

## SAVING FOR COLLEGE

### *TAX ADVANTAGED COLLEGE PLANNING WITH SECTION 529 PLANS<sup>1</sup>*

It's a difficult world putting your kids through college these days. First, no-one seems to do the four year plan anymore. Plus, college is more expensive. But, a variety of savings options are now available to parents (and grandparents, aunts, uncles, siblings) to lead children through these expensive years.

The most flexible option is the Section 529 plan, named after Section 529 of the Internal Revenue Code, and contains helpful new provisions that kicked into gear in January, 2002. It is currently slated to sunset in 2010. Section 529 plans are fashioned state by state, and allow investment contributions for the benefit of a beneficiary's college or graduate expenses. Investments are made into "accounts" which the state's chosen plan manager administers. Plan managers for various states include TIAA-CREF, Prudential, Alliance Capital, and others. Most states have a variety of investment options that have more or less risky philosophies.

Section 529 plans carry substantial tax advantages in that contributions can appreciate tax free and/or tax deferred. Saving for college expenses early and without paying taxes over time can substantially leverage those dollars for later expenses. And withdrawals through distributions may actually be fully non-taxable when taken. Moreover, there are gift and estate tax benefits. And, there is no income limit of the donor in determining who can contribute, unlike most other saving options.

#### *Tax Advantages*

Like retirement funds, contributions will grow without annual income tax under any circumstance during the period they aren't tapped. Withdrawals may be taxed depending on the purpose for the withdrawal. As of January, 2002, and at least until 2010, distributions that are for *qualified educational expenses* are not subject to any income tax or penalty, meaning that all the appreciation, interest, and dividends on the initial contributions are totally non-taxed. (After 2010, depending on the action congress takes with respect to Section 529, the earnings will be taxed at the beneficiary's rate, as was the law before 2002). Distributions that are *non qualified*, such as withdrawals by the account owner or distributions for a child who doesn't go to college, are subject to income tax and a 10%

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penalty on the earnings. If a beneficiary doesn't go to college the account owner can change beneficiaries to some other relative within the generation of the beneficiary.

Contributions are made with after tax dollars, but some states, such as Oklahoma, provide an income tax deduction every year a contribution is made to provide incentive for Oklahomans to use the in-state plan. Oklahoma's income tax deduction is \$2,500 per beneficiary.

Section 529 plans not only provide income tax savings, but also "transfer" tax savings escaping some gift and death taxes. Contributions qualify for the gift tax annual exclusion of \$11,000 per year (unlike many contributions to an ordinary trust with a child or grandchild as beneficiary). Gift splitting is available. Further, contributions are excludible for generation skipping transfer tax purposes. Also a contribution in one year can be prorated over a five year period to use the next four years' annual exclusions; i.e., front loaded. This is beneficial to use the power of investing over time to accumulate value. Also, this is a legitimate way to transfer wealth from one generation to the next in what could be fully non-taxable.

### *Qualified Higher Education Expenses*

When funds are finally distributed for "qualified higher education expenses," otherwise known as QUEEs, the earnings portion of the distribution will not be subject to income tax. QUEEs are fairly broadly defined to include expenses that are required for enrollment or attendance, (and may often include a computer, say) and reasonable room and board.

Unlike a Coverdell Education Savings Account (previously Education Savings Account), distributions can be used at any institution that is qualified, whether or not in the state where the owner sets up the account, the state the owner resides, or the state the beneficiary resides. Institutions that are qualified generally include all post-secondary institutions offering bachelor's, associate's, graduate or professional degrees. Some post-secondary vocational institutions qualify as well as approximately 750 foreign institutions.

### *State Law*

Section 529 Plans are state created. However, most state plans allow any U.S. citizen to open and contribute to an account for a beneficiary. (A few states' plans may require the account owner or beneficiary to be state residents when the account is opened. However, there are only 3 states which do at this time.) Some states have harsher penalties on non-qualified withdrawals.

Each state has a limit on what can be contributed because of the requirement that the plan provide safeguards to prevent contributions on behalf of a beneficiary in excess of those necessary to provide for upper education expenses. Some states have a specific contribution

limit, but most have balance limitations for all Section 529 plans for a specific beneficiary. Oklahoma's balance limit is \$235,000; after the balance is reached no more contributions may be made, although the fund can grow non-taxed beyond that amount. While it is possible to open many accounts that would exceed the maximum, the IRS will probably eventually be watching for misuse.

Most states also offer income tax deductions for their residents, and some exceed Oklahoma's \$2,500 per year per donor. Some states (not Oklahoma) offer matching grants or scholarships. The Oklahoma College Saving Plan Act is found at Okla. Stat. tit. 79, Section 3970.1.

Note that Oklahoma's plan received a "five cap" (five out of five) rating for in-state residents from the rating system on [www.savingforcollege.com](http://www.savingforcollege.com), and "four cap" for out of state participants.

### *Account Ownership*

The account can be opened by an individual and controlled by another, called the "account owner." This may be useful where a grandparent wants to contribute to an account but doesn't want to make distribution decisions or is concerned the account might interfere with Medicaid qualification. The account owner can revoke the plan and take the funds back at any time, less income tax on earnings and the penalty. The funds in an account that is not revoked won't be included in the estate of the donor or account owner (except that if the donor dies within the four year period of a front-loaded contribution, the amount of contributions in the four years remaining after death will be included).

Additionally, account owners need not be individuals. Corporations are allowed by some states to be account owners. In this case, a company would set up a Section 529 account with the child of an employee as beneficiary. If the child goes to college at the time of distribution the employee will pay income tax on the entire amount, the child pays no tax, and the company apparently gets a deduction for the entire amount.

A trust could also contribute to a Section 529 plan, in which case a beneficiary can be changed from one trust beneficiary to another. There are some advantages to using a trust, since a successor trustee can be named and the funds remain subject to the trust terms. If another individual becomes account owner, presumably that individual could withdraw the account and keep the funds. However, only cash can be contributed to a Section 529 plan, so if a trust holds non-cash assets, they would have to first be liquidated and subject to income tax consequences. Also, there can't be any front-loading of contributions with trusts.

Some states allow custodians of custodial accounts to contribute the custodial account to a plan, although when the minor reaches the relevant age for distribution he or she becomes entitled to the funds as would be the case otherwise. The beneficiary could probably not be changed.

## *Beneficiaries*

Beneficiaries can be almost anyone, including yourself. However, if a beneficiary is changed to a non-family beneficiary or to someone outside of the same generation as the old beneficiary there may be gift or generation skipping tax consequences.

While an account cannot be set up for an unborn beneficiary, one can be set up for sibling or cousin in the same generation and then later changed to the anticipated beneficiary, now a life in being.

## *Investment Control*

While an account owner can't participate in investment decisions, one may choose among different investment strategies offered by a program when the account is established or among states to find the most attractive program. Most offer options that have more or less risk. Also, an owner can roll over an account to a different state once every 12 months, and investment options can be changed once per calendar year. Oklahoma's investment manager, TIAA-CREF, offers three options, including an equity fund, a managed fund, and a guaranteed fund (the earning is guaranteed). TIAA-CREF charges .78-.84% of account assets annually on the equity and managed fund. The guaranteed fund's fee is taken outside of the guaranteed percentage.

Note that purchasing a plan through a broker will add fees and commissions, and the state tax breaks may be lost.

## *Reduction Because of Other Programs*

Qualified expenses are reduced by any expenses used for the Hope Credit or Lifetime Learning Credit, educational assistance not subject to income tax, such as qualified scholarships, and otherwise may be influenced by college savings accounts or prepaid tuition. However, you can use a Section 529 in conjunction with other programs. The Hope credit could be used for the first two years if income is less than \$89,000 jointly (or \$47,000 single); the Lifetime Credit can be used if joint income is less than \$84,000 (or single \$45,000); then use the Section 529 plan afterwards or to the extent the other credits are not used.

## *Unknowns*

There are many unanswered questions regarding Section 529 plans. For example, what is the result of a spouse taking against the will? What state has jurisdiction? (The student's residence, the account owner's residence, the school's residence, where the plan is located). What are creditor's rights in the assets? The existence of a Section 529 plan may interfere with the account owner's eligibility for medicaid or the beneficiary's eligibility for scholarships and loans. In some cases, there may be an estate tax to a beneficiary's estate

who has no control over the plan, and has no right of refund (leading to constitutional issues). Proposed regulations are out and receiving comments on some of these issues.

## *Comparison to Other Education Saving Options*

### *Education Savings Accounts*

The Coverdell Education Savings Account (ESA), formerly known as an Education IRA, is an account created to pay the qualified education expenses of a beneficiary. All contributions must be in cash, made before the beneficiary's 18<sup>th</sup> birthday, and must not exceed \$2000 for a taxable year beginning in 2002 (up from \$500). For parents with income over \$220,000 jointly (up from \$190,000) this is not available. The Section 529 plan, however, does not have an annual contribution limit. In order to take advantage of the gift tax rules the amount would be limited by the annual exclusion of \$11,000 per person (\$22,000 per couple), and the IRS is allowing five years of gifting to be made in one year, using the annual exclusion for five years. Also, there is no income limit by the donors.

Like a Section 529 plan, any distributions that exceed qualified education expenses are included in the beneficiary's gross income plus a 10% penalty.

Unlike a Section 529 plan, payments from ESAs can be used to pay qualified elementary and secondary education expenses as well as college and graduate school.

The donor may entirely control the investment, unlike a Section 529 plan, which offers only certain investment options. However, Section 529 account holders can transfer funds to a different plan once each year.

ESA assets are considered assets of the child for financial aid purposes, which can affect eligibility. The assets are considered at a rate seven times greater than figured for Section 529 plans. And if a grandparent owns the Section 529 plan, it may not even be counted as an asset of the parent.

Administrative fees for managing ESAs are higher than Section 529 plans. They are usually around 2%, while the administrative cost of managing a Section 529 plan is much less. (In Oklahoma, .78-.84 %) A donor can use both ESAs and Section 529 plans starting 2002.

### *Direct Pay of College Expenses*

A direct payment of tuition is not a taxable gift. However, the Section 529 plan covers much more than tuition, such as room and board. Also, the Section 529 plan allows tax free investing.

New advantages are becoming available for direct payment of tuition, however. In

2002, up to \$3000 can be deducted from income for tuition bills, which rises to \$4000 in 2004 and ends in 2006. To qualify, joint income between a husband and wife must be less than \$130,000. In 2004 and 2005, those individuals earning between \$130,000 and \$160,000 jointly can deduct \$2000, while payments of tuition paid with ESA or Section 529 plan funds aren't deductible.

If funds are available at the time, payments should first be made for tuition from current money, with the remainder from the Section 529 plan.

### *Prepayment of Tuition Expenses*

Some states offer Section 529 plans that allow prepayment of tuition expenses. An individual can make payments to an institution years before the child attends school, which is beneficial if it is anticipated that the individual (probably a grandparent) won't be around. The problem is that the payments must be non-refundable, so if the child doesn't attend school at that institution the balance is forfeited. With a saving plan, the funds can be used for any school. Additionally, the owner, or child, can get the money even if payments aren't made for tuition (less tax and penalty).

### *Custodial Accounts*

Custodial accounts are taxed every year, but at the beneficiary's tax rate after age 14 (and parent's rate before then). The funds can be used for any purpose that benefits the minor, unlike a Section 529 plan or ESAs, which require the funds to be used for education purposes.

Like the ESA, a custodial account is considered an asset of the child for purposes of determining financial aid eligibility.

Probably one of the worst problems, however, is that when the child reaches age 18 he or she legally owns those assets outright outside of the control of anyone else. There is no way to transfer assets between beneficiaries, as the owner of the custodial account is the only individual with rights to those funds after the account is set up. A custodial account can't be revoked either. In a Section 529 plan the owner of the plan, who can be the donor, controls the assets, makes the decision when and how much distributions will be, can change beneficiaries and revoke the plan and take back the funds (with tax and penalty).

### *Conclusion*

Given all factors, Section 529 plans make a valid saving option, alone or in conjunction with other alternatives, and provide a tremendous succession planning opportunity. Questions should not be a deterrent to forming a plan as part of the estate planning mix. Getting funds inside a tax-deferred or free vehicle to begin growing as soon as possible will ease college expenses later. To learn more, look at

[www.savingforcollege.com](http://www.savingforcollege.com) on the internet. To learn more specifically about Oklahoma's plan, look at [www.ok4saving.org](http://www.ok4saving.org), or contact TIAA-CREF at 1-877-654-7284.