

Correction of Publication

Accordingly, the publication of the final regulations (T.D. 9375), which were the subject of FR Doc. 08–1, is corrected as follows:

1. On page 1058, column 3, in the preamble, under the paragraph heading “Background”, seventh line of the fifth paragraph of the column, the language “2005–52 I.R.B. 1204 (December 07,” is corrected to read “2005–52 I.R.B. 1204 (December 7,”.

2. On page 1062, column 1, in the preamble, under the paragraph heading “D. Disclosures to Other Tax Return Preparers”, thirteenth line of the column, the language “Service provider. The commentator’s” is corrected to read “service provider. The commentator’s”.

3. On page 1066, column 3, in the preamble, under the paragraph heading “H. Multiple Disclosures or Multiple Uses Within a Single Consent Form”, fifteenth line of the second paragraph, the language “Section 301–7216–3(c)(1) of the final” is corrected to read “Section 301.7216–3(c)(1) of the final”.

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Guidance on Qualified Tuition Programs Under Section 529

Announcement 2008–17

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Advance Notice of Proposed Rulemaking.

SUMMARY: This document invites comments from the public regarding rules under section 529 of the Internal Revenue Code (Code) that the IRS and the Treasury Department expect to propose in a notice of proposed rulemaking. The rules focus mainly on the transfer tax provisions applicable to accounts (section 529 accounts) in

Qualified Tuition Programs (QTPs). It is anticipated that these rules will generally apply to section 529 accounts after the effective date of final regulations. All materials submitted will be available for public inspection and copying.

DATES: Written and electronic comments must be submitted by March 18, 2008.

ADDRESSES: Send written comments to: Internal Revenue Service, Attn: CC:PA:LPD:PR (REG–127127–05), room 5203, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–127127–05), Courier’s Desk, Internal Revenue Service, 1111 Constitution Ave, NW, Washington, DC, or sent electronically, via the Federal eRulemaking Portal at www.regulations.gov (IRS-REG–127127–05).

FOR FURTHER INFORMATION CONTACT: Concerning submissions, Richard A. Hurst at Richard.A.Hurst@irs.counsel.treas.gov or, (202) 622–7180; concerning rules relating to estate, gift, and generation-skipping transfer tax issues, Mary Berman, (202) 622–3090; concerning other proposed rules, Monice Rosenbaum, (202) 622–6070 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Prior Administrative Guidance

A Notice of Proposed Rulemaking under section 529 was published in the **Federal Register** on August 24, 1998 (REG–106177–97, 1998–2 C.B. 344 [63 FR 45019]) (the 1998 proposed regulations). Additional guidance was published in Notice 2001–55, 2001–2 C.B. 299 and Notice 2001–81, 2001–2 C.B. 617. Notice 2001–55 provides guidance regarding the statutory restriction against investment direction. Notice 2001–81 provides guidance on recordkeeping, reporting and other requirements applicable to QTPs in light of certain amendments made to section 529 by the Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107–16, 115 Stat. 38) (EGTRRA). See §601.601(d)(2)(ii)(b).

Although the 1998 proposed regulations and these notices provide rules

regarding many issues arising under section 529, other issues remain unresolved. Current law regarding the transfer tax treatment of section 529 accounts is unclear and in some situations imposes tax in a manner inconsistent with generally applicable transfer tax provisions of the Code. In addition, current law raises the potential for abuse of section 529 accounts in certain situations.

Pension Protection Act of 2006

The Pension Protection Act of 2006 (Public Law 109–280, 120 Stat. 780) (the PPA) permanently extended the EGTRRA amendments to section 529, which previously were scheduled to expire at the end of 2010, including the provision that exempts from Federal income tax distributions made from section 529 accounts that are used to pay qualified higher education expenses (QHEEs). See section 1304(a) of the PPA. At the same time, section 1304(b) of the PPA enacted section 529(f). Section 529(f) provides that, notwithstanding any other provision of section 529, the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 529 and to prevent abuse of such purposes, including regulations under chapters 11, 12, and 13.

In discussing new section 529(f), the Technical Explanation prepared by the Joint Committee on Taxation provides two examples of how present law creates the opportunity for abuse of section 529 accounts. See Joint Committee on Taxation, Technical Explanation of H.R. 4, The “Pension Protection Act of 2006,” as Passed by the House on July 28, 2006 and as Considered by the Senate on August 3, 2006, (JCX–38–06), at 369. Abuse may arise because of the ability to change designated beneficiaries (DBs) in certain circumstances without triggering transfer tax. For example, taxpayers may seek to establish and contribute to multiple accounts (taking advantage of the 5-year rule of section 529(c)(2)(B)) with different DBs with the intention of subsequently changing the DBs of such accounts to a single, common beneficiary and distributing the entire amount to such beneficiary without further transfer tax consequences. Abuse may also arise because taxpayers seek to use section 529 accounts as retirement accounts, with all of the tax benefits

but none of the restrictions and requirements of qualified retirement accounts.

Potential for Abuse of Section 529 Accounts

The IRS and the Treasury Department are aware of other situations where current law raises the potential for abuse of section 529 accounts. For example, abuse may also arise if a person contributes a large sum to an account for himself or herself and then changes the DB to a member of his or her family who is in the same or a higher generation (as determined in accordance with section 2651) as the contributor. The contributor's contributions to his or her own account would not trigger the gift tax because an individual cannot make a gift to himself or herself. The contributor may claim that the subsequent change of DB to a member of the contributor's family who is in the same or a higher generation avoids the gift tax under the special transfer tax rules of section 529. Abuse may also arise because contributions to accounts are treated as completed gifts to the DB even though the account owner (AO) may be able to withdraw the money at his or her discretion.

Overview of Proposed Regulations

Section 529(f) authorizes the IRS and the Treasury Department to promulgate regulations as needed to protect against these and other types of abuse. Accordingly, the IRS and the Treasury Department intend to issue a notice of proposed rulemaking to address the potential for abuse of section 529 accounts. The notice of proposed rulemaking will provide a general anti-abuse rule that will apply when section 529 accounts are established or used for purposes of avoiding or evading transfer tax or for other purposes inconsistent with section 529. In addition, the notice of proposed rulemaking will include rules relating to the tax treatment of contributions to and participants in QTPs, including rules addressing the inconsistency between section 529 and the generally applicable income and transfer tax provisions of the Code. The notice of proposed rulemaking also will include rules relating to the function and operation of QTPs and section 529 accounts.

With some exceptions, the 1998 proposed regulations will be repropounded in the

notice of proposed rulemaking. The guidance published in Notice 2001-55, Notice 2001-81, and the instructions and publications related to Form 1099-Q, "*Payments From Qualified Education Programs (Under Sections 529 and 530)*," also will be included in the forthcoming notice of proposed rulemaking. Taxpayers and QTPs may continue to rely on the information provided in existing published guidance, including any effective dates therein. See §601.601(d)(2)(ii)(b) of the regulations. The IRS and the Treasury Department anticipate that the forthcoming notice of proposed rulemaking also will address additional comments that have been received with regard to certain administrative, income tax, and other issues affecting QTPs and section 529 accounts.

The IRS and the Treasury Department anticipate that the new rules to be provided in the notice of proposed rulemaking will generally apply prospectively to all section 529 accounts. Transition rules will be provided if necessary. However, the anti-abuse rule may be applied on a retroactive basis pursuant to section 7805(b)(3).

The IRS and the Treasury Department also anticipate that the notice of proposed rulemaking may require some States (or agencies or instrumentalities thereof) and eligible educational institutions that have established and maintained QTPs to make changes to the terms and operating provisions of their programs in order to ensure that their programs remain qualified under section 529. The forthcoming notice of proposed rulemaking will provide a grace period of no less than 15 months to implement most changes.

The following discussion sets forth the rules expected to be included in the notice of proposed rulemaking and explains the rationale for these rules.

Explanation of Provisions

I. Anti-abuse Rule.

The IRS and the Treasury Department are aware that the inconsistency between the section 529 transfer tax provisions and the generally applicable transfer tax provisions of the Code create the potential for abuse of section 529 accounts.

As described above, the Technical Explanation accompanying new section 529(f) provides two examples in which

present law creates the opportunity for abuse of section 529 accounts. Concern has also been raised as to the potential for abuse in other situations. For example, assume that in 2007, when the gift tax annual exclusion amount under section 2503(b) is \$12,000, Grandparents wish to give more than \$1 million to Child, free of transfer taxes. Grandparents open section 529 accounts for each of their 10 grandchildren, naming Child the AO of each account. Grandparents use the 5-year spread rule of section 529(c)(2)(B) to contribute \$120,000 (\$60,000 from each Grandparent) to each grandchild's account without triggering any gift or generation-skipping transfer (GST) tax liability. The earnings then accumulate on a tax-deferred basis in the accounts and Child may withdraw the balances at any time. If Grandparents survive for 5 years, the account balances will not be included in their gross estates at death. In effect, Grandparents have transferred \$1.2 million to Child while claiming that no transfer taxes are due and claiming to use none of their applicable credit amount (formerly the unified credit). As discussed more fully below, similar concerns have been raised where there is a change from one AO to a new AO, thus giving the new AO all rights to and control over the section 529 account, including the right to completely withdraw the entire account for the new AO's benefit.

The forthcoming notice of proposed rulemaking will contain an anti-abuse rule designed to prevent opportunities for abuse of section 529 accounts such as those set forth above. The anti-abuse rule generally will deny the favorable transfer tax treatment under section 529 if contributions to those accounts are intended or used for purposes other than providing for the QHEEs of the DB (except to the extent otherwise allowable under section 529 or the corresponding regulations). The IRS and the Treasury Department anticipate that the anti-abuse rule will generally follow the steps in the overall transaction by focusing on the actual source of the funds for the contribution, the person who actually contributes the cash to the section 529 account, and the person who ultimately receives any distribution from the account. If it is determined that the transaction, in whole or in part, is inconsistent with the intent of section 529 and the regulations,

taxpayers will not be able to rely on the favorable tax treatment provided in section 529. The anti-abuse rule will include examples such as those set forth above that provide clear guidance to taxpayers about the types of transactions considered abusive.

The IRS and the Treasury Department intend to monitor transactions involving section 529 accounts. If concerns regarding abuse continue, the IRS and the Treasury Department will consider adopting broader rules including, for example, rules limiting the circumstances under which a QTP may permit AOs to withdraw funds from accounts; limiting the circumstances under which there may be a change in DB; and limiting the circumstances under which the AO may name a different AO. These rules may be adopted in addition or as an alternative to the general anti-abuse rule.

II. Rules Relating to the Tax Treatment of Contributions to and Participants in Section 529 Accounts.

A. AO's liability for any gift and/or GST tax imposed on a taxable change of DB.

Section 529(c)(5)(B) provides that the gift and GST tax apply to a transfer by reason of a change in the DB of a section 529 account (or a rollover to the account of a new DB) unless the new DB is both: (1) assigned to the same or a higher generation (determined in accordance with section 2651) as the former DB, and (2) a member of the family of the former DB. The statute does not identify the individual who would be liable for the gift and/or GST tax in such a situation.

Section 1.529-5(b)(3) of the 1998 proposed regulations, in accordance with the legislative history (H.R. Rep. No. 148 at 328), provides that, if the AO changes the DB, or directs a rollover of credits or account balances from the account of one beneficiary to the account of another beneficiary, and if the new DB is not both a member of the family of the former DB and in the same or a higher generation (as determined under section 2651) as the former DB, the change of DB by the AO is treated as a taxable gift by the former DB to the new DB. This result follows

from generally applicable transfer tax provisions because each contribution to the section 529 account on behalf of the former DB was treated as a completed gift to the former DB. As a consequence, under the 1998 proposed regulations, the former DB is deemed to be the owner of the funds contributed to the account and, therefore, is the donor/transferor of the account to the new DB.

Because the AO rather than the DB has the power to change a beneficiary, several comments on the 1998 proposed regulations raised concerns about the imposition of tax on the former DB. In many cases, the DBs are minors who may not be aware of the existence of the account for their benefit.

The term "account owner" does not appear in section 529. The definition of account owner in §1.529-1(c) of the 1998 proposed regulations was included to reflect practices used at that time to facilitate the establishment of accounts for minor beneficiaries. In practice, the AO retains control over the selection of the DB and has personal access to the funds in the account.

In order to assign the tax liability to the party who has control over the account and is responsible for the change of any beneficiary, the forthcoming notice of proposed rulemaking will provide that a change of DB that results in the imposition of any tax will be treated as a deemed distribution to the AO followed by a new gift. Therefore, the AO will be liable for any gift or GST tax imposed on the change of the DB, and the AO must file gift and GST tax returns if required. This position comports with the income tax provision under §1.529-3(c)(1) of the 1998 proposed regulations that treats a change of DB to a new DB who is not a member of the family of the former DB as a distribution to the AO, provided the AO has the authority to change the DB. Special rules may be needed to address situations in which a trust or an entity such as a bank, rather than an individual, is the AO. The IRS and the Treasury Department welcome comments regarding such special rules and on possible alternative approaches to collecting any transfer taxes due upon a change of DB.

B. AO's liability for tax imposed on any withdrawal by the AO from a section 529 account for the AO's own benefit and on a change in AO.

Section 529(c)(3)(A) provides that, in general, any distribution from a section 529 account is includible in the gross income of the distributee in the manner provided under section 72, to the extent not excluded from gross income under any other provision of chapter 1 of the Code. Section 529(c)(3)(A) does not limit the class of potential distributees.

As discussed previously in this preamble, the AO of a section 529 account is the party with control over the account. Concerns have been raised regarding the potential tax consequences in situations where the AO withdraws part or all of the funds from the section 529 account for the AO's own benefit. For example, a contributor might attempt to avoid gift tax by making contributions that do not exceed the gift tax annual exclusion amount under section 2503(b) to multiple accounts having the same AO. The AO could then withdraw some or all of those funds for the AO's own benefit. The AO, as distributee, would claim to owe only the income tax and a 10-percent additional tax on the earnings portion of the withdrawal, while the taxpayer who contributed those funds would claim to owe no gift or GST tax.

Concerns also have been raised regarding the possible tax consequences in situations where an AO transfers control of the account to a new AO, or names himself or herself (or the AO's spouse) as the DB. The IRS and the Treasury Department expect to develop additional rules to address these and other similar transactions by AOs, including (1) limiting AOs to individuals; and, (2) making the AO liable for income tax on the entire amount of the funds distributed for the AO's benefit except to the extent that the AO can substantiate that the AO made contributions to the section 529 account and, therefore, has an investment in the account within the meaning of section 72. The IRS and the Treasury Department welcome comments on such additional rules and on any alternative approaches to preventing misuse by AOs of section 529 accounts.

C. Application of transfer tax where permissible contributors to section 529 accounts include persons other than individuals.

Under section 529(b)(1), a QTP is a program under which a person may purchase tuition credits or certificates on behalf of a DB which entitle the DB to the waiver or payment of QHEEs or, in the case of a program established and maintained by a State or agency or instrumentality thereof, may make contributions to an account which is established for the purpose of paying the QHEEs of the DB of the account. Section 1.529-1(c) of the 1998 proposed regulations provides that, for purposes of section 529, the term “person” has the same meaning as under section 7701(a)(1). Section 7701(a)(1) provides that, when the term “person” is used in the Code and not otherwise distinctly expressed or manifestly incompatible with the intent thereof, the term shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.

Since publication of the 1998 proposed regulations, this broad definition of “person” has raised questions concerning the application of the transfer tax and, in certain situations, the income tax and the employment tax.

With respect to transfer taxes, section 529(c)(2)(A) provides that any contribution to a section 529 account on behalf of a DB shall be treated as a completed gift of a present interest in property to the DB. Section 2501(a) imposes a tax on the transfer of property by gift by an “individual.” Under §25.2501-1(a) of the Gift Tax Regulations, the gift tax is not applicable to transfers by corporations or persons other than individuals, except as provided in §25.2511-1(h)(1). Section 25.2511-1(h)(1) provides that a transfer of property by a corporation to an individual is a gift to the individual by the stockholders of the corporation. If the individual is a stockholder, the transfer is a gift to the individual by the other stockholders to the extent it exceeds the individual’s own interest in such amount as a stockholder.

Because any contribution to a section 529 account is treated as a completed gift, and because the gift tax is imposed only on individuals, it can be argued that the definition of “person” in section 529(b)(1)

should be limited to individuals. Nevertheless, the IRS and the Treasury Department believe it may be possible to interpret sections 529(b)(1) and 529(c)(2)(A) consistently without limiting the class of permissible contributors to individuals by providing special rules for contributions made by corporations, partnerships, estates, trusts, and other entities. For example, based on §25.2511-1(h)(1), a contribution by a person other than an individual may be treated as a separate gift by each beneficiary, member, shareholder, partner, etc., in an amount representing that individual’s allocable share of the contribution.

Accordingly, the forthcoming notice of proposed rulemaking will follow the 1998 proposed regulations in providing that the definition of “person” as used in section 529(b)(1) will have the same meaning as under section 7701(a)(1).

The IRS and the Treasury Department welcome comments on whether the definition of “person” in section 529(b)(1) should be limited to individuals and on rules necessary to ensure appropriate transfer tax consequences in situations where persons other than individuals make contributions to section 529 accounts. In addition, comments are welcome as to whether the complexity of any special rules would outweigh the benefit of allowing non-individual contributors.

Comments are also welcome regarding potential income tax consequences when contributions are made by non-individuals, such as a trust or estate, and whether the complexity of any special rules would outweigh the benefit. For example, if a trust makes contributions to a section 529 account, how should the trust treat the contributions to and distributions from the account for income tax purposes? If the trustee of the trust is the AO, would the income tax treatment be the same?

The IRS and the Treasury Department also have considered the possibility that employers may consider funding section 529 accounts for employees’ children or that a debtor may fund an account for the lender’s child. Section 529 does not override (or permit avoidance of) federal taxes otherwise applicable to payments that are not in the nature of gifts. The IRS and the Treasury Department believe that if such contributions are made, all necessary procedures and reporting mechanisms must be

in place to ensure the assessment and collection of all appropriate income, employment, and gift taxes. The IRS and the Treasury Department welcome comments as to whether (and how) this could be accomplished without undue burden.

D. Special rules apply in the case of individuals who contribute to section 529 accounts for their own benefit and in the case of Uniform Gifts to Minors Act (UGMA) and Uniform Transfers to Minors Act (UTMA) accounts that contribute to such accounts for the benefit of their minor beneficiaries.

The 1998 proposed regulations do not address situations in which individuals contribute to section 529 accounts for their own benefit, or where UGMA and UTMA accounts make contributions for the benefit of their minor beneficiaries. (This situation should be distinguished from a section 529 account established with the program as an UGMA or UTMA account.) The IRS and the Treasury Department believe guidance is needed regarding contributions by individuals for their own benefit and by UGMA and UTMA accounts for the benefit of their minor beneficiaries in order to ensure consistent tax treatment with section 529 accounts set up by persons for the benefit of other DBs.

As stated in the previous paragraph, section 2501(a) imposes a tax on the transfer of property by gift by an individual. Section 529(c)(2)(A) provides that any contribution to a section 529 account on behalf of any DB shall be treated as a completed gift of a present interest in property to the DB. A contribution to a section 529 account by the contributor for the contributor’s own benefit cannot be treated as a completed gift because an individual cannot make a transfer of property to himself or herself, and a transfer of property is a fundamental requirement for a completed gift. Although there is no express statutory intent to prohibit the funding of a section 529 account for the contributor’s own QHEEs, the transfer tax provisions of section 529 do not appear to contemplate such a result.

Minor beneficiaries of UGMA and UTMA accounts are the beneficial owners of the accounts. In this respect, contributions to a section 529 account from an UGMA or UTMA account would be con-

sidered to be contributions to the section 529 accounts by the minor beneficiaries for their own benefit.

The IRS and the Treasury Department recognize that individuals may want to save for their higher education expenses by contributing to section 529 accounts and that individuals might not have parents or other benefactors who are able or willing to make such contributions on their behalf. The IRS and the Treasury Department also acknowledge that section 529 accounts provide an efficient method for UGMA and UTMA accounts to provide for the higher education expenses of their minor beneficiaries.

Accordingly, it is anticipated that the notice of proposed rulemaking will allow contributions to section 529 accounts by individuals for their own benefit and by UGMA and UTMA accounts for the benefit of their minor beneficiaries. In order to ensure consistent transfer and income tax treatment under section 529 for these accounts and accounts created by persons for the benefit of other DBs, special rules will apply in cases of a subsequent change of the DB.

When contributors set up section 529 accounts naming themselves as DB (or UGMA and UTMA accounts set up such accounts for their minor beneficiaries) and subsequently change the DB, the change of DB from the contributor to any other person will be deemed to be a distribution to the contributor followed by a new contribution (as described in section 529(c)(2)) of the account balance by the contributor to a new section 529 account for the new DB. It is anticipated that the deemed distribution to the contributor, followed by the new contribution of the account balance to a new section 529 account for the new DB, will be treated as a rollover (as described in section 529(c)(3)(C)) and thus will not be subject to income tax or the 10-percent additional tax imposed by section 529(c)(6) if the new DB is a member of the family of the former DB. The new contribution by the contributor will be treated in the same way for transfer tax purposes as all other contributions to section 529 accounts under section 529(c)(2). If the change of DB in these situations results in any gift and/or GST tax, the contributor will be liable for the tax and must file gift and/or GST tax returns. However, the contributor may elect

to take advantage of the special 5-year rule under section 529(c)(2)(B).

E. Circumstances under which the account of a deceased DB will be distributed to, and includible in, the gross estate of the deceased DB for estate tax purposes.

Section 529(c)(4) provides that, with two exceptions, 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 section 529 account. The exception relevant to this discussion is for amounts distributed on account of the death of the DB.

Under section 529(c)(4)(B), amounts distributed on account of the death of a DB are subject to estate tax. The legislative history (H.R. Rep. No. 148 at 328) makes no reference to the term “distributed” but provides that the value of any interest in a section 529 account will be includible in the estate of a DB. Section 1.529-5(d)(3) of the 1998 proposed regulations adopts the position stated in the legislative history. This position has raised several concerns because, under generally applicable transfer tax provisions, the gross estate of a decedent does not include property in which the decedent has no interest, or over which the decedent has no power or control.

It is anticipated that the forthcoming notice of proposed rulemaking will provide the following rules regarding the tax consequences arising from the death of a DB.

Rule 1. If the AO distributes the entire section 529 account to the estate of the deceased DB within 6 months of the death of the DB, the value of the account will be included in the deceased DB’s gross estate for federal estate tax purposes.

Rule 2. If a successor DB is named in the section 529 account contract or program and the successor DB is a member of the family of the deceased DB and is in the same or a higher generation (as determined under section 2651) as the deceased DB, the value of the account will not be included in the gross estate of the deceased DB for Federal estate tax purposes.

Rule 3. If no successor DB is named in the section 529 account contract or program, but the AO names a successor DB who is a member of the family of the deceased DB and is in the same or a higher generation (as determined under section

2651) as the deceased DB, the value of the account will not be included in the gross estate of the deceased DB for Federal estate tax purposes.

Rule 4. If no successor DB is named in the section 529 account contract or program, and the AO does not name a new DB but instead withdraws all or part of the value of the account, the AO will be liable for the income tax on the distribution, and the value of the account will not be included in the gross estate of the deceased DB for federal estate tax purposes.

Rule 5. If, by the due date for filing the deceased DB’s estate tax return, the AO has allowed funds to remain in the section 529 account without naming a new DB, the account will be deemed to terminate with a distribution to the AO, and the AO will be liable for the income tax on the distribution. The value of the account will not be included in the gross estate of the deceased DB for Federal estate tax purposes.

III. Rules Governing the Function and Operation of QTPs and Section 529 Accounts

A. Rules for making the election under section 529(c)(2)(B) to treat contributions to a section 529 account as being made over a 5-year period.

The IRS and the Treasury Department have received numerous taxpayer inquiries regarding the operation of and the procedures for making the 5-year election provided in section 529(c)(2)(B). Section 529(c)(2)(B) provides that, if the aggregate amount of contributions to a section 529 account during the calendar year by a donor exceeds the gift tax exclusion amount for such year under section 2503(b), the donor may elect to have the aggregate amount taken into account, for purposes of section 2503(b), over the 5-year period beginning in such calendar year. The forthcoming notice of proposed rulemaking will provide the following rules that clarify the circumstances and manner in which the election may be made.

Rule 1. The election must be made on the last *United States Gift (and Generation-Skipping Transfer) Tax Return* (Form 709) filed on or before the due date of the return, including extensions actually granted, or, if a timely return is not filed, on

the first gift tax return filed by the donor after the due date. The election, once made, will be irrevocable, except that it may be revoked or modified on a subsequent return that is filed on or before the due date, including extensions actually granted.

Rule 2. The election applies to contributions to a section 529 account on behalf of a DB during a calendar year that exceed the gift tax exclusion amount for that year but are not in excess of five times the exclusion amount for the year. Any excess may not be taken into account ratably and is treated as a taxable gift in the calendar year of the contribution.

Rule 2 is illustrated by the following examples:

Example A. Assume the contributor makes contributions to a section 529 account on behalf of DB in 2007, when the gift tax annual exclusion amount under section 2503(b) is \$12,000. If the contributor's aggregate contributions on behalf of DB in 2007 are \$30,000, contributor may elect to account for the gift as 5 annual gifts of \$6,000 to DB, beginning in 2007. Assuming the gift tax annual exclusion amount remains at \$12,000 over the 5-year period covered by the election, the contributor could make additional gifts described in section 2503(b) of up to \$6,000 in each of the 5 years to the same beneficiary without the imposition of any gift tax.

Example B. Assume the contributor makes contributions to a section 529 account on behalf of DB in 2007, when the gift tax annual exclusion amount under section 2503(b) is \$12,000. If the contributor's aggregate contributions on behalf of DB in 2007 are \$65,000, contributor may make the election under section 529(c)(2)(B) only with respect to that portion of the contributions that is not in excess of \$60,000 (5 x \$12,000). The \$5,000 excess will be treated as a taxable gift by the contributor in 2007.

Rule 3. The election may be made by a donor and the donor's spouse with respect to a gift considered to be made one-half by each spouse under section 2513.

B. Income tax issues related to section 529 accounts

The IRS and the Treasury Department have received numerous inquiries relating to several income tax issues that will be ad-

ressed in the forthcoming notice of proposed rulemaking. The following items are illustrative of these inquiries and the IRS and the Treasury Department anticipate addressing additional income tax matters raised by comments.

The notice of proposed rulemaking will provide formal guidance on how to recognize a loss in a section 529 account. Direction on this issue was first provided in Publication 970 (*Tax Benefits for Education: For Use in Preparing 2002 Returns*). Losses in section 529 accounts may be deducted as miscellaneous itemized deductions subject to the 2% of adjusted gross income limit. Taxpayers will continue to be able to rely upon this interpretation.

Section 529 is silent regarding whether distributions must be made from a section 529 account in the same tax year as QHEEs were paid or incurred. Concerns have been raised that individuals could allow the account to grow indefinitely on a tax-deferred basis before requesting reimbursement or use distributions in earlier years to pay QHEEs in later years. Accordingly, the IRS and the Treasury Department propose to adopt a rule that, in order for earnings to be excluded from income, any distribution from a section 529 account during a calendar year must be used to pay QHEEs during the same calendar year or by March 31 of the following year. The IRS and the Treasury Department welcome comments on rules necessary to ensure that distributions from section 529 accounts are appropriately matched to the payment of QHEEs.

C. Recordkeeping requirements and administrative procedures

The forthcoming notice of proposed rulemaking may contain recordkeeping requirements designed to facilitate the implementation of these new rules, including the proposed anti-abuse rule. QTPs may

be required to collect and retain, and in some cases report to the IRS, certain information. Programs may also need to revise their program documents, administrative procedures, and promotional and required literature for AOs and DBs. The forthcoming notice of proposed rulemaking will provide a grace period of no less than 15 months to implement most changes.

The IRS and the Treasury Department welcome comments regarding the information that would be necessary to implement the proposed anti-abuse rule, including a discussion of how to minimize the burden on QTPs of collecting or reporting such information.

Request for Comments

Before the notice of proposed rulemaking is issued, consideration will be given to any written comments that are submitted timely (a signed original and eight (8) copies) to the IRS. All comments will be available for public inspection and copying.

Drafting Information

The principal authors of this advance notice of proposed rulemaking are Mary Berman of the Office of Chief Counsel (Passthroughs and Special Industries) and Monice Rosenbaum of the Office of Chief Counsel (Tax-Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in its development.

Linda E. Stiff,
*Deputy Commissioner for
Services and Enforcement.*

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