Q&A: What you should know about Section 529 plans

Ask most families why they save and invest, and the common responses are likely to be to fund a comfortable retirement and to pay for their children's college expenses.

The task gets increasingly difficult every year. Today, tuition and room and board at a top-notch, four-year private college can be over $50,000 a year.

Many families are exploring the option of opening a Sec. 529 plan as a way to build a fund for college. If you are among them, here are some of the questions that you are likely to want answered.

In a nutshell, what's a Section 529 plan?

A Section 529 plan (the name comes from the U.S. Internal Revenue Code section that authorizes these plans) is a state-sponsored savings account set up, in most states, through a financial institution. The account is set up for the purpose of saving in order to pay for most "qualified" higher education expenses (tuition, room, board, supplies, etc.) at eligible institutions. Amounts accumulated in a Section 529 plan may be used for expenses at in-state or out-of-state colleges, universities and certain technical schools. The big attraction: There are a number of tax breaks associated with setting up a Section 529 plan.

There is also another kind of Section 529 plan, usually referred to as a "prepaid tuition plan." These are state-offered plans that are not savings accounts but, rather, contract-based arrangements that lock in in-state tuition costs at current tuition rates. (In some cases amounts in these plans may be transferred to cover expenses at out-of-state institutions.)

Are the tax breaks significant?

Most definitely. No federal tax is paid on the income earned on amounts accumulated in a Section 529 plan. Even better, when withdrawals are made and used for qualified expenses, they won't be taxed either. Often, there won't be any tax consequences at the state level either. From an estate planning perspective, there can be tax advantages as well (more on this below).

Are there a lot of restrictions that I need to worry about?

Section 529 rules are fairly liberal. “Eligible” institutions are defined as those that may participate in U.S. Department of Education student aid programs. (There are over 8,000 schools from which to choose.) Section 529 plans may be set up for children, grandchildren or other individuals—even someone unrelated. Generally, there are no age or income limitations, nor any restrictions on the number of plans that may be set up for a beneficiary. There is no prohibition on contributing to an out-of state plan (assuming that the plan permits nonresident participants). Should the beneficiary of the plan not need the funds, or if funds are left over after all expenses have been paid, a new beneficiary can be named. Although the new beneficiary must be a relative, within that category there is a wide range of choices.

How much may I contribute to a Section 529 plan?

Contribution amounts may be relatively small—sometimes as low as three figures. Maximum contributions are set by the state and vary, but generally are at least $100,000 per plan beneficiary. As a measuring stick, maximum contributions may be no more than the amount necessary to pay for five years of undergraduate education and two years of graduate school. This has been interpreted in many states’ plans to permit accumulations in excess of $200,000.

Do I give up control of my money when I put it in a Section 529 plan?

In general, the beneficiary of a Section 529 plan has no automatic right to the money in his or her account. In other words, *you* maintain control over when withdrawals are taken and for what purpose. Many state plans allow you to withdraw the funds for any reason, whenever you wish. However, for any amount withdrawn that is not used to pay for the beneficiary’s college expenses, a penalty of at least 10% will be owed on earned income and the net capital gain realized in the Section 529 plan assets, *in addition to* income tax at your marginal income tax rate. However, the penalty will not be assessed if the account is terminated as a result of the beneficiary’s disability, or if funds are withdrawn because the beneficiary has received a scholarship, and the funds are not needed for higher education expenses. And no tax or penalty is paid on the amount that represents a return of contributions.

What are the investment choices offered in a Section 529 plan?

There is a variety of investment options from which to choose, including growth and income funds and more conservative investments such as money market funds. Many plans offer an "age-based fund," which includes investments that have been targeted to a child's time horizon for entering college. In choosing a plan, the number of investment choices and fees associated with the plan should be considered. In most plans investment choices may be changed once every 12 months, sooner if you are changing the beneficiary.

Are there estate planning implications to contributing to a Section 529 plan?

Amounts contributed to a Section 529 plan are no longer considered to be your property and, as a result, are not subject to federal estate tax at your death—even though you retain control over the plan, the investments chosen, and how and when funds are distributed. The contributions are considered gifts for federal gift tax purposes and are eligible for the annual gift tax exclusion (in 2010, $13,000). A special federal gift-tax provision allows you to use five years' worth of annual exclusions, or $65,000 in 2010, at one time. Three points to consider: Taking maximum advantage of this special exclusion precludes additional annual exclusion gifts to the beneficiary for the year of the contribution and the next four years. And should you die anytime during that five-year period, a prorated amount will come back into your estate. Finally, contributions made in excess of the annual gift tax exclusion amount use up a portion of your lifetime gift tax exclusion (currently, $1 million).

How does a Section 529 plan affect chances to qualify for federal aid?

According to guidance provided by the U.S. Department of Education, the individual who sets up and contributes to a Section 529 plan is considered the owner of the plan for purposes of determining eligibility for federal financial aid. Thus, only 5.6% of the value of the account would be counted in figuring a parent's expected contribution toward costs for each academic year, much better than the 35% that would be assessed if the plan were to be considered as owned by the student or were in a custodial account. However, when a withdrawal is made, it is considered income to the student and, therefore, could affect eligibility for aid in a subsequent year.

As you can see, a Section 529 plan offers significant benefits for college savers, but there's a great deal to learn as well. Do you have additional questions about 529 plans? Or do you want to find out more? If so, let us know. We would be glad to be of assistance.