

IMPLICATIONS OF THE
KANSAS POST-SECONDARY EDUCATION SAVINGS
PROGRAM
FOR THE ESTATE PLANNER

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This outline should not be utilized as a substitute for professional service in specific situations or to provide legal advice. This outline is intended to provide general information about certain aspects of the law. Since the law changes over time, questions about individual problems should be addressed to the attorney of your choice.

Qualified State Tuition Programs are authorized by Section 529 of the Internal Revenue Code of 1986, as amended (the "Code"), as created under the Small Business Job Protection Act of 1996 and Prop. Treas. Reg. §§ 1.529-0 to 1.529-6. Kansas enacted its savings program in 1999, which will become operational beginning July 1, 2000. This state program is known as the Kansas Post-secondary Education Savings Program (the "Program"). K.S.A. §§ 79-640 to 79-648. The Program is administered by the State Treasurer. At the time of the preparation of these materials, final regulations have not yet been issued by the State Treasurer. However, proposed regulations are attached to these materials.

The Program is a vehicle to create savings accounts to pay for qualified educational expenses at accredited post-secondary institutions in Kansas and other states. Qualified educational expenses are defined under the Internal Revenue Code to include such expenses as tuition, books and required fees and supplies, and with certain restrictions, room and board. American Century, located in Kansas City, Missouri, has been designated as the Program Manager for the next seven years.

A. The Rules.

1. Who May Open the Account and When. Anyone may open the account without regard to income limitations. The person or persons opening the account must be a family member of the designated beneficiary. This includes the beneficiary, the beneficiary's spouse, parents, step-parents, children, step-children, siblings, step-siblings, aunts, uncles, grandparents, step-grandparents, and in-laws. In addition, state and local governments, agencies and registered charities may also open accounts to fund scholarships. K.S.A. § 75-646(o). Finally, the account must be opened before the designated beneficiary attains age 25 years. K.S.A. § 75-646(q).

2. Who May Be A Beneficiary. Anyone may be a beneficiary, including a person named as a scholarship recipient under an account opened by a state or local governing body, agency or registered charity. Code § 529 and the Kansas statute require separate accountings for each individual beneficiary. K.S.A. § 75-646(j).

An account owner may change the designated beneficiary of an account and may transfer all or a portion of an account to another post-secondary education savings account, so long as the beneficiary of the new account or of the account receiving the transfer is a member of the prior beneficiary's family. However, changes or transfers will "not be permitted to the extent they would constitute excess contributions or unauthorized investment choices." K.S.A. § 75-646(f).

3. What May Be Contributed And How Much May Be Contributed. Only cash may be contributed to the account. K.S.A. § 75-646(d). In addition, the account contributions are limited to the average expenses of five years of higher education in Midwestern states (for Kansas accounts), set at \$127,000 for 2000. K.S.A. § 75-646(m). Under Prop. Reg. K.A.R. 3-2-2, this average will be determined annually by the State Treasurer. There is no limit on the total account value.

4. When May Withdrawals be Made. Qualified account withdrawals may be made after two years from the date of the account opening. K.S.A. § 75-646(q). Withdrawals must be completed by the time the designated beneficiary attains age 30 years or within 10 years after the initial qualified withdrawal is made, whichever occurs first. Id. Any amounts remaining in the account at such time must be promptly withdrawn as a nonqualified withdrawal or transferred to another education savings account. K.S.A. § 75-646(m)(2).

5. Penalties for Withdrawals. There is a penalty on any refund of earnings. The materials disseminated by the State Treasurer and American Century state that the penalty is 10% on the earnings portion of the withdrawal plus any required taxes. There appears to be an inconsistency in the amount as stated in K.S.A. § 75-646(g)—“an amount equal to 15% of the portion of the withdrawal constituting income as determined in accordance with the principles of section 529 of the federal Internal Revenue Code of 1986, as amended, plus an amount equal to the amount of interest earned on such portion shall be withheld as a penalty.”

Such penalty will not be imposed for (a) qualified higher education expenses of the designated beneficiary; (b) those distributions made on account of the death or disability of a designated beneficiary; and (c) those distributions made on account of a scholarship received by the designated beneficiary so long as the amount of the withdrawal does not exceed the amount of the scholarship. These three categories of distributions are expressly excepted under the statute from the definition of “nonqualified withdrawals.” K.S.A. § 75-643(j).

6. Control of Account Investments. The Program Manager, American Century, makes the investment decisions. In fact, K.S.A. § 75-646 (as well as Code § 529) prohibit the account owner or the designated beneficiary from directing the investment of any contributions or the earnings on such contributions. K.S.A. § 75-646(k). Learning Quest (the American Century product) offers three investment tracks based on risk tolerance. Within those tracks account owners are entitled to select a portfolio based on the amount of time until the designated beneficiary would begin making qualified withdrawals.

B. Estate, Gift and Income Tax Implications.

1. Income Taxation. With respect to any distribution or earnings under the Program, no amount is includible as gross income of the designated beneficiary or a contributor, except that amount that is deemed ordinary income on the distributions from the account. When amounts are withdrawn for qualified education expenses, income tax is payable on the earnings portion of the withdrawal based on the student’s income tax rate. However, if the owner withdraws amounts from the account under a nonqualified distribution, income tax is payable on the earnings portion of the withdrawal and based on the owner’s income tax rate (in addition to the penalty).

The State of Kansas is also allowing an annual deduction of up to \$2,000 from Kansas adjusted gross income for contributions into each beneficiary’s account. K.S.A. § 79-32,117(c)(xv).

2. Gift Tax

Under Code § 529, a contribution to a post-secondary education savings account is a completed gift. In addition, contributions exceeding the donor's or donors' annual exclusion amount(s) may be applied ratably over the five-year period beginning with the calendar year of the contribution (with the proper indication of such election on a gift tax return). In effect, a donor could give \$50,000 in one year (assuming no other taxable gifts to that donee during the five-year period) without gift tax consequences. Spouses could contribute \$50,000 each for a particular donee for a total transfer of \$100,000 (over the five-year period) without gift tax consequences for transfers to that donee.

3. Estate Tax

Code § 529 provides for special estate tax treatment of contributions to a qualified state tuition program. Amounts contributed will not be included in the gross estate of an individual contributor, regardless of Code § 2035 (transfers within 3 years of death). In the case of the donor who dies before the close of the five-year period for excess contributions as discussed above, the gross estate will include the "portion of such contributions properly allocable to periods after the date of death of the donor." Code § 529(c)(4).

C. Implications for Estate Planners.

For an estate planning client who wishes to reduce his or her gross estate, but is not willing to relinquish control over assets as with an irrevocable trust, establishing an account and making contributions will be an option. Even if the designated beneficiary chooses not to attend an accredited institution, predeceases the donor, or falls out of grace with the donor, beneficiaries may be changed easily or the account may be transferred to another educational savings account with no penalty (so long as there are no "excess contributions" as to the new beneficiary). Provided the contributor is willing to incur a nominal penalty, any amount or all of the assets of the account may be removed at the election of the contributor.

Code § 529 allows the client to transfer property from his or her estate without transfer tax consequences (so long as he or she lives long enough after the contribution) and to keep strings on the account. For example, a husband and wife who have five grandchildren could set up post-secondary education savings accounts for each grandchild. Each could contribute up to \$50,000 with no gift tax consequences for each grandchild. Provided they both live five years after the year of contribution, \$500,000 and the appreciation on such amount could be removed from their combined estates with no estate or gift tax consequences. If the husband or wife should ever need access to the account for whatever reason, for a very nominal penalty (and for inclusion in the gross estate of the donor) such amounts may be returned.