Steven M. Vogt, CPA, EA

Tax-Advantaged College Savings

Overview

Section 529 Plans (named after the section of the IRS Code that created them) are plans established to help families save and pay for college in a tax-advantaged way and are available to everyone, regardless of income. These state-sponsored plans allow you to gift large sums of money for a family member's college education, while you maintain control of the funds. The earnings from these accounts grow tax-deferred and are tax-free if used to pay for qualified higher education expenses. They can be used as an estate-planning tool as well, providing a means to transfer large amounts of money without gift tax. With all these tax benefits, 529 plans are an excellent vehicle for college funding.

Types of Plans

Section 529 Plans come in two types, allowing you to either save funds in a tax-free account to be used later for higher education costs, or to prepay tuition for qualified universities.

College Savings Plans – These allow you to contribute after-tax dollars that are invested in some sort of savings vehicle. Many of these plans offer more aggressive investments when a child is quite young, which will then be transferred to more conservative investments as the child gets closer to college age. As with any investment, there are no guarantees of growth, and the plans are subject to the normal investment risks, even though state governments sponsor them. A big plus for these plans is that they are not geared towards in-state schools but are meant to be applied to whichever school your child chooses to attend.

Prepaid Tuition Plans – As the name implies, a Prepaid Tuition Plan allows parents to pay for college education at today's tuition rates. By locking in your tuition payments, worries about the increase of tuition costs in the future can be set aside. This gives the assurance that the child will have the money to attend college when that time comes. These plans sound very attractive; however, most of these plans guarantee that you will be covered only if your child chooses to go to a public in-state college or university. Therefore, if your child decides to attend an out-of-state school, you won't be fully covered, simply because these plans are not meant to fund the higher costs of private or out-of-state education. However, prepaid tuition programs may be set up and maintained by private institutions, and distributions from private tuition plans are eligible for tax-free treatment.

Control

If you make sacrifices to save for a child's college education, you certainly want to make sure those savings end up being used for college and not some other purpose. 529 Plans allow you to keep control of the account. If you save money for college in a UGMA or UTMA (the name depends on the state in which you live and are essentially custodial accounts, set up for minors), the account becomes the child's property once he or she reaches the age of majority – usually 18 or 21 and you lose control. Unlike UGMA/UTMAs, Section 529 plans are not irrevocable gifts and you retain control. Control stays in the hands of the adult responsible for the account. Generally, this is the same person who contributed the money, but it doesn't have to be the case. Someone else, for example a grandparent, could make the donation but name the child's parent as the account owner. Money does not come out of the account without permission from the account owner. If the designated beneficiary of the plan decides not to go to school, then the account owner can simply change the beneficiary to someone else in the family.

Tax Benefits

There is no federal tax deduction for making contributions to a 529 plan, but taxes on the earnings

within the plan are tax-deferred while they are held in the account, and are tax-free when withdrawn to pay for qualified education expenses. This allows you to accumulate money for college at a much faster rate than you can in an account where you had to pay tax on the investment gains and earnings.

In the graph below, compare the growth of $10,000 accumulating tax-free (the purple line) to the same $10,000 after taxes (the black line).

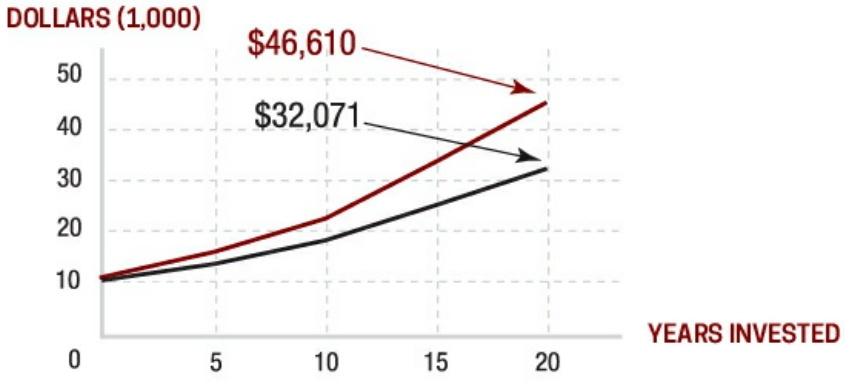

Figure #1

To be tax-free when withdrawn, the funds must be used to pay for qualified college expenses such as tuition, room and board, books, supplies, and equipment. The more time you have until your child needs the money for college, the more significant this tax-free compounding becomes.

How Much Can Be Contributed?

Unlike the Coverdell Education Savings Accounts that limit the anual contribution to $2,000, Sec 529 Plans allow you to put away larger amounts of money. There are no income or age limitations for the Sec 529 Plans. The maximum amount that can be contributed per beneficiary is based on the projected cost of a college education and will vary between state plans. Some states base their maximum on an in-state four-year education, while others use the cost of the most expensive schools in the U.S., including graduate studies. The limits for most states range from $235,000 to $520,800. Generally, once an account reaches the state designated maximum, additional contributions cannot be made, but that doesn't prevent the account from continuing to grow.

Contributions to a 529 college savings plan must, by Federal law, be made in cash and always consist of after-tax money. Most programs also have a minimum contribution that is within everyone's budget. Many have payroll or automatic withdrawal programs.

Penalties

If the earnings from the 529 Plan are withdrawn and not used for higher-education expenses, the earnings withdrawn will be subject to both regular taxes and a 10% penalty. Before you become concerned, refer back to Figure #1. Had you not utilized the tax deferral benefits of the Sec 529 Plan, you would have accumulated significantly less in the account, which will generally more than offset the 10% penalty. You can avoid penalties by making a tax and penalty-free rollover from one 529 Plan to another, and remember that you are able to change beneficiaries to a 529 Plan without penalty.

Impact on Financial Aid

Predicting financial aid eligibility is no easy task, since it's based on a myriad of factors, including income, the age of the parents, and the methodology used. A question that always arises when

discussing the benefits of saving for college is the impact those savings will have on future financial aid Investing in a college savings plan could affect your financial aid eligibility but a 529 plan is typically viewed as a parental asset, rather than a child's, and that means that a financial aid officer would count only a small portion of the plan's assets toward the financial aid eligibility.

However, don't let the fear of hurting your child's eligibility for financial aid deter you from developing a sound savings strategy. Keep in mind that a lot of financial aid comes in the form of student loans, which means you'll save yourself (or your child) some money by planning ahead.

Gifts and Estate Considerations

Contributions to Section 529 Plans are considered completed gifts and are subject to the gift tax rules. Under these rules, individuals can each year give away (gift) money up to the annual limit to another individual (double for a married couple) without triggering gift taxes or reducing their lifetime gift and estate tax exclusion. The annual gift exclusion amount is $15,000 in 2018 and 2019, and is inflation adjusted. Please call this office for the limit for a year after 2019.

In addition, individuals are allowed to make five years' worth of gifts to a Section 529 Plan in one year. For example, that means an individual could contribute $75,000, or a couple $150,000 in 2018 or 2019. However, no additional gift could be given to the beneficiary of the Section 529 Plan for that entire five-year period. The gift would reduce the donor's estate by the full amount of the gift by the end of the five-year period. Should the donor die before the five-year period elapses, any amount in excess of the allowable annual exemptions would revert back to the donor's estate.

Note: A gift tax return must be filed for the year of the contribution if it exceeds the annual gift tax exclusion claiming this special exemption.

Section 529 Plans are increasingly being promoted as an estate-planning device for wealthy grandparents, since making a large contribution to a 529 Plan reduces your taxable estate much quicker than the current annual gift exclusion. But while the assets leave your estate, they don't leave your control.

Please Note: Transfers and change of beneficiaries can trigger gift and generation-skipping taxes if not planned correctly. If you are contemplating a change in beneficiary or transferring an account to another beneficiary, you are cautioned to call this office in advance.We can plan the change or transfer in such a way to avoid or minimize any potential gift or generation-skipping taxes.

Plan Sponsors

Section 529 Plans are state-sponsored programs. You are actually investing in a program authorized by the Federal government and run by the various states. To attract their own residents, some states offer tax deductions for contributions, while others will disregard the account balances when calculating state financial aid. It is important to understand that you are not limited to establishing a plan with your resident state. You should investigate the various state plans available and evaluate their performance, expenses, and investment options before making your selection.

Gift Tax Exception

As an alternative to a Sec 529 plan, there is an exception to the gift tax rules that allows individuals to DIRECTLY pay the tuition or medical expenses of another individual and those payments are excluded from gift tax. Thus, for example, a grandparent could pay directly to the college their grandchild is attending the grandchild's tuition, regardless of the amount, without incurring any gift tax liability.

Tax Reform Changes

Effective beginning in 2018, tax reform allows withdrawals from 529 plans for elementary or secondary school tuition expenses but limits the annual tax-free withdrawal for each beneficiary to $10,000 (regardless of the number of 529 plans in the beneficiary's name). Elementary or secondary means kindergarten through grade 12 as determined under State law. This special $10,000 amount applies for tuition only paid to public, private or religious schools.

Getting Started

While the cost of a traditional college education keeps going up and up, today's on-line education costs are just a fraction of the expense of a traditional college education. On-line classes may come to be the standard in the years to come. If this proves to be the case, the Section 529 plans may not be suitable as the education savings mechanism of the future, as they lock up huge sums of money that can be applied penalty-free only to pay for the high costs of a traditional school. You should think about how the changing methods of educating students will affect your children or grandchildren before committing large sums to a 529 plan.

Evaluating the various plans available, selecting one that meets your needs, and deciding on the amount of money to contribute to the fund can be time-consuming and complex. If you need professional assistance, please call this office.

Frequently Asked Questions

Q– Must the student attend a college in the state that sponsors the selected plan?
A – No, you can utilize the plan of any state regardless of your state residency, and the student can attend virtually any college, graduate school, and even certain vocational schools anywhere in the country.

Q – I am used to selecting my own investments. Can I direct the investments for the plan?
A – No, Section 529 Plans do not allow you to self-direct the investments. Each plan has its own investment strategy generally based upon the child's age. Some allow you to select certain investment options.

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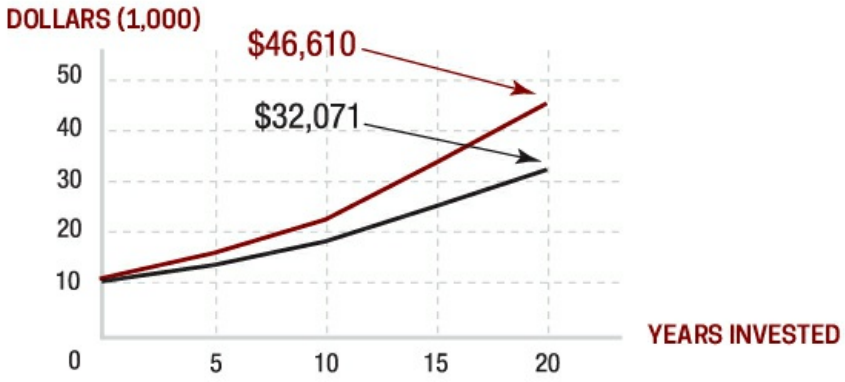

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