

USING LIFE INSURANCE AS AN ALTERNATIVE  
TO 529 PLANS FOR COLLEGE SAVINGS  
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Recent changes in IRC Section 529 plans for college savings have created a proliferation of so-called "529 Qualified Tuition Programs" (previously known as Qualified State Tuition Programs), and have had a profound effect on education savings in the United States. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("The 2001 Tax Act"), qualified educational expenses (tuition, books, and certain room and board costs at colleges and universities in the United States) became exempt from income taxes, and funds contained in Section 529 plans were exempted from the donor's estate, with certain exceptions, despite the retention of ownership and control. Although this tax treatment is scheduled to sunset in 2010<sup>1</sup>, most states have rushed to sponsor new savings plans designed to take advantage of the changes in the law. Most older plans offered only in-state pre-paid tuition for state schools. The more dynamic college savings plan, offering a choice of investment options and permitting plan assets to be used at any qualified higher education institution in the United States, was rare. Today, however, almost all states sponsor Section 529 plans of one type or another.

Permanent life insurance can also be used as a college savings vehicle. The use of life insurance for college savings is well recognized, but has not been widely promoted by the financial services industry, and is often overlooked by financial advisors and even life insurance agents themselves. In appropriate circumstances, life insurance can be effectively used, and has been used for many years for this purpose. Its cash values may be withdrawn or borrowed for any type of need, including education expenses, with certain limitations that will be detailed in this article. Although any type of permanent life insurance can be used for this purpose, we intend to focus on one particular form of life insurance, "whole life" as a viable college savings vehicle either in combination with or as an alternative to Section 529 plans. This method of funding will be detailed in Appendix B.

#### I. Principal Features of Section 529 Plans.

Each Section 529 plan is permitted to have only one beneficiary, although the beneficiary may be changed (see below). Section 529 savings plans (as opposed to prepaid college tuition plans) are typically sponsored by large mutual fund companies and are sold by licensed securities representatives. These offerings vary considerably in commission, fee and expense structure, investment options offered, limitations on

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<sup>1</sup>There is currently a bill before the U.S. Senate to make the current tax treatment of these plans permanent.

investment or beneficiary changes, and other factors. The structure is like that of a mutual fund. The plans contain various investment options, in addition to an age-based investment option that becomes increasingly more conservative as the beneficiary approaches college age.

Unlike mutual funds, however, Section 529 plans restrict changes in investment options to once per calendar year, unless they are coupled with a change in beneficiary, although new deposits may be invested in any of the options available in the plan. Section 529 requires sponsoring states to restrict the maximum amount that may be invested in any one plan. Different states interpret these restrictions in different ways.

Maximum investment amounts vary from state to state. Most states do not permit more than about \$250,000 to be invested in any one plan. If the accumulated value of the investment exceeds that amount, no further investment may be made. Typically, a plan with more than the maximum amount in its account cannot be rolled over to another beneficiary or another plan without funds in excess of the maximum being returned—those amounts would be taxable as ordinary income, with a 10% penalty added.

At the present time, the existence of a Section 529 plan has no effect on financial aid to the student because the plan is considered (for that purpose) an asset of the donor. Tax free withdrawals could in the future decrease the student's eligibility for financial aid, although it does not at present, and inclusion of the plan in the parents' asset base could reduce the need-based aid awarded to a student.

## II. Taxation of 529 Savings Plans

### Income Tax Exemptions and Penalties

Before the 2001 Tax Act, federal income tax was deferred in Section 529 savings plans until funds were withdrawn, but distributions made from the account were taxed at the student's income tax rate (usually 15%). The 2001 Tax Act eliminated the tax on distributions made for qualified educational expenses: Distributions used to pay "qualified educational expenses" as that term is defined in the code, tax-free until 2010. Those expenses include tuition, fees, books, supplies, certain equipment required for enrollment, and room and board at any qualified educational institution in the United States.<sup>2</sup> These rules apply to students attending most higher educational institutions in the US, but not to students attending most foreign institutions of higher learning.

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<sup>2</sup> The amount of room and board that qualifies is limited to the educational institution's "cost of attendance" allowance for federal financial aid purposes.

Under current law, distributions used for non-qualified expenses are taxed as ordinary income of the donor to the extent of any gains, and a penalty equal to 10% of such gains is added.

### Gift Tax Rules

In addition to the income tax advantages, Section 529 Plans have several gift tax advantages not found in other types of tax-advantaged investments. Contributions to Section 529 Plans qualify for the annual exclusion from gift tax (currently \$12,000). Ordinarily, married donors could elect to split their gifts and make contributions of up to twice the annual exclusion amount per year per donee. However, donors to Section 529 Plans are permitted to make up to five years' worth of gifts in the same year, effectively accelerating five years' worth of exclusions (provided that no additional gifts are made to the beneficiary during that period). Thus, under current law, a single donor could gift up to \$60,000 this year, and married couples could gift up to \$120,000 this year. (As the gifts will be prorated over the next five years, donors are subject to gift tax on any further gifts to the same beneficiary within the next five years.)

Annual exclusion contributions to a Section 529 plan established for a beneficiary two or more generations below the donor also qualify for the exclusion from generation-skipping transfer ("GST") tax. A donor need not consume any of his or her available GST exemption if contributions are limited to the allowable annual exclusion amount.

### Exemption From Estate Tax

The date of death fair market value of the Section 529 Plan is generally not included in the estate of the account owner for estate tax purposes. However, account owners who elect the five-year acceleration of their annual exclusions must survive the five-year period to have the entire amount of contributions excluded from their estate. If the beneficiary dies, however, any Section 529 Plan assets remaining in the plan will be included in the beneficiary's estate.

### State Tax Deductibility For Residents

Twenty-eight states and the District of Columbia permit residents to obtain additional tax advantages, such as deductibility of contributions and tax free withdrawals from Section 529 plans. However, there are significant variations. For example, California's plan does not presently provide for state tax deductibility and charges a 2.5% additional penalty for non-qualified withdrawals. Virginia and Georgia allow a state tax deduction of up to \$2,000 contributed in any one year. New York and

Connecticut allow up to a \$5,000 state tax deduction per individual owner/contributor (\$10,000 per married couple filing jointly). Rhode Island allows only \$500 per individual. Massachusetts and Delaware allow none. Except for Pennsylvania, such state specific tax benefits apply to residents of the state itself.

### **Transferability of Beneficiaries**

The account owner is generally considered the owner for property law purposes. Provided that the state-sponsored plan permits a change in beneficiary, the owner may change the beneficiary every 12 months without facing adverse income tax consequences, as long as the new beneficiary is in the same family as the old beneficiary. Members of the beneficiary's family include his or her spouse, siblings and their spouses, step-siblings and their spouses, aunts and uncles, parents-in-law, ancestors, descendants and their spouses, stepchildren and their spouses. While the definition of family is expansive and has recently been expanded to include first cousins, there are some potential traps for the unwary. If the new beneficiary is not in the same generation as the old, the transfer could trigger a gift tax obligation for the previous beneficiary.

### III. Permanent Life Insurance As A College Savings Vehicle

Permanent life insurance offers an alternative to Section 529 plans for college funding that in many cases offers significant advantages over the restrictions in those plans. Although the savings element in permanent life insurance contracts is secondary to the death benefit, there are several features that make life insurance plans particularly useful for education savings. The principal features are exemption of cash value accumulation from income taxes, lack of restrictions on uses of funds withdrawn or borrowed from the policy, the self-funding nature of the vehicle in the event of premature death, flexibility of contributions, and particularly in the case of whole life insurance, the predictability of positive investment returns.

For college funding, the insurance policy should be specifically designed to accomplish these goals at the inception. The basic design for such a policy is detailed in Appendix B. It should be clearly understood at this point, however, that the amount of funding required to fund a college savings plan will be significantly greater than would be the case for an ordinary life insurance policy, because of the significant planned withdrawals.

#### A. Investment Characteristics Of Whole Life Insurance

Fundamentally, there are three basic forms of permanent (cash value) life

insurance: whole life, universal life, and variable (universal) life. The essential differences between these are considerable, and comparing them is not the purpose of this article. Instead, we will focus primarily on whole life insurance, although much of the discussion applies to all three forms to a greater or lesser degree.

Although there are many possible designs for a whole life insurance policy, the garden variety policy features a basic death benefit with a guaranteed premium that is payable for a set term of years,<sup>3</sup> a guaranteed cash accumulation percentage, and policy dividends which are not guaranteed. The guaranteed cash accumulation percentage guarantees that the cash value of the policy will equal the initial death benefit by a specified age, usually age 95-100. The non-guaranteed dividends are usually used to purchase paid up additions to the base policy (PUA's), which increase the death benefit and continue to increase in cash value over time.

Most of the major whole life issuers claim to have paid dividends continuously for over one hundred years.<sup>4</sup> Although the dividend is not guaranteed and can vary considerably over time, these dividends have provided a consistent and reliable source of increased policy cash values for many years.<sup>5</sup>

## B. Taxation of Life Insurance

Life insurance is one of the most tax-favored vehicles for accumulation of wealth existing in the United States. Life insurance cash values are exempt from taxation under current law unless the insurance policy is surrendered or becomes a Modified Endowment Contract ("MEC").<sup>6</sup> The accumulated cash values may be withdrawn or borrowed at will by the policy owner, usually the insured.

If the policy is surrendered, any gains over the basis are taxable as ordinary income. However, unlike Section 529 plans, there is no tax penalty on the surrender. If

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<sup>3</sup> The most common options are 20 years, payable to age 65, and payable to normal maturity (from age 95 to 100).

<sup>4</sup> These include New York Life, Northwestern Mutual, Mass Mutual, Guardian Life, and National Life of Vermont, among others.

<sup>5</sup> A chart detailing Guardian's dividends since 1958 is attached as Appendix A.

<sup>6</sup> Internal Revenue Code Section 7702 contains guidelines that limit the funding for life insurance policies. If these guidelines are exceeded, the policy becomes a modified endowment contract ("MEC") and withdrawals and loans are then taxed to the extent of any gains on a last in, first out basis. Obviously, this result is to be avoided. Most companies will not accept premium payments that will cause the contract to become a MEC, and life illustrations will advise when the policy design will create a MEC.

the policy becomes a MEC, any money withdrawn will also be taxed as ordinary income to the extent of any gains over basis, but also without tax penalties. Death benefit proceeds are income tax free, but they are included in the estate of the owner for estate tax purposes (depending how ownership is structured), unlike 529 plan assets, which are ordinarily excluded.

### C. Contribution Flexibility

As previously noted, Section 529 plans are usually limited approximately \$250,000. Once the plan has reached the maximum value permitted by the sponsoring state, no more contributions can be made. In addition, the maximum amount per annum that can be contributed without incurring gift tax liability is currently limited to \$12,000 per donor per beneficiary (although the plan can be front-loaded for five years). This means that in most situations, the initial investment cannot exceed \$110,000 (2 parents contributing the maximum excludable amount for five years in advance), with no additional investments during the first five years.

By contrast, the amount that can be invested in a life insurance policy is limited only by the amount of death benefit the insured can qualify for and by IRC limits on per-annum investments for the contract to remain qualified as life insurance. In many cases, an investor can invest more in a life insurance policy than he or she could in a 529 plan.

Another limitation on Section 529 plans is that they require a single beneficiary. If a plan is established for a particular child, that child must be born before the plan can be initiated. While a plan could be established in the name of a parent or someone else and later changed, that is not what most people would do. Thus, in the usual case, there is only an eighteen year window (or less) in which to accumulate funds in the plan before spending begins.

Life insurance, by contrast, can be initiated at any time and may have multiple beneficiaries. Thus, a married couple that plans to have children later on can begin saving for the children's college education by acquiring a policy years before the first child is born. This will likely result in a lower ultimate cost because tax-free investment growth is spread over a longer period.

### D. Full Funding on Death of the Insured

The dominant feature of any life insurance is death benefit protection, which when properly designed can automatically fully fund education expenses with tax free dollars if the insured dies before being able to invest enough to fully fund the plan. Most policies also accelerate most of the death benefit if the insured is diagnosed as

being terminally ill. This is achieved simply by setting the death benefit at a level necessary to fund the college savings plan in addition to the other insurance needs of the family in the event of death of the insured.

If an insured parent dies at any time, even one day after the policy goes into effect, the full death benefit is paid tax free and can be held in a separate account until the child needs it for college. Even if the insured parent becomes disabled, the contributions will continue and the plan will be fully funded (see Appendix B).

By contrast, if the owner/contributor of a Section 529 plan dies or becomes disabled two years after the plan is established, the funding stops, the plan fails, and the child may lose his or her chance at a college education.

#### E. Permitted Tax Free Uses of Withdrawn or Borrowed Funds

Money withdrawn or borrowed<sup>7</sup> from a life insurance policy can be used without restriction, while money withdrawn from Section 529 plans are permitted to be used only for qualified educational expenses. Money taken from Section 529 plans for any non-qualified expense is subject to taxation as ordinary income and a ten per cent penalty applies on the withdrawal(s) to the extent of any gains over basis in the plan.

Ordinarily the policy must be in force for a significant period of time before money can be withdrawn. This is ordinarily not a problem for college savings. While excessive withdrawals or loans may cause the policy to lapse, a properly designed whole life policy will provide which performs as designed for sufficient cash to be available without affecting the overall viability of the policy itself. See Appendix B.

If the child does not attend college or wins a scholarship and doesn't need the money, policy funds accumulated for college may be left inside the policy or used for something else. Policy withdrawals and loans may also be used to pay for expenses not allowed by Section 529 plans, such as repaying student loans, living expenses beyond the allowable amount, attendance at a private high school, transportation expenses, or attendance at a school anywhere in the world.

Also, unlike Section 529 plans, no accounting need ever be made for the expenditures, and no records need be kept. Expenditures are entirely within the discretion of the owner of the policy, not the IRS.

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<sup>7</sup> Loans accumulate interest, can affect the policy performance, and must be repaid at some point.

## F. Planning advantages

One of the most important problems in planning for college education is knowing how much to put away. If not enough funds are available when needed, the student may be forced to forego attendance at a top school and attend a lesser school that is within the existing budget.

Although we can predict the future cost of attendance at a particular college based on current inflation rates of education costs, we cannot predict with any significant degree of accuracy what the investment returns of a Section 529 plan will be.<sup>8</sup> Investment returns on securities are volatile and unpredictable by definition. This makes it difficult to know how much money to save. Unfortunately, this leaves parents and financial advisors with a dilemma. The natural tendency (and perhaps the only logical approach) is to make assumptions about the returns based on historical averages. But the returns predicted as a result may or may not be achieved in the relevant time period. If they are not, the plan could fall significantly short of its goals.

Unlike securities market returns, which can be positive or negative, dividends paid on whole life insurance policies always generate a positive return. Obviously, this does not guarantee that the goal will be achieved. However, even when the dividends do not keep pace with projections, it may be possible to make adjustments on an annual basis to cover any shortfalls that occur. This is much more difficult with Section 529 plans, not only because of the restrictions on contributions, but because the volatility in returns could make it impractical.

## G. Financial Aid Eligibility

Section 529 plans are savings plans and thus are included in the parents' assets when calculating the expected family contribution for financial aid eligibility. Because life insurance would ordinarily be owned by the student's parent, it is not an asset of the student for purposes of determining eligibility for financial aid, and the cash value of life insurance is also not included in the parents assets for purposes of EFC. Thus, the life insurance funding plan does not affect financial aid eligibility.<sup>9</sup>

## IV. Summary

The whole life insurance policy provides a viable savings program for education

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<sup>8</sup> Unless, of course, it is invested in a guaranteed return fund, which has very low returns.

<sup>9</sup> Source: Sallie Mae Expected Family Contribution Estimator.

as an alternative to Section 529 plans that provides substantial funding for the child's education, whether the parent/insured lives, becomes disabled, or dies. Insurance policies contain are numerous features which make them particularly suitable for this purpose and superior to Section 529 plans in many respects.<sup>10</sup>

#### V. Cautionary Note

Total investment returns in whole life contracts are guaranteed only to the extent of accumulating cash values. Dividends are not guaranteed. The assumption on which the article is based is that whole life policies will continue to pay dividends as they have done in the past. Without payment of such dividends, or with a substantial reduction in the amount of those dividends, the results of such an investment might not be sufficient to achieve the purposes discussed herein. Information about life insurance companies can be obtained from A.M. Best insurance rating service, Standard and Poors, and Moody's Investor Services.

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<sup>10</sup> Limitations are determined by IRS formulas which prevent the insurance policy from becoming a Modified Endowment Contract, or "MEC", which would destroy the tax advantages discussed herein.

## V. Comparison Chart.

The following is a chart comparing typical plans. Plans of each type may vary.

Investment type ► Features ▼	Section 529 Plan	Whole Life Insurance Policy
Income limitations	Unlimited	Unlimited
Maximum Annual Contribution	\$11,000 per yr. or \$55,000 in 1 <sup>st</sup> of 5 yrs. (\$22,000 if married); or \$110,000 in 1 <sup>st</sup> of 5 yrs.	Only limit: cannot exceed generous IRC limits for life insurance
Account Earnings	Tax deferred; qualified withdrawals tax free until 2010	Tax free as long as policy not surrendered or lapsed*
<b>Control of withdrawals</b>	Account owner	Policy owner
<b>Qualified use of proceeds</b>	Colleges, universities graduate schools in U.S. only	Unlimited
<b>Penalties for non-qualified withdrawals</b>	10% penalty withheld on earnings	No penalty.
<b>Taxation of qualified withdrawals</b>	Federal Income Tax free until 2010	Withdrawals and loans are non-taxable unless the policy is a MEC or is surrendered, then taxable as ordinary income to the extent of gains.
<b>Ownership of assets for financial aid purposes</b>	Some assets may be included; varies by state	Policy owner
<b>Funding upon premature death of investor</b>	Only assets accumulate, which may be less than college saving goals	Full funding of college savings goal possible with death benefit
<b>Funding upon death of accountholder/owner</b>	Account passes to plan beneficiary	Death benefit paid to policy beneficiary income tax free

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This article is a summary of the authors' understanding of current tax laws and is not inclusive. Please consult your own tax advisor or attorney for issues related to your situation. This article was commenced in 2004. However the compliance departments of the insurance company and the broker dealer for whom Mr. Blakeman worked refused to permit its publication.

## Appendix B

### POLICY DESIGN

Life insurance costs are based on three primary factors: age, health, and sex. The optimal case for using this type of funding vehicle involves a couple aged 40 or below and in good health.

Because the Internal Revenue Code limits the amount of cash that can be paid into a life insurance policy without destroying its tax-favored status, the policy intended to fund college education should be carefully designed to accomplish the maximum advantage and the lowest cost of life insurance itself. To begin with, the estimated college costs should be calculated (numerous websites provide a free cost calculator). The death benefit (or combined death benefits if both parents earn income) should approximate these estimated costs, thus assuring the plan will be fully funded in the event of premature death.

A paid up additions rider should be added to the policy and funded to the extent required to accumulate a cash value of additions equal to the cost of the education by the time the funds are needed. The illustration systems of all major carriers will allow the designer to show withdrawals of specified amounts at particular times. The paid up additions can then be surrendered tax free when the funds are needed. Once the funding is complete, the base policy (original death benefit) will remain. The dividends may then be used to reduce premiums, which will usually result in a self-sustaining policy after about 15 years.

It is also critical that a waiver of premium rider be added for the full contract premium. This insures that if the parent becomes disabled, the policy will be funded by the insurance company. These riders are not expensive and do not require separate underwriting.

Alternatively, policy loans can be taken for the college funding. However, if this method is used, one must be careful to monitor the performance of the policy to make sure that the interest charges do not cause the policy to decline in value and ultimately lapse.

The college funding vehicle can also obviously be combined with a life insurance policy for general life purposes, such as retirement or income replacement. If this is done, however, one must be careful not to subvert the vehicle for other purposes and lose the benefit of the college savings "plan".