USING A 529 PLAN TO SAVE FOR COLLEGE

Learn why a 529 might work for your college savings needs
and what to consider when selecting a plan.

LET'S BEGIN WITH THE BASICS

Most 529 plans are similar to 401(k) plans or variable annuities in that the plans offer a menu of investment choices to choose from. Typically, investments consist of mutual funds and exchange traded funds (ETFs). In addition to individual funds to choose from, age-based portfolios are very common as well as risk-based allocation portfolios. Internal Revenue Code section 529 prohibits investment direction, directly or indirectly, so no individual securities are available within 529 plans for practical reasons.

There are three parties to an account:

- The owner, or participant, which in most cases has to be an adult, a corporation, a trust, estate, partnership or association; some plans even allow for joint account owners
- The beneficiary, who must be a person and often is a child but it does not have to be; it can be anybody as there is no age limit
- The contributor, which oftentimes is the same as the owner but it does not have to be.

The same person can fulfill all three parties, hence you can open up a 529 account for yourself, and you can open up an account for anybody as it does not have to be a relative. The important point here is that a regular 529 account is not a "kiddie" or custodial account but a standard account. And just as owner implies, the participant is always in control of the account.

FUNDING THE PLAN

There is no income restriction to establish an account. Contributions to a 529 plan are considered completed gifts to the beneficiary for federal gift and estate tax purposes and are excludable from your taxable estate.

On a federal level, money is contributed on an after tax basis and any earnings grow tax deferred. Withdrawals are tax-free when used for qualified higher education expenses.

There is no annual contribution limit, but all plans have a maximum funding limit that is determined by the sponsoring state. Many plans now offer contribution limits in excess of $350,000 with the highest current plan limit at $400,000 (once the account reaches that limit from either contributions or gains, no more contributions can be made).

Unique to 529 plans is the possibility to make a larger immediate gift and spread it over five calendar years. Taking advantage of the annual gift tax exclusion amount, which currently is $14,000, an individual can contribute up to $70,000 ($140,000 per couple) per beneficiary in a single year without gift tax consequences provided that donor does not gift any more to the same beneficiary over the next five years (IRS form 709 must be filed to elect the five-year accelerated gifting). The contributor needs to remain alive for the five years or part of the contribution is prorated back to their estate. Contributions in excess of these amounts can be made but may incur gift taxation, or be credited against a contributor's lifetime gift exclusion ($5,430,000). Before contributing to a 529, you should be familiar with your state's gift tax and inheritance tax rules.

Also, many states offer a state tax deduction and/or credit as an incentive for their residents to save toward higher education. To capture a state tax deduction/credit for a contribution, most states require the use of the state sponsored plan, but some states allow a deduction regardless of which plan the client chooses. In some cases the deduction benefit can be significant and worth considering; in other instances it should not be the only factor to consider.

WITHDRAWING THE MONEY

Tax-free withdrawals for qualified educational expenses include the following when a student is attending an eligible educational institution:

- Tuition and fees
- Books, supplies and equipment (that are required by the institution)
- Room and board (if attending school more than half time)
- Expenses for special needs services incurred in connection with enrollment or attendance by a special needs beneficiary*

Tax reporting for 529 plans is simple as nothing is reported until a withdrawal is made. Hence, you will not need to file/declare anything and will not receive a 1099Q until after a withdrawal is made. And if the withdrawal is for qualified education expenses, you still do not need to file anything; just keep records of the expenses in case of an audit.

*An eligible education institution is any postsecondary educational institution such as a college, university or vocational school, including many schools abroad that are eligible to participate in a federal student aid program administrated by the U.S. Department of Education.

For non-qualified withdrawals, the distributee would need to include the earnings portion of the withdrawn amount as income and pay a 10% penalty on the earnings (all withdrawals come out of the account on a prorata basis as return of principal and earnings).

529 LIMITATIONS

Effective January 1, 2015, clients are able to change their investment allocation within a 529 account two times per year. This change was part of the ABLE Act (Achieving a Better Life Experience).

There are limited investment choices made available within each plan. Although many choices exists among the plans, most investors for practical reasons limit themselves to one plan, and your financial advisor can help find the right plan that fits your unique needs.

Fees and expenses are higher for 529 plans when compared to buying the underlying investments directly, as the program manager and the sponsoring state typically charge a fee for their services.

529 PLAN SELECTION

In most cases 529 plan selection can be done in a few steps. To maximize the benefit of the investment, it is smart to compare the plans offered by different states in terms of tax deductions, fees and investment selection. Is a state tax deduction available? What is the dollar amount of the tax deduction? A significant deduction is a sure thing and hard to forgo. If comparing two or more plans that are similar, which one has the lowest expenses? Over time we know that expenses matter; they do eat into performance.

529 plans can be a valuable tool for funding a college education. Your Raymond James financial advisor can answer any questions you may have and help you get started today.

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