# A Primer on Section 529 Plans

By George Chamberlin

The section 529 plan – named after a section of the Internal Revenue Code enacted less than twenty years ago – provides an effective way to save for college expenses. Today over ten million investors participate in these plans with more than $200 billion invested. If you have children or grandchildren with college plans for their future, it might be beneficial to look into the section 529 plan as a part of your funding strategy. Of course, you can contribute to a section 529 plan for your own higher education, too.

Section 529 plans are offered by the states (not the Federal government) and typically include the option of a prepaid tuition plan for particular institutions as well as a more general savings plan option which can be used at any eligible institution nationwide. The terms and investment selections of these savings plans vary from state to state and plan to plan. However, these plans have several factors in common, including their tax benefits, tax risks, significant elements of control for the person funding the plan and more.

## Tax Benefits for Contributions

Federal law allows your contributions to a section 529 plan to grow as tax deferred accounts, a lot like your 401(k) or IRA. When the money is distributed, though, unlike the 401(k) or IRA, there will be no federal income tax due so long as the distributions are for qualified college expenses. See below for a discussion of what may be qualified expenses. As a further tax benefit and encouragement to saving for college, some states allow the contributor to a section 529 plan to receive an income tax deduction for the contributions when they are made.

Monies contributed to a section 529 plan are earmarked for a named beneficiary when the contribution is made and therefore are not included in the contributor's estate for estate tax purposes at death. Although the contributions are gifts and therefore may be subject to gift tax when they exceed $14,000 per beneficiary each year, and possibly generation skipping transfer tax when the beneficiary is more than one generation younger than the contributor as well, there are no such tax consequences when the contribution falls within that annual gift exclusion. Furthermore, the law allows front-loading of gifts to a section 529 plan to the extent of five years of gifts in the first year (currently $70,000), allowing the money to go to work sooner while preventing additional tax-free gifts in the succeeding four years. Don't forget that the annual gift exclusion amount limitation applies to ALL gifts to a particular beneficiary so that funding the section 529 plan may preclude other gifts to that person in the same year.

## Qualified Distributions

The single most important attribute of the section 529 plan is the treatment of qualified distributions from the plan. Distributions on behalf of a beneficiary from the section 529 plan may be tax free if made for "qualified expenses". Such expenses must be for higher education (beyond high school but including graduate school) and include tuition,

fees and related costs. Pending legislation in Congress makes clear that computers will be included as qualified expenses although they have not been included in many prior years. Expenses which may NOT be tax free include those for general expenses such as room and board, insurance, clothing, transportation, medical expenses and the like. Basically, those expenses that are specific to a college education as opposed to day-to-day living are the only ones qualified for purposes of the section 529 plan.

## Control – Very Powerful

Despite the nature of the section 529 plan as a gift to a named beneficiary which is intended to fund qualified college expenses, the contributor retains a tremendous amount of control over the plan account. The contributor typically may choose or change the investment allocation for the account, may take withdrawals for oneself (if willing to abide by the negative income tax results), change the designated beneficiary to another person and, of course, will be able to direct when and if withdrawals are made for the qualified college expenses of the beneficiary.

What is interesting about this level of control is that despite the contributor's retention of control, the monies in the plan are treated as a gift to the beneficiary and are not a part of the contributor's estate. As a result, they are not subject to federal or state estate taxes. This is a very unusual result when compared to many other investing and gifting vehicles.

Even with all the control, there are factors apart from possible tax consequences that may make selection of some state's section 529 plans less attractive. Depending on the particular plan chosen, there may be more limitations on available investment selection than other plans. Other plans mandate a move into less volatile and risky investments as the time nears for the beneficiary's college attendance, which may not fit a contributor's preference for investing. In addition, there is a wide variation in the expenses associated with section 529 plans that might make some plans relatively unattractive. Having the ability to choose among such plans is another aspect of control useful to a contributor.

## Tax Hazards and Non-Qualified Withdrawals

Federal law also allows the contributor to the section 529 plan to use the money for something other than qualified college expenses, even to take the money back. However, any growth in the accounts will be fully income taxable AND may be subject to a ten percent penalty ("additional tax"). This tax hazard may be avoided, of course, by using the funds for qualified college expenses. Note, however, that not all expenses seemingly related to college are deemed qualified; so be careful on the expenditures.

Where your section 529 plan is overfunded and you wish to withdraw money for other uses, any state income tax deduction for a contribution will be subject to recapture. However, where the overfunding is the result of a scholarship received by the beneficiary, the penalty for a withdrawal may be waived, although the income tax on growth will still be due. Where expenses have been paid but the beneficiary withdraws from college and receives a

refund, pending legislation would allow the beneficiary to refund the money to the section 529 plan and escape both income tax and the penalty. In the unfortunate case where a beneficiary dies or becomes disabled and unable to attend college, the penalty on non-qualified withdrawals may also be waived.

Tax hazards also come with the gift tax and limits on annual gifts for contributions to the plan as we discussed above.

If you are interested in learning how a section 529 plan could help funding your education plans for yourself or family members, ask your advisor for more information and examples of how the plan may work for you.

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