same area.

Even if § 529 lacks coherence with many wealth transfer taxation principles, an immediate response is: "So what?" Although there is some fundamental logic to the Code, much of the detail is a hodgepodge of layers of inconsistent compromises. Nevertheless, an unprincipled piece of legislation may be seen to lack integrity in carving out its special


191. While the wealth transfer tax exemptions were set firmly in place with the 1997 Act amendments, the section still provided only for the deferral of income taxes as the account accumulated. See supra Part II.A (discussing the history of the income tax treatment of § 529 plans). The 2001 Act expanded the benefits of § 529 by introducing the income tax exemption for distributions used for qualified higher education expenses. 2001 Act, Pub. L No. 107-16, § 402(b), 115 Stat. 38, 61-62.

192. See Ann McFeatters, Clinton, GOP Call a Truce for Tax Cuts, PATRIOT LEDGER (Boston), Aug. 6, 1997, at 4, available at 1997 WL 8187715 ("The new laws were hammered out of the granite of partisan rancor that turned into a desperate need to show voters that Congress and the White House could get something done."); Marsha Mercer, Clinton Lauds Bipartisanship Behind Budget; He Signs Bills That Will Cut Taxes for Many, RICHMOND TIMES-DISPATCH, Aug. 6, 1997, at A2, available at 1997 WL 7625738 ("Clinton lauded the bipartisanship that led to the first balanced budget in nearly 30 years: 'The sun is rising on American again.' . . . Like Reagan, Clinton embraced a tax cut, but, unlike Reagan, Clinton also held out for increases in spending on education, health care and welfare benefits.").

193. In statutory interpretation, for example, some would apply a presumption of interpretation favoring continuity over change in legal obligations to protect reliance interests. E.g., WILLIAM N. ESKRIDGE, JR., DYNAMIC STATUTORY INTERPRETATION 137-40 (1994).

194. Ronald Dworkin makes much of integrity in legislation, aiming to create laws that are morally
dispensations. If § 529 is seen as an unsupportable loophole, inconsistent with the rest of wealth transfer taxation principles, that perception arguably could be corrosive to the overall respect for, and compliance with, the wealth transfer tax system. Certainly, a wealth transfer taxation "purist" might be offended by the unprincipled assault on the structure of the wealth transfer taxes. While taxpayers and their advisors may have reduced respect for the wealth transfer tax laws, albeit an already porous system, it is probably quite a leap to assert that any substantive problem, such as a reduction in compliance with the system, is a consequence of Congress' actions in this regard.

All of this brings us full circle to where this section began: the question whether § 529 is just another example of Congress not taking wealth transfer taxation seriously. It could be just that or, as discussed below, § 529's approach might be justified.

B. The Special Status of Education Incentives

If § 529 reflects a policy of encouraging incentives for education, is the special status of § 529 justified on that basis, and on such a scale? In that respect, the Economic Recovery Tax Act of 1981 singled out education expenses for special treatment for wealth transfer taxation purposes. That act introduced § 2503(e) of the Code, which permits unlimited gifts of tuition

coherent. RONALD DWORKIN, LAW'S EMPIRE 176–84, 190–92 (1986).

195. The purist would most likely be a person without a direct stake in the discussion, such as a law professor.

196. Although limits (such as the enactment of §§ 2701–2704 of the Code in connection with corporate and partnership valuation freezes) have been placed on some of the particular gimmicks identified by Professor Cooper, the wealth transfer taxes are probably no more comprehensive than when he published his famous article referring to the system as a de facto "voluntary tax." See generally George Cooper, A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance, 77 COLUM. L. REV. 161, passim (1977).


198. Id. § 441(b), 95 Stat. at 319. Section 2503(e) in part states:

Any qualified transfer shall not be treated as a transfer of property by gift for purposes of this chapter. . . . For purposes of this subsection, the term "qualified transfer" means any amount paid on behalf of an individual as tuition to an educational organization described in [§] 170(b)(l)(A)(ii) for the education or training of such individual, or . . . to any person who provides medical care (as defined in [§] 213(d)) with respect to such individual as payment for such medical care.

Section 529 acknowledges the kindred nature of §§ 529 and 2503(e) by expressly providing that a contribution to a qualified tuition program shall not be treated as a qualified transfer under § 2503(e). I.R.C. § 529(c)(2)(A)(ii).
and fees, free of gift taxes, and the GSTT. A gift tax return is not required to claim the exclusion. From a gift tax standpoint, the § 2503(e) exclusion may be appropriate because the transfer is for immediate consumption by the donee, and there is not a direct opportunity for an accumulation of wealth by the donee. In 1969, the American Law Institute proposed such a gift tax exclusion reflecting the "transfer-for-consumption" idea. This concept prompted other proposals to expand the annual gift tax exclusion for other transfers beyond the limited scope of § 2503(e). The wealth transfer taxation of § 529 plans is consistent with this concept if the funds are all consumed for education expenses. If the funds are consumed for other purposes, or refunded to the donor/account owner, the concept does not apply. In that respect, the 1996 Act's version of § 529 had it right—treat the original contribution to the § 529 plan as a nontaxable event and wait and see how the funds are applied. If the funds are applied for qualified higher education expenses, then no taxable gift is created.

Even assuming that § 2503(e) is an appropriate exemption, it is very circumscribed. The payments must be made directly to the educational institution, and it covers only tuition and fees, not room and board. Section 529 in comparison also permits distributions for living expenses. Because of the § 2503(e) requirement that payments be made directly to the educational institution, there is no possibility of the beneficiary using the payments for other purposes, or for the donor reclaiming the transferred amounts. Section 529 in comparison permits contributions to the plan far in

199. The GSTT exemption is implemented by § 2642(c) of the Code, which dictates a zero tax for direct skips that qualify as nontaxable gifts due to § 2503(b) or (e). Furthermore, § 2611(b)(1) exempts from the GSTT, transfers which, if made inter vivos by an individual, would not be treated as a taxable gift by reason of § 2503(e). This exemption would encompass transfers such as a bequest by an estate, as well as distributions for education expenses by a trust, if the manner of payment would have otherwise qualified under § 2503(e).


201. Of course, if the donee can preserve other resources that would have been used to pay the education expenses or avoids borrowing to meet the education expenses, the donee is indeed better off, even if one ascribes no value to the education purchased with the gifts.


203. E.g., Dodge, supra note 177, at 343-44.


205. Id.


advance of when the designated beneficiary will actually attend the institution of higher learning. Because of the ease with which new beneficiaries can be designated if they are members of the broad class of "family" as defined in the statute, remaining funds in the plan can be diverted to new designated beneficiaries who were unborn at the time of the original gift. In addition, § 529 plans can permit the donor/owner to reclaim the funds as a refund. Nevertheless, if the § 529 plan funds are ultimately applied toward education costs, the transfer for consumption principle underlying § 2503(e) would arguably apply with some force.

The § 2503(e) exclusion is not an estate tax exclusion. In comparison, § 529 also offers an estate tax exclusion. It is not a convincing argument that the estate tax exemption is necessary to implement the overall education tax incentives of § 529 by complementing the income tax exemption for plan earnings. The Roth IRA, for example, was created as an incentive for retirement savings, and it, like the § 529 plan, offers an income tax exemption. However, the unexpended proceeds of a Roth IRA are included in the decedent's estate for estate tax purposes. Likewise, the proposed RSAs and LSAs are also included in a decedent's gross estate. One could argue that the Roth IRA is fundamentally different, however, because upon death the account owner has no further need for the retirement funds. In comparison, it would usually be the case that the designated beneficiary who survives the deceased § 529 plan account owner would have further need for the § 529 plan funds. The deceased § 529 account owner nevertheless had access to the funds. Like the owner of a Roth IRA, he or she could have tapped the § 529 plan funds if necessary during his or her lifetime. The § 2503(e) analogy in that respect is not compelling because § 2503(e) deals with completed gifts to a third party for the benefit of a student. The estate

208. Id. § 529(c)(3)(C), (e)(2).
209. "The proposal as to transfers for consumption is applicable only to lifetime transfers. The considerations behind the proposal do not carry over significantly to deathtime dispositions. This, of course, is also true of the annual per-donee exclusion which is not available with respect to deathtime transfers." Am. Law Inst., supra note 202, at 20. Some of the special lifetime considerations include limiting taxpayer recordkeeping and filing burdens, consistency with normal taxpayer expectations of what should be a taxable gift, and avoiding close questions of what constitutes regular support.

211. Id. § 408A(d).
212. See id. § 2039.
213. See Office of Public Affairs, supra note 65.
214. This argument is still valid if the account holder is married, because the estate tax marital deduction would defer estate taxes otherwise imposed on account proceeds passing to the surviving spouse. I.R.C. § 2056.
tax, in comparison, is concerned with powers over property that the decedent retains at death, which is a separate issue. It is not inconsistent or inappropriate to impose an estate tax on § 529 plans in this situation.

C. Simplicity

It is a basic tax policy tenet that, all other factors being equal, a simple tax system is preferable to a more complex one. This obvious, common sense notion is supported by benefits of improved enforcement and compliance and reduced transaction costs. With the applicable exclusion amount currently $1,500,000 and set to increase to $3,500,000 by 2009, the wealth transfer taxes will increasingly be a concern only to people of more than moderate wealth. This might suggest that there is no need to focus on the details and the creation of exemptions, inasmuch as most Americans would never be subject to wealth transfer taxes, irrespective of whether § 529 assets are included in their gross estates. A § 529 structured along the lines of established wealth transfer tax principles that is more inclusive from a wealth transfer tax perspective would consequently apply to everyone, but might only have effects on wealthier taxpayers, implementing the broader goals of the wealth transfer tax.

Still, this end result approach to the § 529 exemption could be undesirable. Unless the gift tax return filing obligation is fundamentally changed, even individuals of modest wealth would be potentially snared by a system in which § 529 were more inclusive. Consistent with the primary justification for the annual gift exclusion as a de minimis amount for routine gifts, § 529 contributions should be subject to minimal gift tax reporting to avoid making individuals of modest wealth subject to unnecessary transaction costs or become non-filers. Aside from the gift tax return filing obligations, a less liberal § 529 wealth transfer tax posture could discourage even persons

215. Professor Casner, as the Reporter to the American Law Institute study of wealth transfer tax reform, identified seven goals to guide the study. One goal was "to have a tax system that is readily understandable in the normal and routine transfer situations." AM. LAW INST., supra note 202, at 78. David Bradford argues that "[b]y undermining popular support, complexity erodes the self-assessment on which economical compliance depends." DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 266 (1986). He divides complexity into three types: compliance complexity (required records and forms), transactional complexity (taxpayer planning responses), and rule complexity (interpreting the law). Id. at 266–67.

216. I.R.C. § 2010(c).

217. Under a more robust wealth transfer tax treatment of § 529 accounts, the estate tax return would not be a concern for individuals of moderate wealth because a return does not need to be filed if the gross estate, plus adjusted taxable gifts, does not exceed the applicable exclusion amount. Id. § 6018(a).
of modest wealth from financial planning for the education of family members by creating a perception of an overly complex system in which one does not want to become entangled. That would defeat the legislation’s goal of encouraging saving for higher education, particularly for individuals of modest wealth. These competing tensions are considered in Part V, where this essay proposes some amendments to § 529.

D. Incentives, Subsidies, and Loopholes

It can be unpopular to criticize tax provisions that reduce taxpayers’ burdens, particularly for something as fundamental and costly as higher education. However, if a progressive income tax rate structure remains an accepted feature of the income tax system,\textsuperscript{218} it would seem that the subsidy for higher education expenses should be limited on the basis of income. This would reinforce the progressivity of the income tax structure. It would also direct the subsidy to those taxpayers who might not be able to attend college but for the subsidy, rather than directing the subsidy to taxpayers who would attend college in any event. As demonstrated earlier, other income tax subsidies for education such as the Hope Scholarship Credit,\textsuperscript{219} Lifetime Learning Credit,\textsuperscript{220} deduction for tuition and fees,\textsuperscript{221} and Coverdell Education Savings Account\textsuperscript{222} all contain phase-outs of contributions tied to income.\textsuperscript{223} The § 529 plan contains no such limits.

\textsuperscript{218} The current income tax structure is indeed progressive if measured by the progression of the income tax rate structure, which currently ranges from 10\% to 35\%. \textit{Id.} § 1. The effective rate of tax, after taking into account exclusions, deductions, exemptions, credits, phase-outs of certain items, and so forth, will not necessarily reflect the progression of that rate structure—the effective rates of tax are probably flatter. Still, although the degree of progressivity may be in question, it is probably a fair statement that the overall structure is progressive to some degree. This essay assumes that maintaining the progressive structure that has survived almost a century of legislative pushes, pulls, and adjustments of the Code is a valid objective in assessing the income tax system. It is beyond the scope of this essay to otherwise join the debate on the merits of a progressive income tax structure. \textit{E.g.}, Joseph Bankman & Thomas Griffith, \textit{Social Welfare and the Rate Structure: A New Look at Progressive Taxation}, 75 Cal. L. Rev. 1905 (1987); Walter J. Blum & Harry Kalven, Jr., \textit{The Uneasy Case for Progressive Taxation}, 19 U. Chi. L. Rev. 417 (1952); Donna M. Byrne, \textit{Progressive Taxation Revisited}, 37 Ariz. L. Rev. 739 (1995); Marjorie E. Kornhauser, \textit{The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction}, 86 Mich. L. Rev. 465 (1987).

\textsuperscript{219} I.R.C. § 25A(b).

\textsuperscript{220} Id. § 25A(c).

\textsuperscript{221} Id. § 222.

\textsuperscript{222} Id. § 530.

\textsuperscript{223} Id. § 408A(c)(3) (Roth IRA limits on the contributor’s income); id. § 530(c)(1) (Coverdell Education Savings Account limits on the contributor’s income).
With the potent income tax benefit of tax-exempt savings, one might expect limits on the amount of contributions. That is the case with the Coverdell Education Savings Account and the Roth IRA. The § 529 plan contains a vague limit to avoid overfunding accounts,²²⁴ but, as discussed earlier, that has been interpreted as permitting accumulations as great as $315,270 per designated beneficiary.²²⁵

Although the income tax exemption apparently drives the interest in the § 529 plan, the wealth transfer taxation aspects can be significant for wealthier individuals. Furthermore, the benefits of § 529 plans increase with the marginal income tax rate of the contributor or account owner, and the attractiveness of § 529 plans is reportedly greatest for wealthier taxpayers who do not rely on the subsidy in order to attend college.²²⁶ A recurring criticism of the increase in contribution limits for IRAs and retirement plans asserts that few taxpayers have enough disposable wealth to fully take advantage of the expanded contribution limits.²²⁷ Accordingly, wealthier taxpayers are the primary beneficiaries of such legislation.²²⁸ That might become the case with § 529 plans as well, especially considering that § 529 plans are a welcome vehicle to which taxable accounts can be shifted to avoid the imposition of income taxes as well as estate taxes.²²⁹ As discussed earlier in this essay, if the limits of the Roth IRA are eliminated with the enactment of RSAs and

²²⁴ ld. § 529(b)(6).
²²⁵ See The Internet Guide to Funding College: Maximum Contributions, supra note 58.
²²⁶ E.g., Merrick, supra note 9, at 316 ("The resulting states' plans are designed primarily with wealthy investors in mind."); Thomas, supra note 9 ("Robert J. Kuehl, a certified financial planner . . . says he is 'neutral on § 529 plans except in specific cases. I don't think for the average client they are the most practical or prudent approach. They are best for high net worth individuals.'"). A bar journal article even suggests that a highly compensated individual, such as a partner in a major law firm, could open a § 529 plan account to provide for education, including living expenses, during a career change. Gunnarsson, supra note 159, at 174. The cost of the tax subsidy produced by the income tax exemption for qualified tuition program earnings will increase with invested assets. Recent estimates quantify that subsidy as $0.5 billion for 2004, rising to $0.9 billion by 2008. STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2004–2008, at 25 (Comm. Print 2003).
²²⁸ Id.
²²⁹ E.g., News and Views: Prepaid College Tuition Plans: A Government Bounty for Middle-Class Whites, J. BLACKS HIGHER EDUC. 41 (Winter 1996), available at 1996 WL 15734544 ("Enrollment data for the states that presently operate these prepayment plans demonstrate that the plans primarily benefit middle- and upper-income families"); see also Michael A. Olivas, State College Savings and Prepaid Tuition Plans: A Reappraisal and Review, 32 J.L. & EDUC. 475, 501 (2003) (suggesting that the benefits of § 529 plans may be skewed toward upper-middle class and wealthy families). A recent study of § 529 plan ownership could not determine whether § 529 plan investments are "new dollars saved or dollars shifted from other investments." Dynarski, supra note 16, at 365 n.10.
LSAs, those new savings vehicles could divert many, if not most, potential § 529 contributors from making such contributions to instead making contributions to RSAs and LSAs. The result would be to further channel only wealthy taxpayers into § 529 plans. For the wealthy, the extraordinary exceptions from wealth transfer taxation created by the § 529 plan are simply too broad if Congress is interested in preserving the integrity of wealth transfer taxes.

V. FIXING § 529

A. Revisiting the 1996 Act

The 1996 Act’s version of § 529, although flawed, came close to balancing simplicity and incentives for saving with preserving the coherence of the wealth transfer tax system. As discussed above in Part III, contributions to the plan were treated as a nontaxable incomplete gift. Accordingly, no gift tax return would need to be filed by anyone. Distributions from the plan that were used for qualified higher education expenses were not treated as gifts. That is consistent with the “transfer-for-consumption” doctrine discussed in Part IV. Still, the broad incomplete gift rule of the 1996 Act was not consistent with established principles if the contributor retained no continuing control over the § 529 plan.

The estate tax treatment of the 1996 Act was also imperfect, as it included the value of the account in the contributor’s gross estate rather than in the estate of the account owner who typically enjoyed power over the account.

230. See supra notes 74–76 and accompanying text.
231. “In no event shall a contribution to a qualified State tuition program on behalf of a designated beneficiary be treated as a taxable gift for purposes of chapter 12.” 1996 Act, Pub. L. No. 104-188, § 1806, 110 Stat. 1755, 1896 (current version at I.R.C. § 529(c)(2)).
232. I.R.C. § 6019(1).
233. The 1996 Act treated a distribution as a gift at that time, but if the distribution was made directly to the educational institution, it was treated as a qualified transfer under I.R.C. § 2503(e), ultimately producing no taxable gift. See supra notes 95–98 and accompanying text.
234. “The value of any interest in any qualified State tuition program which is attributable to contributions made by an individual to such program on behalf of any designated beneficiary shall be includible in the gross estate of the contributor for purposes of chapter 11.” 1996 Act § 1806, 110 Stat. at 1897 (current version at I.R.C. § 529(c)(4)).
B. Improving the 1996 Act

1. Wealth Transfer Tax Modifications

The 1996 Act's treatment of § 529 plan contributions as incomplete gifts was generally consistent with established wealth transfer tax principles. However, the 1996 Act was not consistent with wealth transfer tax doctrine in deeming all contributions to be incomplete gifts. A donor who is not also the account owner, such as a grandparent making contributions on behalf of a grandchild, should be treated as making a completed gift to the account owner. Because there is no question as to the identity of the donee, the statute should provide that the gift is treated as a present interest eligible for the annual exclusion. This is consistent with the 1997 Act's treatment of gifts. Although this introduces some complexity into the scheme, if the annual contributions do not exceed the annual gift exclusion, no gift tax return will be required.

The 1997 Act's special five year election permits front-loading of the contributions, but that produces complications of its own because it requires a gift tax return where none would have been required had the contributions been actually made over five separate years in an amount not in excess of the annual exclusion. Moreover, if the donor dies during the five year period, one must contend with the estate inclusion rule. Finally, as a matter of wealth transfer taxation policy, this type of front-loading is an extraordinary estate depleting preference that ostensibly can be utilized only by the very wealthy who can afford such large lump sum cash gifts, the group for which wealth transfer taxes are retained. The benefits of the front-loading can be multiplied by making maximum gifts on behalf of multiple beneficiaries, such as contributions for several grandchildren. Although opinions may differ on the

235. Consistent with current law, the contribution would also be exempt from the GSTT. See I.R.C. § 2642(c).
237. Id.
238. Id., 111 Stat. at 811 (current version at I.R.C. § 529(c)(2)(B)).
239. Id. § 211(b)(3)(B), 111 Stat. at 811 (current version at I.R.C. § 529(c)(4)(C)).
significance of this provision, the five year election should be eliminated because of its potential for abuse.

If the donor is not the account owner and has no retained power over or rights to the plan assets, the account should not be included in the donor's estate. This approach would preserve an estate planning incentive for transfers to § 529 plans, but would be a result consistent with fundamental wealth transfer tax principles.

If the account owner is not the donor, there should be a completed gift to the account owner for contributions made. Because the account owner has the equivalent of a general power of appointment, the account proceeds should be included in the account owner's estate. Estate planning techniques would probably emerge that emphasize naming the designated beneficiary as the account owner, assuming that the designated beneficiary has little wealth to comprise a taxable estate, as well as a lower probability of dying while there are unconsumed account assets. Of course, many donors would not want an

240. The benefits of front-loading the gifts might be quantified as follows, assuming a five percent growth rate:

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<td>0</td>
<td>3,343</td>
<td>70,195</td>
<td></td>
</tr>
</tbody>
</table>

Interest Rate = 5.0%

If the donor lives for the five years, the "estate depletion" is the potential growth of the excess donation during such time before it would otherwise be available (and made) as annual exclusion gifts. The principal of the gift is not an estate depleting transfer because it is included in the estate of the donor who dies before the expiration of the five years, but even then there is an advantage because only the original gifted amount is included, not any appreciation. I.R.C. § 529(c)(4)(C). Assuming the donor survives for five years and the account earns a five percent return per year, the front-loading produces about $6300 of additional growth per donee than is possible if the gifts were made $11,000 per year. The advantage would be multiplied by the number of donees, and the savings would be increased if the investment returns exceeded the assumed five percent.
infant or other designated beneficiary to be the account owner. A grandparent, for example, would often prefer, from the standpoint of prudence and indirect control, that their child be the account owner.

If the donor is also the account owner, there should be no completed gift for contributions, but the account proceeds should be included in the account owner's estate. The estate tax inclusion would arise only if the account proceeds are not exhausted prior to the account owner's death, so for parents contributing for the benefit of their children this result could be the exception. Distributions for qualified higher education expenses would not be treated as gifts, applying a rough analogy to § 2503(e). Distributions to individuals other than the account owner for other than qualified higher education expenses would be treated as a gift and, in addition, a GSTT transfer if the generation assignment of the distributee is two or more generations below that of the account owner.

As a precaution against the creation of potentially excessive accumulations and manipulations of plan assets, one might retain the gift and GSTT rule of the 1997 Act that imposes a gift tax and GSTT if a beneficiary is a generation or more below the original designated beneficiary. However, if the plan assets are potentially included in the account owner's estate, this should not be a concern. Indeed, this aspect points out the dilemma posed by § 529 plans in general: in the absence of the current wealth transfer tax exemptions, the wealth transfer taxation aspects would be a function of the structure of the plan agreements. That structure may evolve, rendering the underlying statutory assumptions no longer applicable. As discussed later, there is some question whether, after all of the predictable adaptive modifications in § 529 plan structure, changes to the statute would produce significant additional wealth transfer tax revenues.

2. Income Tax Modifications

It is probably true that the income tax aspects of § 529 plans are paramount, with the wealth transfer taxation aspects of secondary importance. The future of § 529 plans will probably turn on Congress' appraisal of those income tax benefits. However, certain modifications to the overall provisions governing § 529 plans could play a role in improving the wealth transfer tax

considerations by removing some of the incentives for behavior that might compromise the integrity of the wealth transfer tax system.

For example, as suggested earlier in this essay, it may be appropriate to impose an overall cap on § 529 plan contributions for a given designated beneficiary that would be cumulative across all § 529 plans. In addition, in contrast with the current, pliable contribution standard, a fixed cap could be imposed, far short of the $315,270 figure currently permitted. Even with soaring college costs, that is a large sum and commands a large income tax subsidy. In comparison, the estimated average 401(k) retirement balance in 2003 was only $64,600 for all participants.\footnote{242}

With the limits placed on the Hope Scholarship Credit, Lifetime Learning Credit, and the Roth IRA, § 529 plans should also be subject to meaningful limits. Also, contributions could be phased-out for higher income taxpayers.\footnote{243} Arguably, the children and grandchildren of higher income taxpayers would not be denied access to a college education even in the absence of a § 529 plan, so the § 529 plan provides a welcome, but unnecessary, windfall subsidy.\footnote{244} Limitations on the age of the designated beneficiary, the amount of contributions, and the income levels of contributors would make the treatment of § 529 plans more consistent with the Coverdell Education Savings Account.\footnote{245} Consideration should be given to increasing penalties on distributions not made for qualifying higher education expenses;\footnote{246} mindful that excessive penalties could reduce participation by

\begin{itemize}
\item \footnote{242} U.S. Employees Sluggish in Interacting with 401(k) Plans, Workspan, July 1, 2004, available at 2004 WL 69512789. This estimate was based on a study conducted by Hewitt Associates. The study also found that the average participant was 43 years old, had 10 years of tenure, and earned a $59,000 salary. \textit{Id.} A study of § 529 plan owners found that education savers have higher incomes ($91,000 median income) and higher net worths ($281,000 median net worth) than the rest of the population, but also as compared to retirement savers. \textit{See} Dynarksi, \textit{supra} note 16, at 365. \"[T]hose who take up \[§\] 529 and Coverdell accounts are a relatively elite group.\" \textit{Id.}

\item \footnote{243} Income is an admittedly rough proxy for the wealth of the taxpayer, but here the income tax aspects are more robust than the wealth transfer tax aspects, so this is appropriate if one likens it to the income limitations for Roth IRAs. For a critical discussion of the imposition of phase-outs and limitations, see generally Richard J. Kovach, \textit{A Seldom Considered Aspect of Tax Fairness and Simplification: The Need for a Coherent Policy Perspective on the Many and Varied Dollar Limitations Contained in the Internal Revenue Code,} I Pitt. Tax Rev. 1 (2003) (discussing the imposition of phase-outs and limitations).

\item \footnote{244} \"And at a time when access to higher education is increasingly becoming the ticket to economic opportunity, the complete tax exemption of § 529 plans exacerbates existing income and wealth inequalities and operates to perpetuate these disparities into succeeding generations.\" Kaplan, \textit{supra} note 227, at 2000.

\item \footnote{245} While beyond the scope of this essay, it is readily apparent that the frustrating jumble of education incentives needs to be coordinated, simplified, and reduced in number.

\item \footnote{246} An inclusion in taxable income plus a ten percent penalty regime applies to premature withdrawals of assets from retirement plans. Nevertheless, by one account, less than 50% of those
taxpayers of more moderate wealth, who would be more interested in
emergency access to the funds. Moreover, if the wealth transfer taxation
provisions were to remain in their current form, such limitations would better
prevent the use of § 529 plans for significant wealth transfer tax avoidance
purposes.

C. A Potential Empty Victory of Principles

As noted earlier, a fault of the 1996 Act's version of § 529 was
prescribing an absolute rule of estate tax inclusion, irrespective of the actual
terms of the tuition program. A fault of the current version of § 529 as
introduced by the 1997 Act is that it prescribes an absolute rule of estate tax
exclusion, irrespective of the actual terms of the tuition program. Either
approach can be valid, depending on the desired outcome: revenue
enhancement versus not impeding incentives for desired taxpayer behavior.
Both approaches provide a simple rule that is easy to apply and there is some
value in that from the standpoint of taxpayer compliance.

Neither approach promotes national uniformity in the terms of § 529
plans, as both approaches essentially ignore the actual terms of the § 529 plan.
For example, the 1996 Act would include the plan assets in the gross estate of
the contributor, whether or not the contributor was also the account owner.

individuals who receive premature distributions from retirement plans reportedly roll over those assets into
IRAs to avoid the income tax and ten percent penalty. Edward J. Gac & Wayne M. Gazur, Tapping "Rainy
Day" Funds for the Reluctant Entrepreneur: Downsizing, Paternalism, and the Internal Revenue Code,
employees who left their jobs in 2002 produced better results. Eighty-seven percent of those with 401(k)
account balances of $5,000 or less cashed out, presumably paying the income tax and premature withdrawal
penalty. Kelly K. Spors, Moving Pains: Rolling Over Your 401(k) when You Leave a Job Can Be Difficult;
However, only twenty percent of those with 401(k) account balances exceeding $5,000 cashed out. Id.

247. In the context of life insurance and retirement savings accounts, it has been shown that access
to the invested funds (e.g., through loan provisions) can increase participation by taxpayers of more
moderate means. Gac & Gazur, supra note 246, at 150. A study of § 529 plan ownership concluded that
the income tax and ten percent penalties imposed for nonqualifying use of plan assets can disadvantage
lower income taxpayers more than higher income taxpayers because of the greater differential in income
tax rates between the contributor and the beneficiary, who ostensibly would pay the income tax, for higher
income taxpayers. Dynarski, supra note 16, at 382-83. Professor Dynarski suggests that this result could
be altered by taxing withdrawals at the parents' tax rate and by modifying the ten percent penalty to be
proportional to the account owner's tax rate, rather than be imposed at a flat ten percent for all taxpayers.
Id.

248. See supra note 234.
249. See supra Part III.B.2.e.
250. See supra note 234.
The 1997 Act would exclude the plan assets from the gross estate of a contributor/account owner who holds the power to reclaim the plan assets.\textsuperscript{251} Still, if a more principled approach to the estate taxation of § 529 plans is applied (i.e., one that looks to the substance of the powers created by the § 529 plans), that will involve more complexity. The complexity may be reduced with experience and routine, as has been the case with life insurance,\textsuperscript{252} but it would further shape the terms and structures of § 529 plans.

For example, if traditional wealth transfer tax principles were applied to § 529 plans, an estate tax sensitive donor would not become the account owner, thereby avoiding the powers of revocation and the power to change the designated beneficiary. An account owner who is not the donor may still be taxable under traditional principles as the holder of a general power of appointment, due to the refund feature.\textsuperscript{253} One would expect that wealth transfer tax sensitive account owners would avoid a refund feature and be content with wielding only the power to designate beneficiaries, other than himself or herself, to gain the benefit of retaining only a nontaxable special power of appointment.\textsuperscript{254} This would involve a greater degree of complexity over the current system. Even if the § 529 plan contract terms did not evolve sufficiently, the estate tax sensitive donor could avoid the powers of revocation by creating an irrevocable trust to invest in the § 529 plan.\textsuperscript{255}

Ultimately, the thrust of the changes would be to force donor/account owners to relinquish control over the § 529 plan or suffer the estate tax inclusion consequences. While that is consistent with the overall structure of the estate tax, it is relatively easy to avoid those consequences. It is easier for wealthier taxpayers, with other available resources, to relinquish that control. Relinquishing the refund aspect would probably reduce the attractiveness of the § 529 plan, particularly to less wealthy donors, but only for those who are wealthy enough to be sensitive to wealth transfer taxes.\textsuperscript{256}

\textsuperscript{252} With proper planning, almost no life insurance proceeds should ever be includable in the insured's gross estate if the retention of "incidents of ownership" is avoided. See I.R.C. § 2042. The principal exception is the death of the insured within three years of the transfer of the policy, which invokes § 2035 of the Code. This planning is very routine and well understood by most life insurance salespeople.
\textsuperscript{253} See I.R.C. §§ 2041, 2514.
\textsuperscript{254} See id.
\textsuperscript{255} See supra notes 89–91 and accompanying text.
\textsuperscript{256} One could envision plans with various options, some for wealth transfer tax sensitive taxpayers, others for those without wealth transfer taxation issues. Indeed, for donor/account owners of moderate wealth, one might see § 529 plans that still offer a refund feature, because the assets could be included in
Reforms would inevitably produce planning responses and a proliferation of more § 529 plan ownership options, but perhaps little substantive change beyond more transaction costs would result. One matter of substance that would be accomplished would be forcing estate tax sensitive taxpayers to relinquish direct control over § 529 plan accounts.257

Nevertheless, in spite of this dreary appraisal of the end results of wealth transfer tax reforms, § 529 plans do require some modifications. If progressivity remains a policy goal of the income tax system, § 529 plans do require some limitations from the perspective of income taxes. As discussed earlier in this essay, limitations on the amount of contributions and the income of contributors, much like the Coverdell Education Savings Account and the Roth IRA, could focus the § 529 plan more on taxpayers who need the most help with funding higher education.258 Eliminating much of the income tax "magnet" of § 529 plans could also indirectly, but more fundamentally, place more constraints on the wealth transfer tax avoidance potential of the plans. These conclusions could very well be upset by the creation of new savings vehicles such as the RSA and LSA discussed earlier, which could further restrict the § 529 plan clientele to the very wealthy.259 In that event, the wealth transfer tax provisions may indeed need to be revisited along the lines of this Article.

257. Forcing disposal of control over § 529 plan assets in order to avoid estate tax is the practical effect of the reforms. Much of the inclusionary aspects of the estate tax are built on that principle of retained control and disposing of control is the key to estate tax avoidance. See, e.g., I.R.C. §§ 2036-2038, 2042. It may seem like a waste of resources to maintain a system that can be so easily avoided, but a review of the case law will confirm human nature's desperate need to retain control. Disposing of control over wealth is not a trifling matter for many individuals.

258. Ironically, although such reforms could reduce the attractiveness of § 529 plans to wealthy taxpayers, they would not necessarily increase the attractiveness of the plans for less wealthy taxpayers. Indeed, one study concludes that § 529 plans can have a negative impact on lower and middle income taxpayers if the account balances are treated as an asset that reduces college financial aid awards. Dynarski, supra note 16, at 382-83. In comparison, very wealthy taxpayers who do not otherwise qualify for financial aid do not share that concern. Id. Although beyond the scope of this essay, it is questionable whether the tangle of education tax subsidies provided by the Code is the best tool for distributing financial aid for higher education, as compared with the traditional case-by-case evaluation of financial need.

259. See Office of Public Affairs, supra note 65.
VI. CONCLUSIONS

Section 529 currently carves out extraordinary exceptions to established wealth transfer taxation principles. Congress will have an opportunity to revisit the statute before its 2011 sunset date. At the same time, Congress will probably be assessing the role of the federal estate tax, which in 2011 is scheduled to be restored to its pre-2001 Act status. Although the income tax benefits of § 529 will probably take center stage, there will be an opportunity to reappraise the wealth transfer tax aspects.

If Congress is interested in restoring coherence to the wealth transfer taxation aspects of § 529, simple amendments could accomplish that. As proposed in this essay, most of the amendments should have little impact on the overall incentives to creating § 529 accounts, at least with respect to the moderately wealthy taxpayer. To some extent, they would add to the complexity of the provision, as compared with the current statute, which provides few limits on wealth transfer tax avoidance. There is also some question whether the changes restoring established wealth transfer taxation principles would provide much additional limits on wealth transfer tax avoidance after taxpayers and § 529 plans adjust to the changes.

Consequently, this essay concludes that if § 529 is to be modified, the more appropriate focus is on limiting the income tax exemption. Dollar limits on contributions and contribution limits on high-income taxpayers should be considered, as well as age limits for the designated beneficiary, to create consistency with other education incentives and the Roth IRA. Those limits may also reduce the attractiveness of § 529 plans to wealthier individuals, producing a correlative reduction in possible abuses of the wealth transfer tax system.
