

Maximizing the Benefits of Maryland's Section 529 Plans:  
Choices Under the College Investment Plan

When President Bush signed the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act"), college savings plans authorized under § 529 of the Internal Revenue Code became even more attractive vehicles to save for a child's college education. Prior to the Act's passage, earnings within a "Section 529 account" accumulated free of taxes, but disbursements were taxable. The Act provided that certain disbursements for "qualified expenses" may be made tax-free. Qualified expenses include tuition, fees, books, room, and board at colleges, universities, and graduate schools. Thus, under the revised § 529, money contributed to an account and used to pay approved higher education expenses can grow and be spent without ever paying taxes on investment earnings.

Section 529 plans are established by the states and generally are managed by one of the large financial management firms. Nearly every state operates at least one Section 529 plan. Maryland maintains two different plans. The first -- the Maryland Prepaid College Trust -- allows participants to buy credit, loosely based on current tuition costs, toward future college tuition for children from newborn to 9th grade, thereby guarding against rising costs of public college education in Maryland. While the Prepaid College Trust guarantees against rising tuition at one of Maryland's public colleges or universities, that guarantee does not extend to private or out-of-state schools. The funds available to a child attending an out-of-state or private institution will be limited to a "weighted average" of Maryland's public college tuition costs.

The second -- the Maryland College Investment Plan (the "College Investment Plan") -- does not provide any guarantee against future costs, but allows participants to invest assets in a tax-advantaged environment. The Maryland College Investment Plan exposes its participants to the risks and potential benefits of investment performance. Thus, a person who wishes to contribute to the education costs of an older student or a student who hopes to attend a private or out-of state school, or a person who is willing to run some risk in order to better participate in investment rewards, may find the College Investment Plan more attractive than the Prepaid College Trust. Detailed information about the College Investment Plan, including the plan disclosure statement and enrollment forms, can be found at the College Savings Plans website, [www.collegesavingsmd.org](http://www.collegesavingsmd.org).

1. General Overview of the College Investment Plan

(a) Opening an Account. Contributions to a College Investment Plan are held in an individual account or accounts and invested in one or more of ten

investment portfolios. Each account has a single Beneficiary, who can be any person of any age, and an Account Holder, who can be any individual or legally recognized entity (including a trust). The Account Holder controls the account, choosing investment portfolios and directing disbursements and rollovers. The Account Holder need not be the person who makes contributions to the account.

(b) Contribution Limits. The minimum initial contribution is \$250, except for accounts funded by payroll deductions or automatic monthly deductions directly from a bank account. The minimum subsequent contribution is \$25. No additional contributions are permitted once the aggregate balance of all accounts held for a single Beneficiary reaches \$175,000. This does not mean that accounts for a Beneficiary cannot grow beyond \$175,000; investment performance may drive the value above that level.

(c) Distributions. The Account Holder may direct distribution of assets to any person or entity, including himself. However, certain distributions are more tax-favored than others. "Qualified expense distributions" to pay qualifying educational expenses for the Beneficiary receive the most beneficial tax treatment -- they are not taxed at all. Other "Qualified Distributions," which include distributions to the Account Holder in the amount of a scholarship or grant received by the Beneficiary and distributions made because of the Beneficiary's death or disability, are taxed on the accrued investment earnings, but are not subject to any penalty. Other distributions (other than a rollover to another account) are "Non-Qualified Distributions" and receive the least favorable treatment -- they are taxed on accrued investment earnings and are subject to a 10% penalty. Congress may raise the penalty on Non-Qualified Distributions at some point in the future.

(d) Investment Options. As § 529 requires, the College Investment Plan prohibits the Account Holder from directing the investment of assets in an account. The Account Holder is permitted to choose one or more of ten "investment portfolios" in which to invest account assets. The investment portfolios, managed by T. Rowe Price, consist of bundles of mutual funds. Each portfolio has a different allocation, designed to serve a different goal. Some of the portfolios automatically adjust the allocation to become more conservative as the Beneficiary gets older. Detailed information about the portfolios can be found on the College Savings Plans website, [www.collegesavingsmd.org](http://www.collegesavingsmd.org).

The ability to choose investment portfolios and to shift assets from one portfolio to another as often as once each year gives the Account Holder at least some control over the account's investment. However, the Account Holder is restricted to choosing

from among the options presented by T. Rowe Price. If the Account Holder chooses one of the seven portfolios that automatically adjust asset allocation, he should pay close attention each year to make sure that the new allocation is acceptable.

(e) Fees. There is a \$90 enrollment fee for each Account Holder and Beneficiary "group of accounts" -- an Account Holder is not charged an additional enrollment fee to open multiple accounts for the same Beneficiary. The enrollment fee is reduced when rolling assets over from another § 529 plan, either in Maryland or in another state's program. In addition, there is an annual \$30 account fee per group of accounts, although the fee is waived if the group of accounts is automatically funded, or if the aggregate balance of the group of accounts exceeds \$25,000. There is an annual program fee of up to .38% of the accounts value, and there are indirect investment fees ranging from .35% to .99%. The program fee and the investment fees are subject to change. In addition, if the Account Holder liquidates an account for Non-Qualified Distributions, there is a \$75 cancellation fee.

2. Gift Tax Implications. Section 529 plans receive special treatment for purposes of the annual exclusion from gift tax (currently \$11,000 per person). A gift made to a Section 529 plan can be spread over up to 5 years for purposes of the donor's annual gift tax exclusion. Thus, a gift of \$55,000 in Year 1 can be made entirely free of gift taxes by applying the donor's annual exclusions for Year 1 and the following 4 years. This special treatment allows a donor to "front-load" a Section 529 account, gaining extra years of investment for the account without using up any lifetime gift tax exemption.

3. Other Issues. Opening and maintaining an account under the College Investment Plan involves several decisions, including choices regarding Beneficiaries, Account Holders, and investment options. The materials on the Savings Plans' website are very helpful to inform these decisions, but there are a few tricky decisions that are not completely clear in these materials.

(a) How Many Accounts Should I Open? Each account may have only one Beneficiary, so an Account Holder must open at least one account for each Beneficiary. The Plan Disclosure Statement appears to suggest that an account can have only one investment portfolio (thus, diversification among portfolios would require different accounts). However, the enrollment form suggests that an account can be diversified between several investment portfolios, and Plan administrators have informally stated that a single account may be invested in more than one portfolio.

There is, however, one reason to consider multiple accounts for the same Beneficiary. Maryland gives state residents a state income tax deduction for contributions to the College Investment Plan or the Prepaid College Trust. The

legislature may have intended to limit this deduction to \$2,500 per year per Beneficiary; but, in fact, that was not how the law was drafted. The law currently limits the deduction to \$2,500 per account. Thus, instead of contributing \$10,000 this year to one account for a Beneficiary and deducting only \$2,500, the Account Holder could instead contribute \$2,500 to each of four accounts for that Beneficiary and deduct the full \$10,000 this year.

The legislature passed a bill to correct this loophole and limit the deduction to \$2,500 per Beneficiary, retroactive to January 1, 2002. However, the legislature added other provisions to the bill (including allowing the deduction for contributions to Section 529 plans maintained by other states), and Governor Glendening vetoed it.

Thus, this loophole remains in the law. The legislature may act to correct it, or the Governor may try to close it administratively. However, they might not act this year, or their action might not be applied retroactively. Thus, donors who plan to contribute more than \$2,500 for a single Beneficiary might consider spreading that contribution over more than one account, to increase the state income tax deduction. Even if the legislature or Governor shut off the increased deduction, it is still worth trying, since there is little downside to opening multiple accounts for one Beneficiary.

(b) Who Should Be The Account Holder? The Account Holder can be anyone. It need not be the person who makes the contributions, and the Account Holder need not be related to the Beneficiary (eligible rollover beneficiaries are defined as relatives of the Beneficiary, not the Account Holder). However, there are a few things to keep in mind when selecting an Account Holder.

First, while the contributor need not be the Account Holder, only an Account Holder is eligible to take the state income tax deduction. Thus, a donor should consider naming himself as Account Holder, at least at first (Account Holders may be changed for a \$25 fee), to claim the state income tax deduction.

Second, the choice of Account Holder could affect a child's eligibility for college financial aid. Because these Section 529 plans are relatively new, there is no consensus on how financial aid offices will treat them. However, it is very possible that a Section 529 account may be considered an asset of the Account Holder. Thus, if a parent is the Account Holder and is treated as "owning" the account, the account could end up reducing the Beneficiary's financial aid. However, an account that has a grandparent, uncle, aunt, or family friend as Account Holder is much less likely to be taken into consideration by a financial aid office.

4. Tax Relief Sunset. One final issue to keep in mind relates to the future of the Act. The Act is scheduled to sunset on December 31, 2010. After that date, its provisions would be void, unless Congress extends it. Sunset would reduce the tax

advantages of Section 529 plans. In particular, distributions for qualified expenses would no longer be tax-free; taxes on investment earnings would be deferred, but these earnings would be taxed when the assets are distributed.

It would be surprising if Congress allowed the Act to sunset, at least with regard to accounts created in reliance on its provisions. Congress has taken some steps to make these provisions permanent. However, it is possible that the Act will lapse, and potential donors should be aware of this risk.

If you would like to discuss the benefits of including a Section 529 account in your estate plan, please call Charles S. Abell in our Estate Planning Department.

Charles S. Abell  
301-652-6880 (tel)  
cabell@fdalaw.com

The information contained in this article is for information purposes only and is not intended to constitute legal advice or a solicitation of clients. It does not create an attorney-client relationship between the reader and Furey, Doolan & Abell, LLP. Professional legal counsel should be sought for specific opinions or situations.

Furey, Doolan & Abell, LLP is not warranting the accuracy of the information contained in this article, nor is it updating the information or case and statutory citations contained therein. Readers should be mindful that the law is constantly developing, and legal principles can change over time.