

A 529 Primer: A Tax-Advantaged College Savings Option Just Got Better

529 college savings plans were a good idea from the start, but severely hobbled by a yearend 2010 expiration date for the tax-free withdrawals that made the plans so attractive.

As part of sweeping pension reform signed into law by President Bush in August, withdrawals from 529 plans are now permanently tax-free. In some states, contributions may also be deductible on state tax returns. Nearly all states have 529 plans and roughly 30 states provide additional incentives, such as a state-tax deduction to in-state residents who invest in their respective plan.

It's a good idea to have your financial adviser help you sort through the details of various state plans. There are a variety of services – including Morningstar Inc. – that now rank the offerings of each state's plan. SavingforCollege.com and finaid.org are leading sites to help educate you in how these plans work.

The Administration's action couldn't have come a moment too soon. Investments were starting to wane in the plans over the past two years as parents and other family members began considering the expiration and started looking for other options to save college money for their children.

How a 529 plan works: 529 college savings plans are named for their place in the federal tax code and come in two varieties – 529 college savings plans and 529 prepaid tuition plans. Prepaid tuition plans are just that—tax-deferred savings plans that guarantee your child's tuition will be paid based on today's cost. Also, it's important to note that prepaid tuition plans are not an automatic guarantee a student will get into that college.

A 529 college savings plan allows college savings to grow tax-deferred and withdrawals are completely tax-free as long as the money is used to finance college expenses. Each plan has various investment choices that range from low- to higher-risk, and that's why it's critical to discuss any plan's offering with an expert first.

Financial aid issues: Earlier this year, the Deficit Reduction Act of 2005 was enacted and gave some positive news on the financial aid front. This law prevents a 529 account from being treated as a student asset on a Free Application for Federal Student Aid (FAFSA), which could limit the student's chances for aid. Also, a tax-free distribution from a 529 plan to pay current-year college expenses won't impact income levels that could reduce financial aid eligibility in the next school year.

Gift and estate tax advantages: Federal tax law allows for a general accelerated gift option that allows individuals to average gifts over \$12,000 per beneficiary (\$24,000 for married couples based on 2006 levels) over a five-year period without incurring federal gift tax. So an individual can contribute up to \$60,000 per beneficiary in one year and a married couple up to \$120,000 per beneficiary without incurring gift tax. If you give the full amount, you will not be able to give any gifts to the same individual during the five-year period without incurring gift tax or using up a part of your lifetime exclusion.

Possible benefits for other members of the family: If a beneficiary doesn't need the money for college, everyone up and down a beneficiary's so-called "lineal family tree"—parents, aunts, uncles, brothers and sisters as well as kids—may benefit from the tax breaks and educational rewards of these plans. And depending on state laws, relatives and friends may get a tax benefit for contributing funds to a particular beneficiary's plan.

Control issues: This is one of the more attractive aspects of the 529 plan—the person who opens the account retains control of the funds. That means that parents can keep control of this substantial asset until the funds are spent. The holder also has the power to transfer accounts or excess

amounts to pay for higher education costs for other children or other lineal family members.

Performance: This is the one area where the choice of a 529 isn't always a lock. There are definitely mutual funds and other investment choices that may possibly earn more for your future student and possibly outweigh any of the tax advantages you get with a 529 plan. This is why it's particularly important to work with a planner who knows your financial situation and goals before you invest.

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