A Bit of Education May Help to Understand Popular College Savings Program

New Law Tweaks 529 Plans

by Alexandra Armstrong, CFP, and Kelly Wright, CFP

Thirty years ago, Section 529 plans were introduced as a way for people to save for college education. These plans became more popular when tax reforms in 2001 made the earnings on these accounts free of taxation if used for education.

Previously, people saved money in custodial accounts, but these accounts had the disadvantage of belonging to the children when they were no longer a minor (age varies according to state), and they could use the money for whatever they wished. In addition, capital gains and dividends held in a custodial account were being taxed above very low limits. But Section 529 plans have gained popularity over the years as people became more familiar with these vehicles.

Recent tax laws have modified the rules of Section 529 plans. In this article, we'll focus on the details of the Section 529 savings plan, which is a trust account that allows you to fund future college or graduate school expenses of a designated beneficiary. Typically, the beneficiary is a child or grandchild, but these accounts may be set up for anyone.

The primary benefit of the 529 savings plan is that any appreciation of the assets in the plan isn't taxed when the distributions are used for qualified higher education expenses (QHEE). In addition, in some states you obtain a tax deduction for your investment when you invest in a 529 plan.

What Can Distributions From 529 College Savings Plans Be Used for?

Money withdrawn from these plans is fully tax-free if used for qualified higher education expenses. A QHEE is defined as tuition, room and board costs, and student activity fees.

Expenses for course-related books, supplies and equipment are also included in qualified education expenses only if the fees and expenses must be paid to the institution as a condition of enrollment or attendance at an eligible educational institution. Students living off-campus or at home with parents can include certain expenses in lieu of "room and board," subject to FAFSA (Free Application for Federal Student Aid) limits published by school attended.

An eligible educational institution is any college, university, vocational school or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. Eligibility includes virtually all accredited public, nonprofit and proprietary (privately owned, profit-making) postsecondary institutions.

An eligible educational institution also includes certain educational institutions outside the United States that are eligible to participate in a student aid program administered by the Department of Education. You can check online with the FAFSA to see whether your institution qualifies.

New: The PATH Tax Act of 2015 now includes purchase of computers and Internet access as a QHEE.

Will Investing in a 529 Plan Negatively Impact Eligibility for Financial Aid?

Yes, it will. But in most cases, if done correctly, chances are that the benefits will far exceed the minimal effect on financial aid. If a parent saves for college and doesn't use a 529 plan, that asset is generally counted at 100 percent, whereas assets in a 529 plan are only counted at 5.64 percent. Note that setting up a 529 plan doesn't affect chances for a merit scholarship.

The Free Application for Federal Student Aid rules determine how the assets in 529 plans are counted. It depends on who owns them. Federal financial aid is based on family and student earnings and assets. The higher the level of assets and incomes, the less financial aid is available.

If a parent owns the 529 plan, it's counted as a parent's asset at up to 5.64 percent, but there's no income to the student for payment to the school.

For example, if a parent owns a Section 529 college savings plan worth $10,000, the most that's counted against financial aid is $564. If a grandparent owns the 529 plan, the asset isn't counted at all, but the payment to the school can be counted as income to the student at 50 percent.

If the student owns the 529 plan, the asset is counted as a student asset at 20 percent of the assets in the 529 plan and the payment to the school is counted as student income up to 50 percent.

Do I Have to Invest in a 529 Plan Sponsored by My State of Residence?

Currently, the state-sponsored plans from Kentucky, Louisiana, New Jersey and North Carolina are closed to out-of-state residents. Different states have made arrangements with different investment companies to manage the money in these trusts.

You can use the money in these savings plans to fund tuition as well as other postsecondary education-related expenses in any college or university in the United States.

Further, you don't have to contribute all your money for one child into one state's 529 savings plan. You can divide your money for the same child among different plans.

Do I Get a Tax Deduction for Investing in a 529 Plan?

Although the amount of your contribution in these plans isn't federally tax-deductible, it's often partially tax-deductible on your state income tax up to certain limits. This state tax break is most often for your resident state's plan.

What Is the Maximum I Can Invest in a 529 Plan?

Currently each individual may contribute as much as $70,000 at one time into each 529 plan for a particular beneficiary without exceeding the annual gift tax exclusion using a technique called five–year forward gifting.

Be aware, however, that "front-loading" the 529 plan means you're using five years of your annual gift tax exclusion — $14,000 per beneficiary — at one time, and *this requires the filing of an Internal Revenue Service Form 709 gift tax return.*

A husband and wife can contribute twice that amount per child for a total of $140,000 in a lump sum. *This also requires filing a Form 709 gift tax return as an acknowledgement that the gift is being split.*

Is There a Maximum Amount I Can Have in a 529 Plan per Beneficiary?

The maximum account value for a beneficiary is determined by the state that establishes the plan. One plan we reviewed allows contributions until a maximum of $350,000 of account value for that beneficiary is reached.

Are There Estate-Planning Benefits for Contributing to a 529 Plan?

Once you've contributed to a Section 529 savings plan, the assets in that account are excluded from your taxable estate unless you've elected five-year forward gifting.

In that case, the gifts for future years are called back as estate assets until the donor outlives the five-year period.

If the donor doesn't outlive the five-year period, there's a pro rata recapture back into the estate of the donor.

How Are Distributions Made?

Withdrawals from a 529 savings plan can be paid to the account holder, the beneficiary or the educational institution. If financial aid is involved, we suggest not paying the educational institution directly, as some schools reduce a student's financial aid by the amount of the Section 529 distribution.

In this case, we recommend the account holder pay the tuition bill, then reimburse himself with a 529 withdrawal. Note that it's important that the paid education costs and the matching reimbursement withdrawal take place in the same year.

What Are the Penalties if I Withdraw Money in Excess of My Contributions and Don't Use It for Qualified Higher Education Expenses?

In this case, the gains will be taxable at the account holder's tax bracket and will be subject to a 10 percent federal surcharge, with exceptions for the beneficiary's death, disability or receipt of a scholarship.

What Happens if I Set Up a Fund for My Grandchild and He Doesn't Go to College?

In most states these plans can remain in existence indefinitely. There's no age limitation for distributions. Further, the unused benefit can be transferred to another member of the designated beneficiary's family:

- **spouse**
- **son or daughter** or descendant of the beneficiary's son or daughter
- **stepson** or stepdaughter
- **brother, sister**, stepbrother or stepsister
- **father or mother**, or ancestor of either parent
- **stepfather** or stepmother
- **niece** or nephew
- **aunt** or uncle
- **the spouse** of any individual listed above
- **first cousin**
- **any individual** for whom the home of the designated beneficiary is his or her primary home for the entire tax year

The account owner also retains the right to revoke contributions and receive the plan assets at any time, subject to a 10 percent penalty on any gains that are withdrawn and not used for QHEEs.

Who Selects the Investments Made in the 529 Plan?

The account owner — usually the one who contributes the money — chooses the investments in the 529 plan. Prior to 2015, you could only change investments in 529 plans once a year.

The ABLE 2014 tax law now allows two changes of the investments per year.

You can escape this limitation by moving to another state's program, but you can only "roll over" the account in this manner once every 12 months.

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Conclusion

In this article we've tried to cover some of the important points about 529 plans, but obviously space in this column only allows an overview. Your financial adviser can help you decide how these issues apply to your personal circumstances.

The fees, expenses and features of 529 plans can vary from state to state. 529 plans involve investment risk, including the possible loss of funds.

There's no guarantee that a college-funding goal will be met. In order to be federally tax-free, earnings must be used to pay for qualified higher education expenses.

The earnings portion of a nonqualified withdrawal will be subject to ordinary income tax at the recipient's marginal rate and subject to a 10 percent penalty.

By investing in a plan outside your state of residence, you may lose any state tax benefits. 529 plans are subject to enrollment, maintenance and administration/management fees and expenses.

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