The Ups and Downs of Section 529 College Savings Plans

By Steve Wightman, CFP

Parents and grandparents should take note of the new breaks that are provided to individuals who make donations to College Savings Plans (a.k.a. Section 529 Plans...after the Internal Revenue Code Section that created these plans). All of the earnings from these plans grow tax deferred until the assets are withdrawn. Since January, 2002, if the assets are used for qualified higher education expenses, the earnings are exempt from federal income tax. This means that for all qualifying expenses, the investment income and gains will never be subject to federal taxation.

What are qualifying expenses? Qualified expenses include tuition, fees, supplies, certain room and board costs and books. A few states also exempt the income from state taxation if the assets are used for qualified higher education expenses or offer deductions/tax credits for contributions to their plan. In addition, 529 plans provide an escape hatch, permitting grandparents to bypass GST, or Generation Skipping Tax at a 55% rate on certain estate assets passing directly to grandchildren.

To help familiarize you with these plans, please visit www.WightmanFinancial.com to find:

1.) A listing of each state's plan and the phone numbers to call for additional information and additional information regarding these plans.

2.) A chart that compares some of the features of these plans with other college savings techniques.

Although 529 plans are but one of several strategies you may use to plan for higher education, they do not solve every need for every person. It is wise to review all planning strategies when considering education funding. The following is a brief summary of the major advantages and disadvantages of College Savings Plans:

The Upside:

1.) Earnings are exempt from federal income taxes if they are used for qualified higher education expenses.

2.) Accounts are transferable to other family members of the beneficiary-gift tax-free. This may be a significant advantage for families with potentially high income and estate tax liabilities.

3.) In some states, accounts may be protected from creditor claims and divorce claims if the beneficiary is other than the donor.

4.) Virtually anyone can contribute to one of these accounts regardless of their income level.

5.) Donors can contribute $200,000 or more to one of these plans in a single year (subject to the plan's donor limits). Gift tax rules still apply. However, section 529 of the Federal Tax Code allows tax-free gifting made though a special gift tax provision. It permits a donor to consolidate up to five years of gifts (i.e., $55,000 per individual, $110,000 per couple) for the year of 2002 to each beneficiary through a special election made on the donor's gift tax return. Contributions in excess of this amount will be counted against your estate tax exclusion amount, or one million for 2002.

6.) The donor retains control over the assets even if the assets are not used for higher education expenses and may reallocate any amount up to 100% to a new beneficiary.

The Downside:

1.) Most states still tax the earnings from these plans when they are withdrawn to pay for qualified higher education expenses. The state income tax liability should be small since the earnings are taxed at the beneficiary tax rate, which is typically lower than that of the donor's. Keep in mind that states that follow federal income taxation laws, like Massachusetts, historically lag updating their laws, but they eventually do. For instance, when Roth IRA provisions were passed in 1997, it took Massachusetts two years to make corrections in their laws so that distributions would neither be taxed or subject to lawsuits as provided in federal legislation.

2.) To receive state-specific tax benefits, state residents must use the College Savings Plan adopted by their own state. For example, Massachusetts' plan is managed by Fidelity. If Massachusetts eventually exempts income from these plans from Massachusetts state taxation, the state will probably only exempt earnings from assets invested in its own plan, and may not provide the exemption for amounts earned in other state's College Savings Plans.

3.) Donors are limited to the investment options that are available within the College Savings Plan that they choose. This is a serious disadvantage, say, over a Roth or Education IRA. For example, the Massachusetts U-Fund Plan currently has two investment lifestyle options and investors must allocate their contributions between one of those options.

4.) Donors cannot move money between the investment options within the plan. For example, if a donor elects to place $50,000 in the 100% equity option, then the assets must remain in the 100% equity option until they are withdrawn. This is a very significant drawback to these plans. However, some states have requested a Private Letter Ruling from the IRS requesting that participants be allowed to move money between investment options within the state's plan. The IRS has ruled in favor of this request. Until this restriction is dropped by the state you are working with there are two ways around this investment restriction:

   a.) A new federal law allows donors to move money between state plans once a year on a tax-deferred basis. So, if a Massachusetts donor was not comfortable with the investment option that he or she selected, the donor could move money to New York's plan on a tax-deferred basis and select new investment options under the New York plan.

   b.) Most plans have an age-based asset allocation investment option available that automatically moves their plan's assets to lower risk investments as the beneficiary moves closer to the date that they would attend college. For example, Massachusetts' age-based option allocates 85% to equities for a 1 to 4-year old beneficiary and by age 16 the allocation to stocks is only 25%.

College Savings plans are not just an effective vehicle for individuals to set aside money for the post-secondary education for their children, grandchildren and other family members, they are an intergenerational planning tool. Since tax avoidance is the primary benefit of these accounts, the earlier you start contributing - even in small amounts, the greater the benefits.

The greatest benefit may be that you have lived a life on purpose by creating a lasting legacy of higher education for your family that may transcend several generations. Education planning is a way of transferring the high cost of college from the student (while in their lowest earning and tax years) to parents and grandparents (while conceivably in their

highest earning years) and receiving the most tax benefits, aka, tax scholarship. Parents take advantage of state income tax deductions not available to their children for 529 plan contributions and contributions grow without any state or federal taxation. With sound education planning, students having received its benefits understand that they too will one day become torchbearers, enlightening future minds and stretching the power of their dollars through tax-free savings.

Choosing the right plan and the right options for you in consideration of your long-term game plan is complex. For starters, cruise our website, www.Wightmanfinancial.com. Later, you may wish to seek the assistance of a trusted financial advisor to help navigate through education, tax and estate issues so that your plan becomes not just a road map to education, but a legacy you can be truly proud of. www.Savingforcollege.com maintains a list of financial advisors certified in education funding. Visit it to learn if there is one in your area.

College Savings Plans: Are there more ups than downs? Most people would say so. With the Federal Tax Code flipping back to its pre-2001 status on January 1 2011 unless re-enacted, let's hope that congress agrees.

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