



Section 529 College Saving Plan Report

January 2007

INTRODUCTION:

Section 529 College Savings Plans were created by the federal government in 1996. Each individual state offers at least one Qualified Tuition Program (QTP, Section 529 plans are also referred to as QTP plans). Recent tax legislation (2001 and 2006) has improved the plans to the point where they are a **compelling alternative** to other college savings vehicles.

As you can imagine there are many restrictions and qualifications that go with a government approved tax-free saving plan. We'll cover them in a concise manner. You may want to obtain additional information before funding a plan. The best source we have found is <http://www.savingforcollege.com>. You may want to purchase their book *The Best Way to Save for College – A Complete Guide to 529 Plans*.

SUMMARY:

Section 529 plans provide **tax-free** saving for college expenses. The tax-free provision often makes these plans a **first priority for college saving**.

The plan owner (anyone, but usually a parent or grandparent) controls the account completely and **can refund the account if necessary** (penalties usually apply on refunds). There is no federal income tax on the earnings when funds are withdrawn for qualified college expenses. Almost all accredited colleges and universities (including many foreign universities) qualify.

For **college financial aid** purposes, the money within a Section 529 plan is counted as an asset of the account owner. If the account owner is the parent, then this asset will impact the financial aid eligibility of the student. However, if the account owner is a grandparent, then this asset usually does not impact financial aid eligibility. For a college financial aid estimator, try the following:

www.smartmoney.com

click on **Personal Finance** in the left navigation bar

click on **College Planning**

under **College Worksheets**, click on **How Much Aid Can You Expect?**

SECTION 529 PLAN DETAILS:

Since every state has at least one plan, selecting a particular plan is a chore. Some states exempt all or a portion of the contributions to a Section 529 plan from income taxes. That advantage could mean your state's plan should have top priority. Once a state plan is chosen, funding is relatively easy and involves filling out an agreement and sending a check (no

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securities). The plan may be funded all at once or periodically. There is a limit on plan funding but it is quite high (\$250,000+ depending on the plan).

One person, the **plan owner**, controls the plan for the benefit of another person, the **beneficiary**. Funds may be extracted from the plan tax-free for qualified higher education expenses of the beneficiary. Qualified expenses are most normal college expenses (tuition, room and board, books, and fees for undergrad and graduate school) but not travel or personal expenses.

An individual may own multiple plans for the same beneficiary in different states. Different individuals may own separate plans for one beneficiary in the same state. The beneficiary may attend college in any state. The owner and the beneficiary can be the same person. You can change beneficiaries to another family member or change states once per year. If you use a state plan other than your own, you do not have to file income taxes in the state providing the plan. Hope and Lifetime Learning credits must be coordinated with 529 qualified withdrawals.

FUNDING THE PLAN:

Funds placed in the plan are considered **completed gifts** for tax purposes. Each person may gift up to \$12,000 to any beneficiary each year with no gift tax consequence. However these plans have a special five-year "gift averaging" provision. You may give \$60,000 in one year, gift-tax free, but you can't give more to that beneficiary for five years (otherwise those additional gifts are taxable gifts). In effect, a couple could give \$120,000 to a 529 plan for any number of beneficiaries all in one year.

Each state plan has limits on how much can be contributed to a plan but the limits are reasonably high (greater than \$250,000 is typical). This limit is actually per beneficiary, so if there are multiple Section 529 plans for the same beneficiary they must be looked at in total. You can contribute to a 529 plan all at once or periodically. There are reasonable minimums required for initial funding and subsequent additions.

You may **roll over an Educational IRA or Custodial account into a 529 plan**. However this is not advisable or advantageous in most situations. Please consult with your advisor before doing this.

ESTATE TAX IMPACT:

Funding a 529 plan is considered a completed gift and the value of the gift is no longer considered part of the gifter's estate. This is an **exceptional estate planning tool** for anyone, but especially for grandparents. For example, a couple can easily remove \$120,000 per beneficiary from their estate yet still retain control of the asset. There are complex rules concerning generation skipping taxes and recovery of a portion of the gift back into the estate if the giver dies before the five-year averaging period is complete.

WHAT IS THE IMPACT ON "EXPECTED FAMILY CONTRIBUTION?" (FINANCIAL AID):

The assets in the account are considered to be those of the account owner for the purposes of computing the EFC (Expected Family Contribution). When funds are extracted, they are

not considered income of the beneficiary as long as they are used for qualified expenses. The EFC is complex and is dependent on many factors such as assets and income of the parents and the student. It's very likely that 529 plans may make it more difficult to get financial aid. Some private schools may consider the account to be an asset of the beneficiary.

A good approach is for grandparents to be the owners of the account. Grandparent's assets usually do not count for EFC.

Postponing withdrawals from the account to pay for the later college years may make financial aid in the early years more likely.

WHAT IF SOMETHING GOES WRONG?

There are a number of graceful exits from a 529 plan.

1. **What if the beneficiary never attends college?**

The owner of a 529 plan can extract the funds at any time (after the initial waiting period). If the funds are not used for qualified college expenses, then there is a 10% penalty (on the earnings) plus all the earnings in the plan are taxable. If the beneficiary dies or becomes disabled the 10% penalty is waived.

2. **What if the beneficiary receives a scholarship?**

To the extent of the scholarship, the account owner may obtain a no-penalty refund from the 529 account but the earnings are taxable.

3. **What if I want to change beneficiary?**

The owner can change the beneficiary to another family member once per year. There can be generation skipping tax implications if the generation of the new beneficiary is different from that of the current beneficiary (e.g., change from child to grandchild).

4. **What if I don't like the investment performance of the 529 plan?**

You can move the plan to another state once per year (some plans may require a longer wait).

5. **What if the account owner dies?**

Plan ownership is inherited according to the contingent owner stated in the plan documents or if no contingent owner is specified, then the owner's will or trust document may direct the transfer of ownership. It's almost always better to name a contingent owner who will carry out your original intention than to have a general provision in your will determine the transfer of the account.

6. **What if the beneficiary dies?**

Normally the account is rolled over to another family member but the account value is considered part of the estate of the beneficiary.

7. **What if I need the funds for purposes other than qualified college expenses?**

Federal income tax and a 10% penalty is due on all earnings when the withdrawal is a

non-qualified withdrawal. State income tax on the earnings will also be due in most states.

8. **What if there is a bear market, and the 529 plan account is losing money?**

You may with certain restrictions, withdraw the funds and use the loss as a miscellaneous deduction. Speak with your tax professions well before the end of a tax year about the possibility of triggering the losses.

GLOSSARY

Asset allocation - the mix of stocks, bonds, & cash.

Family member of the current beneficiary - almost anyone you would consider a relative.

Qualified education expenses - tuition, fees, books, supplies, equipment, and room & board. (No transportation or personal expenses).

Eligible educational institution - accredited post-secondary educational institutions offering bachelor's, associate's, graduate, or professional degrees.

EFC (Expected Family Contribution) - is used for financial aid computations and uses the following:

- 50% of student's income
- 35% of student's assets
- 22 - 47% of parent's income
- 5.6% of parent's assets

A 529 plan is the account owner's asset, e.g., grandparents as owners have no impact on EFC.

RESOURCES

- ◆ www.ed.gov/offices/OSFAP/Students/apply/search.html
(Eligible educational institution search)
- ◆ www.ed.gov
- ◆ www.csac.ca.gov
- ◆ www.scholarshare.com
- ◆ www.finaid.org
- ◆ www.collegesavings.org
- ◆ www.savingforcollege.com
- ◆ *The Best Way to Save for College* - Joseph Hurley

The bottom line is that Section **529 College Savings plans are very effective vehicles** for individuals to set aside money for the post-secondary education of their children, grandchildren and other family members. Since tax deferral is the primary benefit of these accounts, the earlier you start contributing, the greater the benefits.

As a final word, we would like to point out that we do not receive any direct or indirect compensation from anyone other than you for assisting you in placing assets in these plans. We are providing this information because we want you to be aware of this excellent college savings vehicle. Since we are not fully aware of your tax situation, you are advised to consult with your tax adviser prior to making a final choice of state plan or investment option.

See *College Savings Techniques Table* following

Investor's Capital Management, LLC

College Savings Techniques				
Comparison of Key Features				
1/1/2007				
	College Savings Plans (Section 529)	Education IRAs (aka Coverdell Savings plan)	Uniform Transfer or Gifts to Minors Act (UTMA or UGMA)	Accumulate in Parent's Name
General Operation	If assets are used for qualified higher education expenses, earnings are exempt from federal taxes;(1) otherwise tax-deferred and subject to a 10% penalty. States may tax earnings when withdrawn. Some states tax earnings on withdrawals from out-of-state plans.	If assets are used for qualified elementary, secondary or higher education expenses, earnings are exempt from federal taxes; otherwise tax-deferred and subject to a 10% penalty. States may tax earnings when withdrawn.	Earnings are taxed at children's tax rates. Kiddie tax rules apply to children under age 18.	Earnings taxed at parent's rate.
States allow tax deduction for contributions?	Yes, in some states	No	No	No
High income taxpayers eligible to use this option?	Yes	No, phase-outs begin at: In 2007 - \$95,000 (single) \$190,000 (couple) (Based on modified adjusted gross income.)	Yes	Yes
Gifts count toward the \$12,000 per donor annual gift exclusion?	Yes, though a donor can give \$60,000 in one year and average the donation over five years through an election on their gift tax return.	Yes	Yes	N/A, amounts are kept in parent's name.
Limit on how much can be placed in the account?	Yes. Varies by state. Can be as much as \$250,000 or more per beneficiary.	\$2,000 per year	No limit	No limit
Assets transferable to other family members of beneficiary?	Yes	Yes	No	Yes
Available through banks, brokerage firms and other financial institutions?	No, each state has its own plan. Some brokerages sell plans that are associated with their firm - watch out for total expenses.	Yes	Yes	Yes
Assets can be moved easily between investment options?	The investment details are determined by the plan chosen. Some plans have very limited investment options.	Yes	Yes	Yes
Maximum Account Duration	Unlimited, although many states have imposed their own time limits.	Until student reaches age 30	Until child reaches legal age (as defined by state).	No limit