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529 Plans

Hello and Happy Spring!

This month's topic highlights 529 plans, an increasingly popular way to fund for college expenses, especially given the rate at which these are increasing each year. These plans are also known as qualified tuition programs and are state-sponsored, tax-advantaged accounts designed to save for post-secondary education expenses.

According to a Bloomberg report from 2012, college-related expenses (tuition and fees) have increased 1,120 percent since 1978. The same report states that the rate of increase in college costs has been "four times faster than the increase in the consumer price index." It also notes that over the same time frame, "medical expenses have climbed 601 percent, while the price of food has increased 244 percent."

Types of 529 Plans

- **Savings Plans:** these are similar to other investment accounts where the growth and earnings are based on the market performance of the underlying investments. These vary by each plan as some have static portfolios, age-based portfolios, and/or ability to build a portfolio using a list of specific funds chosen by the plan provider.

- **Prepaid Plans:** they allow an individual to purchase tuition credits at today's rates to be used in the future. Therefore, performance is dependent upon the rate at which tuition costs go up. Most prepaid tuition plans are sponsored by state governments and have residency requirements but only a handful of states offer this type of plan.

How They Work

With 529 savings plans, there are two parties: the participant (owner) and the beneficiary (student). This can be the same person if the student is at least 18 years old. In most cases, either a parent or a grandparent is the participant and a minor is the beneficiary. The participant makes gifts to the 529 plans and they control how the funds are allocated and distributed to the beneficiary. At the participant's discretion, they decide when to transfer the ownership of the 529 plan to the beneficiary and can also change the beneficiary (as long as the 529 plan was not a conversion from a custodial account).

Contributions

With 529 plans, contributions must be made in cash and they may be tax deductible. The annual contribution limit per beneficiary is $14,000 ($28,000 if the participant is married). Anyone can contribute to a 529 plan as there are no income limitations. The lifetime contribution limit varies by each 529 plan, but is typically between $350,000 and $375,000.

There is a special provision which allows for a 5-year advance gift to be made without causing a gift tax liability or using one's unified gift and estate tax credit. This enables a participant to contribute $70,000 in one year ($140,000 if married) to a 529 plan. It is important to note that if the participant makes a 5-year advance gift, those funds and its earnings are out of the estate faster than if the participant had made contributions each year. However, in the event that the participant passes away within the first four years, his or

her estate will have to include some of the 5-year advance gift back into their estate.

In terms of determining if contributions are tax deductible, of the 50 states, seven do not have state income tax, and for the remaining 43 states, 34 offer either a full or partial state income tax deduction to residents for their contributions to their respective state 529 plans. The nine states that currently do not offer a state income tax deduction for contributions are: California, Delaware, Hawaii, Kentucky, Massachusetts, Minnesota, New Hampshire, New Jersey, and Tennessee.

Earnings and Distributions

Earnings in a 529 plan grow tax-deferred and distributions are non-taxable as long as they are used for qualified post-secondary education-related expenses, such as tuition, fees, room and board, books, and supplies. Any non-qualified withdrawals are subject to ordinary income taxes plus a 10 percent federal tax penalty on earnings.

Effect on Financial Aid Eligibility

Each college or university has their own guidelines as to how they treat funds in a 529 plan with respect to qualifying for financial aid, but typically, assets held in these plans will reduce a student's eligibility to participate in need-based financial aid. This is due to funds in a 529 plan being treated as parental assets in the calculation of the expected family contribution towards paying for a student's college expenses.

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