529 Plans

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Introduction

529 plans (also known as a "qualified tuition program") were created under the Small Business Job Protection Act of 1996 (SBA '96) as a means of allowing taxpayers to save for higher education expenses for a designated beneficiary. A 529 plan may be provided by a state, an agency of the state or by an educational institution.

Like the education savings account (ESA), the 529 plan is an excellent way to save for education expenses. Earnings accumulate on a tax-deferred basis and distributions that are used for qualified education expenses are tax- and penalty-free. Unlike the ESA, the 529 plan may be set up in a way that allows individuals to prepay a student's qualified higher-education expenses at an eligible educational institution. Also, the contribution limits for a 529 plan are considerably higher than those for an ESA. Here we take a look at 529 plans, how they work and how you can use them to save for a child or grand-child's college education.

Types of Plans

There are two types of 529 plans:

- *Prepaid tuition programs*, which may be offered by the state of an eligible educational institution. Prepaid tuition programs allow for the advance purchase of credits for the designated beneficiary. These are usually established during enrollment periods established by the state of the eligible educational institution.

- *College savings plans* allow contributions to be made to the account on behalf of the designated beneficiary. These can usually be established at any time, including immediately after the designated beneficiary is born.

Individuals would review the feature and benefits of both types of 529 plans to determine which is more suitable for the designated beneficiary.

The designated beneficiary under a 529 plan is the student the plan is established for. The designated beneficiary can be changed to an eligible person. Typically, the designated beneficiary is changed if the current designated beneficiary will not need the funds in the 529 plan for eligible education expenses. If a state or local government or certain tax-exempt organizations purchase an interest in a 529 plan as part of a scholarship program, the designated beneficiary is the person who receives the interest as a scholarship.

For purposes of a 529 plan, an eligible educational institution is any college, university, vocational school, or other post-secondary educational institution eligible to participate in a student aid program administered by the Department of Education. This includes virtually all accredited public, nonprofit and proprietary (privately owned profit-making) post-secondary institutions.

Certain educational institutions located outside the United States also participate in the U.S. Department of Education's Federal Student Aid (FSA) programs.

Individuals should check with the educational institution to determine if it is an eligible education institution for 529 plan purposes.

Eligibility

Who Can Establish and Contribute to the 529 Plan?
Anyone can establish and contribute to a 529 plan on behalf of a designated beneficiary. This means that relatives, family, friends and even the designated beneficiary can establish the 529 plan for him- or herself. But the rules do vary. For instance, some 529 plans limit participation to residents of the state while others allow anyone to participate, regardless of the individual's state of residence. Individuals should check with the financial institution or the education institution providing the plan to determine the eligibility requirements for establishing an account under the plan.

Some 529 plans may have established enrollment periods before which new accounts must be opened.

Age and Income Requirements
Unlike the ESA, 529 plans do not have income restrictions. Some 529 plans - although there are very few - place age restrictions on designated beneficiaries. Individuals must check with the plan provider and the plan documents to determine whether there are any restrictions that apply to the 529 plan they want to establish for the designated beneficiary.

The investment options available under the plan may be determined by the age of the beneficiary, and are often automatically adjusted as the beneficiary's age moves from one range to another. For prepaid tuition programs, the cost per credit may be determined by the number of years that the designated beneficiary has left before he or she reaches a certain age- usually the age that students typically begin attending college.

Change in the Designated Beneficiary
Like the ESA, the 529 plan allows the designated beneficiary to be changed to a qualified family member who meets any age requirements as determined by the plan.

For the purpose of determining who can become a designated beneficiary of a 529 plan, a qualified family member includes the following:

- The designated beneficiary's spouse
- The designated beneficiary's son or daughter or descendant of the beneficiary's son or daughter
- The designated beneficiary's stepson or stepdaughter
- The designated beneficiary's brother, sister, stepbrother or stepsister

- The designated beneficiary's father or mother, or ancestor of either parent
- The designated beneficiary's stepfather or stepmother
- The designated beneficiary's niece or nephew
- The designated beneficiary's aunt or uncle
- The spouse of any individual listed above, including the beneficiary's son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law
- Any individual for whom the home of the designated beneficiary is his or her primary home for the entire tax year
- The designated beneficiary's first cousin

Amounts that are rolled over to a new designated beneficiary must be rolled over within 60 days of being distributed. Alternatively, the change can be made by changing the name and tax identification number on the 529 account to that of the new designated beneficiary.

Contributions

Regular contributions to 529 plans must be made in cash (which includes checks). In-kind contributions, such as stocks, bonds, mutual funds or other non-cash items cannot be used to make regular contributions to and cannot be made in the form of securities.

Contribution Limit
The maximum amount that may be contributed on behalf of each designated beneficiary varies among states. Typically, contributions to each plan are limited to amounts that are necessary to finance the designated beneficiary's eligible education expenses. Where limits are established, they are usually applied on a lifetime basis. For instance, a plan may limit total contributions to $200,000, which is the maximum total that can be contributed to the designated beneficiary's 529 account over time.

Amounts contributed to a designated beneficiary's 529 account are treated as a gift. However, contributions of up to $13,000 can be made for each designated beneficiary without incurring federal gift tax in accordance with the annual exclusion applies to gifts to each done. Alternatively, an individual may be able to contribute a lump sum that covers five years, giving a total of $65,000 ($130,000 for married couples), provided the individual makes no additional gifts to that designated beneficiary for the five-year period.

Care must be taken to ensure contributions do not exceed amounts necessary to cover eligible expenses, as the earnings portion of distributions not used to cover such expenses may be subject to income tax and early distribution penalties.

Rollovers, Transfers, Changing Designated Beneficiaries
If a designated beneficiary no longer wants or needs the balance in his or her 529 plan, the amount can be given to an eligible family member. For this purpose, eligible family members include the following:

- The designated beneficiary's spouse
- The designated beneficiary's son or daughter or descendant of the beneficiary's son or daughter
- The designated beneficiary's stepson or stepdaughter
- The designated beneficiary's brother, sister, stepbrother or stepsister
- The designated beneficiary's father or mother, or ancestor of either parent
- The designated beneficiary's stepfather or stepmother
- The designated beneficiary's niece or nephew
- The designated beneficiary's aunt or uncle
- The spouse of any individual listed above, including the beneficiary's son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law or sister-in-law
- Any individual for whom the home of the designated beneficiary is his or her primary home for the entire tax year
- The designated beneficiary's first cousin

The amount can be moved to an eligible family member as a rollover, transfer or by changing the name and tax identification number on the account to that of the new designated beneficiary. If the rollover method is used, the rollover must be completed within 60 days of the amount being distributed from the plan.

Tax Deduction Allowance
Some states' 529 plan rules allow taxpayers to receive a tax deduction for contributions, but there may be certain requirements. For instance, while a state's 529 plan may allow anyone (regardless of his or her state of residence) to participant in its 529 plan, only residents of the state may be allowed a tax deduction for the contributions. Individuals must check with the particular plan to determine its features and benefits.

Permissible Investments in 529 Plans
The investment choices for 529 plans are usually limited to mutual funds or annuities. For some plans, the investment choices are based on the age of the beneficiary, allowing more aggressive investments for younger beneficiaries.

Distributions

Distributions from 529 plans used for qualified education expenses are tax- and penalty-free if the amount is equal to or less than the designated beneficiary's qualified education expenses. For distributions that are more than the individual's qualified education expenses, the earnings may be subject to tax and an additional 10% early-distribution penalty. Some states allow qualified individuals, as defined by the state, to claim tax deductions for contributions they make to 529 plans. If a tax deduction is allowed, state taxes may also apply to a distribution of amounts other than earnings.

Qualified Education Expenses
Generally, qualified education expenses include the following:

- Expenses required for the designated beneficiary's enrollment in and attendance at an eligible school. Eligible schools include colleges, universities, vocational schools and accredited post-secondary educational institutions that are eligible to participate in a student aid program administered by the Department of Education.
- Tuition and fees
- Books, supplies and equipment
- Academic tutoring
- Room and board
- Uniforms
- Transportation
- Expenses of a special needs beneficiary that are necessary for that person's enrollment or attendance at an eligible educational institution.

Tax Treatment of Distributions
A distribution from a 529 plan that is not used for qualified educational expenses may be subject to income tax and an additional 10% early-distribution penalty. The penalty will be waived, however, if the distribution occurs for any of the following reasons:

- The designated beneficiary dies, and the distribution goes to another beneficiary or to the estate of the designated beneficiary.
- The designated beneficiary becomes disabled. A person is considered disabled if there is proof that he or she cannot do any substantial gainful activity because of a physical or mental condition. A physician must determine that the individual's condition can be expected to result in death or continue indefinitely.
- The designated beneficiary receives any of the following:
  - a qualified scholarship excludable from gross income
  - veterans' educational assistance
  - employer-provided educational assistance
  - any other nontaxable payments (other than gifts, bequests or inheritances) received for education expenses

- The distribution is included in income only because the qualified education expenses were taken into account in determining the Hope Credit or Lifetime Learning Credit, both of which are tax credits that reduce the amount of taxable income for an individual funding a student's education.

On a state level, the tax treatment for distributions varies. Individuals should consult with their tax professional to determine how distributions from their 529 plans will be treated for tax purposes.

Conclusion

Similar to the education savings account (ESA), the 529 plan is an excellent way to save for education expenses.

Let's recap:

- 529 plans allow for the prepayment of qualified higher-education expenses at eligible educational institutions.
- There are no income restrictions for individuals who want to contribute to a 529 plan; however, because contributions cannot be more than the amount necessary to provide for the qualified higher-education expenses of the beneficiary, individuals should take care not to contribute too much to the 529 plan.
- An individual may contribute up to $13,000 each year to a designated beneficiary's 529 plan without incurring federal gift tax, provided that the individual makes no additional gifts to that designated beneficiary for the year.
- The distribution from the 529 plan may be used for:
    - tuition and fees
    - books, supplies and equipment
    - academic tutoring
    - room and board
    - uniforms
    - transportation
- Materials on each State's 529 plan are available from the College Savings Plans Network's (CSPN) website at www.collegesavings.org.