529 Plans: A College Savings Alternative

As higher education costs continue to soar, many parents find themselves faced with the nagging question, "Will I have enough money to pay for my child's college education?" Although most people today are likely to agree that an investment in higher education usually reaps its rewards in higher long-term earnings—and, hopefully, greater job satisfaction—one key concern is how to choose a smart savings alternative. **529 plans** are flexible investment options with tax benefits.

These state-sponsored plans offer attractive tax benefits and allow you to contribute substantially higher sums than with other savings vehicles, such as the **Coverdell Education Savings Account** and custodial accounts. The funds may generally be used for any "qualified" higher education expense, including tuition, room, board, fees, books, supplies, and equipment. You don't necessarily need to be a resident of a state to participate in its 529 plan. In some states, you may even name *yourself* as the beneficiary, if you are planning to further your education sometime in the future. However, participation does not guarantee admission to college—the prospective student will still have to meet the school's entrance requirements.

Although many details of these plans vary by state, they generally come in two forms—**prepaid tuition plans** and **college savings plans**. Prepaid tuition plans allow participants to "lock in" tuition rates at eligible state colleges or universities with a lump-sum investment or monthly installments. The funds are pooled and invested over the long term, so the earnings should meet or exceed expected future tuition increases. The contract value may also be applied to private or out-of-state schools (although possibly not at full value, depending on the state). College savings plans allow contributions to vary, and the full value of the account can be applied at any accredited institution of higher education nationwide.

Major Advantages

Substantial Contributions Allowed. Contribution limits are significantly higher than with other college savings alternatives. Some states allow you to set aside more than $100,000 per beneficiary, and they generally have no age or income restrictions.

Tax-Free Distributions. Earnings grow tax deferred, and distributions are tax free if used for qualified education expenses. In addition, some states offer their own tax breaks, although you may need to be a resident of that state.

Gift Tax Benefits. 529 plans allow you to transfer up to five years' worth of annual gift tax exclusions in *one* calendar year, as long as no additional gifts are given to that individual during the five-year period. Individuals may gift up to $60,000 in one year, and married couples may give up to $120,000.

Switching Funds Tax Free. You are able to switch funds from one 529 plan to another 529 plan free of any taxes. This allows you to make such a switch as frequently as once a year without changing beneficiaries, and it also allows interstate plan transfers.

Expanded Beneficiary List. Grandparents may be pleased to learn that under 2001 tax reform, the list of possible beneficiaries has been expanded to include cousins. For example, grandparents with multiple grandchildren can set up a 529 plan for their first grandchild. Should that first grandchild choose to delay pursuing an education, the grandparents may transfer the plan to another grandchild.

Other Considerations

Professional Asset Management. 529 plans offer a "hands-off" savings approach. Funds invested in the plan are professionally managed through the appropriate state treasurer's office or by an outside investment firm hired by the plan.

Penalty for Refunds. A federal 10% penalty may be imposed on the *earnings* portion of a nonqualified withdrawal in addition to ordinary income tax. However, you may be able to roll over the account to a new beneficiary to avoid a nonqualified withdrawal.

Effect on Financial Aid. Any investment may affect a student's eligibility for financial aid. Interested organizations are attempting to clarify exactly how 529 plans will affect federal financial aid. For many families who earn less than $50,000 and file 1040EZ or 1040A tax forms, a 529 account may not be counted at all. Others, in higher income brackets, may want to open the account in the parents' names, since financial aid offices typically count only 6% of parental assets compared to 35% of the student's assets. For more specific information, refer to the particular state plan that interests you, and consult a knowledgeable professional.

Worth "Studying"

The Pension Protection Act of 2006 gave a boost to 529 plans by making tax-free distributions a permanent benefit. Since 529 plans operate under individual state laws, costs and details vary by state. For more information and to compare state plans, do a little “homework” and visit these websites: Savingforcollege.com and Collegesavings.org.

529 plans offer no guaranteed rate of return. Out-of-state plans may have in-state income tax ramifications. Always ask for, and refer to, the program description for complete information, including risks, fees, and expenses. Read it carefully before investing.

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