States May Offer the Key to Meeting Education Costs

There is a new option available for families when saving for the expenses of a college education. This new option is called the Qualified Tuition Program (QTP) or more commonly known as a 529 savings plan. As a result of legislation, individual states are able to set up their own tuition programs and, to date; almost all states have adopted some type of program. These programs may aid numerous families in their attempts to provide the opportunity of a college education for their children.

Generally speaking, there are two main types of programs a state may adopt: a credit program (529 prepaid tuition program) or a 529 savings program. The credit programs enable a family to purchase tuition credits or certificates from the state that will cover certain education costs upon a child's acceptance to a covered, in-state college or university. Depending on the state, the parent may purchase prepaid credit units at their discretion or may be required to purchase prepaid two or four-year plans. The benefits of this type of program is the establishment of a disciplined payment schedule along with the guarantee that certain future education costs will be met for the child.

In contrast, the savings program allows families the flexibility to randomly contribute funds to a special account that has the benefit of tax-deferral. The growth of the earnings is not taxed while the funds are held in the savings program and this is the central benefit of the savings program: it permits tax-deferred growth on the funds set aside for future education costs. Upon a child's acceptance into a college or university, the funds in this account may be used to meet the qualified higher education costs of the child at any eligible education institution in the U.S. and some foreign.

As funds are withdrawn to meet qualified higher education expenses, the distribution is 100% tax-free* federally. If an individual contributed $30,000 to a savings program and $40,000 is taken out for qualified higher education expenses, no federal taxes are due on the $10,000 in earnings. Earnings are tax-free* (state taxes may apply).

If the assets in the program are refunded to the parent and are not used for a child's education, the earnings in excess of the contributions is income taxable to the recipient. Additionally, a 10% early withdrawal penalty on the earnings portion of the refund is included in taxable income. This penalty does not apply if the refund is made on amount equal to a scholarship received by the child or death or disability of the child.

Qualified higher education expenses include tuition, fees, books, supplies, equipment, and room and board according to limits set by the education institution. These state programs allow transferability of benefits from one family member to another. Keep in mind that a contribution to a qualified tuition program is subject to the gift tax, but contributions are eligible for the $13,000 annual gift tax exclusion. Also, a special election allows the gift to be treated as if it were made over a five-year period. This means that $65,000 can be contributed to an account gift-tax free, assuming that no other gifts are made during the following five-year period.

Since these programs do differ, consult with your financial advisor for additional information before implementing a college-funding plan.

Withdrawals for qualified education expenses became federally tax-free effective January 1, 2002.

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