The Magic of 529 Plans

By Lorraine F. New

A recent ABC News poll indicated that two-thirds of parents had never heard of 529 plans and that only 8 percent of those who had are actually using them.[1] But even if you have a phobia of numbers and Internal Revenue Code references, 529 plans can be your, as well as your clients', best friend for funding a child's education and estate planning.

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A 529 plan is a tax-advantaged savings plan designed to encourage saving for college costs. It also has estate-planning advantages for parents or other family members who want to encourage college educations. These plans began as a temporary measure under the 2001 Economic Growth and Tax Relief Reconciliation Act, but, on August 17, 2006, the Pension Protection Act of 2006 permanently extended the beneficial provisions allowing special treatment of these plans. This means that you can fund the plans in advance and earn federal and state tax-free dollars to spend on tuition, room, board, and other allowable expenses using investments in qualified tuition programs such as a 529 plan.

How I Learned to Love the Code

Internal Revenue Code § 529[2] relates to qualified tuition programs. Unlike other gifts that are not available to a recipient immediately (such as gifts of a future interest), a contribution to a qualified tuition program is treated as a current gift, so it is eligible for the $12,000 annual gift tax exclusion. Even better, you can make five years' worth of these gifts in advance and contribute $60,000 per donee to a plan. You need to file a gift tax return, to signify that you are making such a gift, but you do not use any of your $1 million lifetime gift tax credit and there is no gift tax to pay. If you were to die during the five-year period you designated, a prorated amount that cannot be used as a gift tax exclusion would be added back to your estate. Meanwhile, you can remove $60,000 from your estate for each child or grandchild, and your spouse can remove similar amounts. Not only is it easy and legal, but you retain control.

Give It Away, But Keep It

First, you can pick the state plan that gives you an investment vehicle that you like. Forty-nine states and the District of Columbia offer plans with various options. It doesn't matter what state you choose or where the student goes to school. The funds can be used at a two-year or four-year college or for graduate degrees or professional studies. While the school and the expenses must qualify, there is a lot of leeway. Check out eligible schools at <http://nces.ed.gov/ipeds/cool/>. There is no age or time limit on using the funds. If you later change your mind about the beneficiary, you can change him or her. The new beneficiary must be in the same family as the original one to use the money and earnings tax-free, but the new beneficiary can be, for example, your spouse, child, sibling, nephew, niece, first cousin, or any spouse of these choices. If the beneficiary gets a scholarship, becomes disabled, or dies, you can withdraw the money, paying tax only on the earnings. If you change your mind about any beneficiary, you can use the funds for education for yourself. If you withdraw the money for another use, however, you will have to pay tax on any earnings as ordinary income and a 10-percent penalty on the earnings.

Don't Miss the Michigan Deduction

The Michigan plan, the Michigan Education Savings Program or MESP, is administered by TIAA-CREF, the Teacher's Insurance and Annuity Association of America. Michigan will even throw in a state income tax deduction for your contribution. This plan has provisions for automatic contribution, with an initial requirement of only $25 or payroll deduction for as little as $15. There are at least seven different investment options. TIAA-CREF's website includes forms to download, frequently asked questions, tools and calculators, newsletters, and information about a "webinar," as well as a toll-free number, 1-877-861-6377. Detailed information, including a disclosure document, is also available at <http://www.misaves.com>.

Yes, There is Paperwork

From personal experience, the most difficult part of the 529 plan is learning how to withdraw funds and computing the "cost of attendance allowance for federal financial aid purposes." Unless you have the payments sent directly to the institution, an option I avoid because the university always wants payments NOW, you are on your own to collect receipts for tuition, room and board, fees, books, and necessary expenses. (Does that college require a computer?) You need to apply for reimbursement the same year that you expend the funds, so watch out for those December bills. Reimbursement does not go by school year, but by calendar year. The MESP no longer requires documentation for withdrawal, but warns you that the IRS may require it. A Form 1099-Q is issued to you at tax time so that you can report any unqualified withdrawals or verify that all withdrawals were qualified. The college sends out Form 1098-T, which records tuition costs and other amounts paid for the student, but since this form is used for other tax credits, it does not reflect all the "qualified" expenditures for

Fast Facts:

You can magically give five years' worth of gifts in advance with no gift tax consequences.

Only 8 percent of parents use 529 plans, but those that do more than double savings for their child's college expenses.

Tuition funds grow tax-free, and qualified use means tax is never paid on earnings.

a 529 plan. The allowable cost of housing and room and board is what is actually paid to the school if your child lives in the dorm. However, calculating the qualified amount for a student living at home or in an apartment is more of a challenge. The University of Michigan financial aid website gives precise figures for tuition and fees, room and board, and books for a particular semester.[3] Similarly, Michigan State University provides a calculator for a semester's tuition, fees, and housing costs that you can personalize.[4]

Beware the Kiddie Tax

Effective in 2008, changes in the income tax rate known as the Kiddie Tax[5] were made for persons up to 18 years old and full-time students 18 to 24 years old. Starting this year, if a child is less than 18 years old, or more than 18 but less than 24 years old and is a full-time student whose earned income does not exceed one-half of his or her support, is unmarried, and has a parent alive, the child's unearned income exceeding $1,700 will be taxed at his or her parents' rate. Assets held under the Uniform Gifts to Minors Act[6] cannot be sold and used to fund education and be taxed at a student's lower rate. Earnings from 529 plans are not subject to income tax if they are used for qualified educational expenses, and so they may be more advantageous.

A Little Research, Please

There are websites that discuss points to consider about college saving and compare various states' 529 plans.[7] The one downside that I have found is that the amount in a 529 plan can count as a child's earnings, and therefore is counted more heavily, for financial aid purposes. In comparison, however, the Coverdell Educational Savings Account (ESA), even with an expansion from a $500 to a $2,000 contribution limit, has costs, problems with finding administrators, and a limit on the parents' income that restricts contributions.[8]

Just Do It

It has been suggested that more use isn't made of 529 plans because there are "too many choices." Added to that, there is often too little money for parents who are juggling current expenses, support of elders, and retirement savings along with college investments. However, 529 plans are an easy, affordable, and useful technique to learn about for your clients and your children and grandchildren. If you need more convincing, that ABC News article cited earlier reported that for the 2006–2007 school year, the average yearly cost at a public college was $12,796 and at a private college $30,367, and the cost continues to increase. Andrea Coombes reported on December 5, 2007, about a new survey done by Fidelity Investments that indicated that "parents who said they're investing in a 529 plan are on track to meet 52 percent of college expenses," versus only 24 percent for the average family.[9] For all these reasons, there is no time like the present to just say 529. ■

Lorraine F. New has a practice in Birmingham, following a career as an IRS estate tax attorney and Michigan manager. She acts as an expert witness on tax issues, handles tax controversies, offers opinions about the reasonableness of tax positions, advises attorneys on estate and gift tax matters, and does estate planning. She often writes and speaks on these topics and was recently profiled in the Wall Street Journal.

FOOTNOTES

1. Berman & Stuart, *Saving for College Tax-Free* <http://www.abcnews.go.com/WNT/LifeStages/story?id=2866998&page=1> (accessed February 27, 2008). All websites cited in this article were accessed February 27, 2008.
2. 26 USC 529.
3. University of Michigan: Office of Financial Aid, *Cost of Attendance* <http://www.finaid.umich.edu/Financial_Aid_Basics/cost.asp>.
4. Michigan State University, *Tuition, Fees and Housing Calculator* <http://ctlr.msu.edu/COStudentAccounts/TuitionCalculator.aspx>.
5. 26 USC 1, IRC 1(g) (certain unearned income of children taxed as if parent's income).
6. In Michigan, the act is codified at MCL 554.521 *et seq.*
7. See SmartMoney.com, *The College-Savings Superpage* <http://www.smartmoney.com/college/investing/index.cfm?story=supertable1>; Savingforcollege.com <http://www.savingforcollege.com>; 529 College Savings Plans <http://www.529savingsinfo.com>; 529 College Savings Plan Information <http://www.529collegesavingsplan.info>; and U.S. Securities and Exchange Commission, *An Introduction to 529 Plans* <http://www.sec.gov/investor/pubs/intro529.htm>.
8. For more details on the Coverdell ESA, read IRS Publication 970, part 7, Coverdell Education Savings Account, available at <irs.gov> or Financial Aid, Coverdell Savings Accounts <http://www.finaid.org/savings/coverdell.phtml>.
9. Market Watch, *The long college-cost haul: New survey finds parents on track to cover just 24 percent of college expenses* <http://www.marketwatch.com/news/story/parents-track-cover-just-24/story.aspx?guid=%7B4AFEF9D9-5533-4B34-A70A-E3F4B8F6D8B8%7D>.

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