

529 Plans: Tax Benefits for Funding Education



What are Qualified State Tuition Programs?

Prior to 2002, many states had developed Qualified State Tuition Programs (QSTP's), which enabled a contributor to fund future higher education costs. Federal Income Tax on the earnings in these plans was deferred until distributed. Because the QSTP's were authorized by IRC Section 529, these were often called "529 Plans."

Changes to Section 529 Now Effective .

The 2001 Tax Act made several significant changes to QSTP's. Among these favorable changes were:

1. Tax free distributions when used for qualified education expenses. Previously the distributions were taxed as income to the beneficiary.
2. Same beneficiary rollovers from one [state] plan to another.
3. Adding "first cousin" to the list of "family members" eligible for beneficiary changes
4. Allowing educational institutions to sponsor plans. Previously qualified programs had to be sponsored by the state.

5. Changing the title of the plans to "Qualified Tuition Programs" (QTP's, since they are no longer limited to state programs, but can encompass the programs of individual educational institutions).

Originally these programs were designed for state residents for use in in-state colleges. However, most plans are now available to in-state and out-of-state residents.

There have traditionally been two type of State sponsored plans: Prepaid Tuition and Savings Plans. Plans established by individual institutions are limited to Prepaid Tuition Plans.

What is the Purpose of a Prepaid Tuition Plan?

Generally, a prepaid tuition plan allows an individual (principally parents) to prepay the higher education costs for a designated beneficiary. This option can now be offered by individual institutions. The purpose is to "lock in" the cost. The prepayments are invested by the plan sponsor. If the investment does not keep up with increases in tuition, the contributor will owe nothing more, when the time comes for the child to matriculate at the designated institution. If however, the plan has earned more than the tuition costs, the plan can keep the excess. This feature is important for rollovers.

Savings Plans: A Viable alternative?

Unlike Prepaid Tuition Plans, there are no "guarantees" with a Savings Plan. However, investment returns in excess of the rate of inflation for college costs are retained by the participants. Basically the contributor decides how much to contribute, and when the beneficiary is ready to enter the institution of higher learning, the plan is drawn down to fund some or all of the recipients eligible educational expenses. Many states (individual institutions cannot sponsor Savings Plans) have agreements with mutual fund families (i.e. Vanguard, Fidelity) for the

investment of these funds. The contributor cannot direct the investments, but can choose between investment options based on age, risk tolerance and other considerations.

What are the Tax Benefits?

There are no income tax consequences to the contributor or the beneficiary, when contributions are made and while the funds remain in the account. However, the contributions themselves are treated as taxable gifts, subject to the annual gift tax exclusion. If these gifts exceed the amount of the exclusion, the contributor can elect to spread the contribution over a five-year period. This allows \$55,000 of initial funding per beneficiary without effecting the donor's unified credit.

There are no AGI-based phase out rules for making contributions to QTP's. Nonqualified payouts from the plans are subject to a penalty of 10%, using the plan's earnings.

Distributions from QTP's are now tax free if used to pay qualified higher education expenses.

What are Qualified Expenses?

Qualified expenses include:

1. tuition
2. fees
3. books
4. supplies
5. required equipment required for enrollment or attendance
6. room and board if the student attends the institution at least half of his or her time.

To determine the amount of eligible room and board, the student may apply the amount applicable in the calculation for financial aid cost of attendance at the institution or what the institution actually charges, whichever is greater. This calculation is the same for a student living off campus.

Eligible institutions now include all colleges, universities, vocational school, or other post-secondary educational institution eligible to participate in the student aid program of the department of education, which includes virtually all accredited public, nonprofit, or proprietary post-secondary institutions.

Can Excess Funds be Rolled Over or Applied to a new Beneficiary?

As long as the new beneficiary is a member of the same "family" as the old beneficiary, the funds from one plan may be rolled over into a new plan (as long as the transfer is made within 60 days of withdrawal), the rollover will not be treated as a taxable distribution. Likewise, the beneficiary can be changed to another member of the family without taxable consequences. First cousins are now considered family members. This allows grandparents to redistribute accounts among all their grandchildren, not just those of a single set of parents.

There are no gift tax consequences to rollovers and beneficiary changes if the old and new designated beneficiaries are members of the same generation. Gift tax does apply if the new beneficiary is one generation lower. The old beneficiary is the giftor in this case.

If the new beneficiary is two or more generations lower, generation skipping rules apply.

Estate Taxes?

QTP account balances are not included in the contributor's estate, unless he or she elected to spread out the gift over the five years. Then the unamortized portion of the contribution is included in the estate.

If the designated beneficiary dies, then the amount is included in their estate.

