529 Savings Plans

Utilizing these savings plans can allow you to provide tax-free educational funding for yourself or others.

BY MICHAEL P. HATCH, CFP, JD

Would you like to establish a fund to help pay for your ongoing continuing education on a tax-free basis? Do you want to obtain further specialization or additional skills (such as endovascular training), but aren't quite sure how to pay for the education and training required? Have you thought about having a second career after you retire from medicine? These are just a few of the issues that a 529 Savings Plan might help you address.

529 PLANS AT A GLANCE

529 Savings Plans (also known as qualified tuition program or QTP) are educational savings plans sponsored and maintained by states or eligible educational institutions (including eligible private institutions). 529 Savings Plans come in two forms: (1) prepaid tuition plans, and (2) savings plans.

Prepaid tuition plans are plans maintained by educational institutions in which the taxpayer buys tuition credits or certificates for the prepayment of qualified higher educational expenses. The 529 Savings Plans are established by states or the agency to which they have delegated this responsibility, and are meant to cover a designated beneficiary's qualified higher education expenses. The scope of this article includes only the 529 Savings Plan, not the prepaid tuition plan.

A 529 Savings Plan allows you to set aside after-tax dollars, have the funds grow in a tax-deferred manner, and withdraw funds from the account on a tax-free basis if they are used for qualified higher educational expenses. Many physicians and parents have looked at setting up these plans for their children or grandchildren, but they may not have considered establishing one for their own benefit. Establishing your own 529 Savings Plan can allow you to help build your own personal educational funding mechanism. The rules around 529 plans were greatly liberalized with the Economic Growth and Tax Revenue Reconciliation Act (EGTRRA). After 2001, EGTRRA amendments allow individuals to set up a 529 Savings Plan for any beneficiary, including themselves. The advantages of this structure include:

- The owner of the 529 Savings Plan maintains control. The owner selects which plan to participate in, can change beneficiaries, and controls when distributions are made.
- The benefits of the 529 Savings Plan are not limited to any certain group of taxpayers, and certainly are not restricted by age or income limitations, such as in many other tax code provisions.

CONTRIBUTIONS TO THE PLAN

Any taxpayer, regardless of income, may contribute to a 529 Savings Plan. A taxpayer must make contributions in cash for a designated beneficiary. Each 529 Savings Plan will have an owner and a beneficiary, and in the case of establishing a plan for yourself, you can fill both roles. You are only limited as to how much you can put into a 529 Savings Plan, based on who the beneficiary is. If you are establishing a plan for which you will be the beneficiary, you are limited to the maximum contributions allowed by the plan you elect to participate in. These maximum 529 Savings Plan contributions vary depending on the state plan you are in, but typically range between $100,000 and $250,000 per beneficiary. If you are establishing a plan for which someone other than you will be the beneficiary, you are making a gift and are subject to the gift tax annual exclusion amount each year, which is currently $11,000 per donor. If you set up a plan for yourself or someone else, you are still subject to the maximum contributions allowable by the state plan that you are in—however, some are as much as $250,000. Assets can remain in this tax-deferred account a very long time—some plans as long as 30 years. Think about the impact of being able to get a tax deferral for 30 years on this money.

SELECTING THE RIGHT PLAN

You do not have to limit yourself to the 529 Savings Plan offered in your state, although some states make contributions to their plans for in-state residents very attractive. Some states offer a state income tax deduction for contributions made by residents of their state to their state-sponsored plan. Some states offer other incentives—for example, Nevada and Texas offer creditor protection for their own residents' assets held in their state's 529 Savings Plan. Contributions to 529 Savings Plans are nondeductible for federal tax purposes. Go to www.savingforcollege.com, one of the best Web sites available on this topic, and research all the plans before deciding which one is best for you. You should certainly review investment options, contribution limits, state tax benefits, as well as costs, before deciding on a plan. But again, the flexibility of the 529 Savings Plan shines through: if you want to make a change you can always rollover your 529 Savings Plan to another plan, tax-free.

Many providers of financial services have gotten into the 529 arena, including Fidelity, Vanguard, and TIAA-CREF, but each plan still has to be sponsored by a state entity. One of the biggest is CollegeAmerica through the American Funds Group, which is sponsored by the State of Virginia.

"We think 529 plans are a very good way for individuals to save for their own educational future, whether they're staying abreast of the latest developments in their field, or simply someone who plans to take classes when they retire," says American Funds Vice President Chuck Freadhoff. "The advantages of a tax-free 529 Education Savings Plan are the same whether they're sending a child to college or they'll be hitting the books themselves."

QUALIFIED HIGHER EDUCATION EXPENSES

Distributions from a 529 Savings Plan are tax-free if they are used for "qualified higher education expenses." These include expenses such as tuition, fees, books, supplies, and equipment necessary for attendance at an eligible educational institution. According to IRS Publication 970, *Tax Benefits for Education*, eligible educational institutions include any college, university, vocational, or other post-secondary educational institution, including virtually all accredited public, nonprofit or proprietary, post-secondary institutions. Expenses also include reasonable room and board costs for students taking a half-time, or greater, course load. The key to whether the institution or course work is a qualified higher educational expense is whether the institution is eligible to participate in programs administered by the Federal Department of Education. Check with your tax advisor on the eligibility of specific education that you would like to pursue. There can be limitations on the amount of tax-free distributions if you are receiving other tax-free assistance, such as fellowships, and 529 assets could limit financial aid awards.

GIFT AND ESTATE TAX IMPLICATIONS

Contributions to 529 Savings Plans are treated as a completed gift to the beneficiary. Thus, the contributor may shield up to $11,000, or $22,000 for married couples, (as indexed for 2003) of the contribution from gift tax liability by using the annual exclusion against the contribution. These limits only apply if you are setting up a 529 Plan for someone other than yourself. In addition, IRC Section 529 permits the contributor to amortize the contributions over a 5-year period, allowing a contributor to donate between $11,000 and $55,000 in a single year (between $22,000 and $110,000 for married taxpayers). Once the 5-year period has passed, you could then make further contributions.

Contributors have no estate tax liability on the account if the gift is complete. However, if the contributor elects to amortize the contribution over a 5-year period, and passes away within that period, the contributor's gross estate will include the unamortized portion. Contributions will be included in the gross estate of a deceased beneficiary to the extent they are distributed to the beneficiary's estate at death.

HOW MIGHT THIS WORK FOR YOU?

As an example, say that over time you put aside $11,000 per year in a 529 Savings Plan, or you are fortunate enough to be able to contribute $110,000 in one lump sum. As shown in Table 1, contributions could grow to $248,699 in 15 years at 6% earnings. If, on the other hand, you were not in a 529 Savings Plan, and instead were paying ordinary

TABLE 1. HYPOTHETICAL VALUE OF A $110,000 INVESTMENT IN A 529 SAVINGS PLAN AT A 6% RETURN

	Tax Deferred in a 529 Savings Plan	Taxable at a Combined 35%
Year 1	$110,000	$110,000
Year 2	$116,600	$114,290
Year 3	$123,596	$118,747
Year 4	$131,012	$123,378
Year 5	$138,872	$128,190
Year 6	$147,205	$133,190
Year 7	$156,037	$138,384
Year 8	$165,399	$143,781
Year 9	$175,323	$149,388
Year 10	$185,843	$155,215
Year 11	$196,993	$161,268
Year 12	$208,813	$167,557
Year 13	$221,342	$174,092
Year 14	$234,622	$180,882
Year 15	$248,699	$187,936

Value if used for education = $248,699

Value if used for noneducational expenses:

20% tax + 10% penalty* on earnings = $41,610

• *Net after tax of $207,089*

35% tax + 10% penalty* on earnings = $62,415

• *Net after tax of $186,284*

income taxes on a $110,000 investment, at say a 35% tax rate, your account could potentially have only $187,936—tens of thousands of dollars less than the 529 Savings Plan.

Of course, you should make an assessment of what funds you really plan to spend on higher education. With the new lower tax rates on dividends and capital gains, it makes more sense to fund a 529 Savings Plan with assets that would otherwise be generating ordinary income, such as corporate or government bonds, or almost any type of bank account, savings account, or CD. Even if you have to pay taxes on the funds because you used the 529 Savings Plan assets for other than qualified higher education expenses, it could still pay to be in a 529 Savings Plan because of the tax deferral.

DISTRIBUTIONS AND ROLLOVERS

Distributions from 529 Savings Plans are excluded from the recipient's gross income if they are used to pay qualified higher educational expenses. Taxpayers may make a tax-free rollover by transferring a distribution received from a 529 Savings Plan within 60 days into another 529 Savings Plan to benefit the same beneficiary or another beneficiary who is a family member of the former beneficiary (only one such rollover can be made within a 12-month period). For purposes of rollover distributions, the definition of family members includes:

- spouse
- child or a descendant of the child
- step-child
- sibling or step-sibling
- parent or an ancestor of either parent
- step-parent
- niece or nephew
- uncle or aunt
- son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law
- the spouse of any individual listed above
- first cousin

Any earnings distributed for purposes other than to pay qualified higher education expenses will be taxed to the contributor (unless the distribution is due to death or disability of the beneficiary, rollover distribution, or receipt of a scholarship). In addition, a 10% penalty tax will be imposed on distributions of earnings not used to pay qualified higher education expenses; however, certain exceptions apply (eg, death, disability, and so forth).

Because you can change beneficiaries, the owner could always change beneficiaries to other family members tax-free. Given that you can change the beneficiaries of your 529 Savings Plan, and looking at the relatively large list that defines who a family member is, you may likely be able to find someone in a lower tax bracket who you want to provide assistance to, if you ever have to take a taxable distribution.

SUNSET PROVISIONS AND 529 PLANS

Many of the education incentives enacted under EGTRRA in 2001 are subject to the Act's Sunset provision. Due to complex procedural rules involving the federal budget and legislation, all newly enacted provisions of EGTRRA will sunset (expire) in 2011 without further Congressional action. Although we cannot predict with certainty what Congress will do, in the past, significant changes that have caused taxpayers an undue burden have been accompanied by grandfather provisions. Old rules would make the distributions from a 529 Savings Plan taxable to the beneficiary, at the beneficiary's rate. As this issue goes to press, Congress is actively considering scaling back the benefits of 529 Savings Plans—they have become so popular that the IRS is now concerned that they are being abused. Consult your tax advisor before making significant decisions in this area.

OTHER RESOURCES AND HELPFUL WEB SITES

IRS Publication 970, *Tax Benefits for Education*, can provide much of the useful details on IRS rules surrounding these plans—you can find it at www.irs.gov. (Bear in mind that the IRS refers to 529 Savings Plans as qualified tuition programs or QTPs.) You can find information on 529 Savings Plans on the Web sites of mutual funds and financial services firms that offer them. In addition, here are several other resources that you may find useful:

- *The Best Way to Save for College*, by Joseph F. Hurley, CPA, author of www.savingforcollege.com Web site.
- www.collegeboard.com
- www.collegesavings.org

CONCLUSION

529 Savings Plans offer the ability to earmark certain funds, which would otherwise be generating taxable interest and dividend income, into a savings vehicle that could defer taxes over many years. With the flexibility to change plans, change beneficiaries, rollover the account, and generous allowable contributions, a 529 Savings Plan might help you achieve some of your financial and educational goals. ■

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