

## College saving enticements States' 529 plans get huge tax break in 2002

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Last Update: 12:06 AM ET March 13, 2002

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SAN FRANCISCO (CBS.MW) -- The getting of knowledge got easier this year - easier to finance, at least.

State-sponsored 529 plans gained added tax incentives in 2002 under last year's federal tax reforms, making these often-misunderstood, college-financing vehicles more attractive than ever.

New rules allow investors to take distributions from 529 plans free of federal income tax, rather than at the student's tax rate. That is a huge step forward for parents and grandparents trying to sock money away for their kids' futures, financial planners said. The plans also are becoming more flexible as states compete for new investors.

"It's an opportunity to save substantial amounts of money," said Joseph Hurley, author of "The Best Way to Save for College: A Complete Guide to 529 Plans."

The programs come in two different forms: A prepaid tuition plan that protects against the rise in school costs and the more popular college savings vehicle to which families contribute as the child grows. The prepaid tuition 529 plans were first to market in 1980, and 20 states now offer them. But the biggest growth has been on the college savings side, which officially rolled out 10 years later.

With tax incentives dangled in front of them, investors poured about \$5.5 billion into 529 savings plans last year, growing them to \$8.6 billion at the start of this year, according to the National Association of State Treasurers. Forty-two states now make savings plans available.

The plans differ from Education IRAs by offering less control over investments. But "529s" are particularly attractive to wealthier investors who can contribute as much as \$250,000 or more compared with the newly quadrupled \$2,000 annual limit for Education IRAs.

529 plans draw their name from the federal law that allowed states to create these tax-advantaged funds. Though they've been available for some time, "529s" offer more relief this year for parents grappling with how to cover college expenses that easily can run \$80,000 for four years, said Charles Failla, a certified financial planner at Raymond James in New York.

By taking distributions tax-free rather than at a student rate of 15 percent, "it saves them about \$12,000 on average in real cash," Failla said. "That would've been money out of their pocket."

### Selling points

The 529 plans also are effective estate-planning tools that allow investors to lighten their estate-tax burden while keeping the ability to change beneficiaries, Hurley said.

Under ordinary circumstances, cash gifts exceeding \$11,000 incur gift taxes, but the new rules allow you to do five years worth of gifting at once if the gift is in the form of 529 contributions -- a savings of potentially millions of dollars if a married couple spreads the wealth to multiple beneficiaries, Failla said. "As many beneficiaries as they can come up with, they can gift away like crazy."

At the same time, plan owners maintain control, Hurley said. "You also maintain the right to revoke the asset and pull it back for yourself," he said. Investors who cash out and use the funds for something other than college expenses, however, incur ordinary income tax and a 10 percent penalty.

Unlike irrevocable trusts and funds set aside under the Unified Gift "It's the only time to Minors Act -- so-called UGMA accounts -- the student can't tap when you can get into the 529 proceeds without the plan owner's consent, Failla said. money 100 percent "It's the only time when you can get money 100 percent out of out of estate tax estate tax liability and you still have complete liability and you control over it." still have complete control over it."

Another inviting feature is that families can choose a 529 plan from any state, regardless of where they live or where the child plans to go to school. That means they can choose to invest in one of the 23 states that allow income tax deductions on at least some amount of 529 contributions.

Charles Failla,  
certified financial  
planner at  
Raymond James

### States get competitive

One of the advantages of going with a 529 plan instead of an Education IRA, also greatly expanded under last year's tax law, is the higher or sheer lack of contribution limits.

Investors of all incomes often can put in as much as they want. But there's a catch: Some states that allow income tax deductions on the contributions restrict that benefit to a certain amount, or only allow it for residents who attend school in-state, Hurley said.

There are now only five states -- Colorado, New Mexico, Illinois, South Carolina, and West Virginia -- that allow unlimited contributions for tax deduction purposes, he said. But it's not unusual for states to loosen up their rules to become more competitive.

"A state may start out with a contribution maximum of \$100,000 and in order to be more attractive they'll bump it up to \$250,000," Hurley said. "Changes like that occur all the time."

Some states also are vying for business by offering preferential treatment in financial aid eligibility or lowering expenses for their residents, he said.

#### More flexibility in investment options

For the last four or five months, many states have been making their plans more flexible for investors who want to fine-tune their holdings, Failla said.

Until recently, "if you wanted to change your allocation, you would actually have to shut down your 529 account and open a new one, which is a pain in the neck," he said, noting that investors now can switch allocations once a year without a hassle.

Some of the major distributors also are adding direct deposit features to make 529 plans a more accessible company benefit, Failla said. Alliance Capital, which runs the Rhode Island-based program, also recently waived charges for employers with more than 1,000 workers, he said.

"The 529's are going to be the new 401(k)," Failla said, referring to the popular defined-contribution retirement plan. "It's going to be an employee benefit just like anything else."

In addition to offering age-based allocations that require states to limit risk exposure as a child nears 18, many states are broadening their range of investment options to include growth and value approaches, he said.

Investors are wise to monitor the trade-off of fees versus selection options, Hurley said. "The range of expenses, including the expense of the underlying mutual fund, can be anywhere from 35 basis points to as much as 300 basis points, 3 percent per year," he said.

What's more, the 13 states that have TIAA-CREF programs offer stable value investments that offer lower risk than the stock market, said Rich Chambers, a certified financial planner in Palo Alto, Calif.

#### Drawbacks and considerations

While the tax bill broadened the appeal of 529 plans, they're not without caveats. One of the biggest unresolved issues is the impact on a student's financial aid eligibility.

"That's kind of a question mark," Hurley said. It's unknown how lawmakers will treat 529 plans now that the tax law has passed. They're expected to set guidelines in the next few months as they design next year's Free Application for Federal Student Aid or

FAFSA, he said.

The plans' short performance history and difficulty making comparisons between wide-ranging investment options also can work against investors trying to make educated choices, Hurley said.

Still, given the tax incentives, families would be better served to invest in any 529 plan than none at all, Failla said. "The advantage is so huge that it outweighs whether Fund A is going to do better than Fund B."

Finally, a sunset provision calls for the new tax treatment of 529 plan distributions to expire in 2010, potentially making earnings taxable to the student at that time.

But such a dramatic change is unlikely and shouldn't deter families from contributing to their education nest eggs, Chambers said. "In the worst case, the amount of earnings starting in 2011 might then become taxable and (lawmakers) would grandfather the earnings before then, making the plan very worthwhile getting in now."

Coming Thursday: Using the Web to research and manage 529 plans.

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