

Elder Law: Be wary of 529 plan becoming a spend-down asset for seniors

Sunday, May 22, 2011

By Julian Gray and Frank Petrich

In previous columns, we discussed the issues seniors face when unanticipated nursing home expenses foil the best laid retirement plans. However, as baby boomers come of age, we are seeing more 529 Plans in use (and, at risk) of long-term care cost exposure. Let's first review the basics of this type of plan.

A 529 Plan is a way to save money for future college costs. The term "529" is derived from the IRS code section that authorizes tax preferred treatment of such plans. The primary advantage of qualified tuition plans is to either lock in future college costs at current prices or invest funds that can grow income tax free if eventually used for college expenses. While this type of planning can provide a significant benefit for younger family members, there are unintended consequences that more seniors are facing now that 529 Plans are more common, especially for grandchildren.

Take the Davis family, which deeply values the importance of higher education. Mr. Davis was an engineer who provided a lifetime of financial support for his family while his wife raised their four children at home. The Davises are proud grandparents and wanted to ensure that their grandchildren would have a solid education and set up a 529 Plan to provide for them. The Davises initially funded the plan with several thousand dollars, which has grown to approximately \$80,000. This money would be available for the grandkids' tuition and would lift a significant financial burden carried by the Davises' children. However, the Davises never considered that Mrs. Davis would develop Alzheimer's disease before the 529 Plan was used.

While Mr. Davis has tried to care for his wife at home, he has realized that this is no longer feasible given his own age and health. With the average monthly cost of nursing care in Pennsylvania at \$8,000, Mr. Davis has decided to apply for Medicaid, which covers more than 60 percent of nursing home residents who cannot afford the high costs of nursing care.

It is important to realize that there are very strict asset limitations for Medicaid eligibility. That's where the Davises' 529 Plan is now in jeopardy of being "spent down" to pay for Mrs. Davis' long-term care costs before she can become eligible for Medicaid.

So what's the problem? The inherent structure of the 529 Plan is both a blessing and a curse. It is important to realize that IRS rules for 529 tax treatment are very different than Medicaid rules. In fact, these rules can be irreconcilable. The 529 Plan removes funds transferred to the plan from the Davises' taxable estate for Federal Estate Tax purposes, while still providing them control over the funds until they are used for college expenses. This is a unique provision allowed by the IRS, which typically taxes any asset that the person maintains control over during her/his lifetime. That said, while the 529 Plan appears to be a separate account for the benefit of the Davises' grandchildren, the Medicaid rules provide that if an applicant can obtain any funds, they must be used to pay for long-term care costs (or otherwise legally disposed) prior to obtaining Medicaid coverage.

The end result is that the Davises will have to make a difficult choice: use the funds allocated for their grandchildren's college costs for Mrs. Davis' nursing home costs or release their control over the 529 Plan by changing ownership of the account to another person or entity. If the former is chosen, not only do the grandkids lose their college fund, but the Davises will have to pay income tax on any appreciation in the 529 Plan since its inception plus a 10 percent federal income tax penalty for taking the money. If they choose the latter option, the Medicaid rules will impose a significant transfer penalty and delay Medicaid coverage, forcing Mr. Davis to find a way to pay his wife's nursing home care out of other assets during the penalty period.

How could this situation have been avoided? Well, many grandparents like to maintain control over 529 Plans by remaining the owner of the plan and then naming their children as the successor owners in the event the grandparents die before the funds are used for college. However, if the Davises' overall estate plan does not provide for the possibility of long-term care cost exposure, such as nursing home expenses, they should consider having the 529 Plan owned by their children. Many parents are not thrilled with having their children own these plans because their offspring may not use the funds properly or could endure adverse economic conditions such as divorce. So, another option is to have the 529 Plan owned by a protective trust, which still gives the grandparents some measure of control while protecting the plan from spend-down exposure for long-term care costs.

Whether the grandchildren will be rooting for the Panthers or the Nittany Lions, it's important to make sure the funds will actually be there in the future when they are needed.

Julian Gray and Frank Petrich are both certified elder law attorneys with more than 50 years of combined elder law experience who practice in the Pittsburgh area at Gray Elder Law. Send questions for consideration in this column to elderlawguys@grayelderlaw.com and visit their website at www.grayelderlaw.com.

First published on May 22, 2011 at 12:00 am