

## **529 Plans: The Ins and Outs of Contributions and Withdrawals**

Section 529 plans can be powerful college savings tools, but you need to understand how your plan works before you can take full advantage of it. Among other things, this means becoming familiar with the finer points of contributions and withdrawals. A little knowledge could save you money and maximize your chances of reaching the educational goals you've set for your children.

### **How much can you contribute?**

To qualify as a 529 plan under federal rules, a state program must not accept contributions in excess of the anticipated cost of a beneficiary's qualified education expenses. At one time, this meant five years of tuition, fees, and room and board at the costliest college under the plan, pursuant to the federal government's "safe harbor" guideline. Now, however, states are interpreting this guideline more broadly, revising their limits to reflect the cost of attending the most expensive schools in the country and including the cost of graduate school. As a result, most states have contribution limits of \$250,000 and up (and most states will raise their limits each year to keep up with rising college costs).

A state's limit will apply to either kind of 529 plan: prepaid tuition plan or state savings plan. For a prepaid tuition plan, the state's limit is a limit on the total contributions. For example, if the state's limit is \$125,000, you can't contribute more than \$125,000. On the other hand, a state savings plan limits the value of the account for a beneficiary. When the value of the account (including contributions and investment earnings) reaches the state's limit, no more contributions will be accepted. For example, assume the state's limit is \$125,000. If you contribute \$95,000 and the account has \$30,000 of earnings, you won't be able to contribute anymore--the total value of the account has reached the \$125,000 limit.

These limits are per beneficiary, so if you and your mother each set up an account for your child in the same plan, your combined contributions can't exceed the plan limit. If you have accounts in more than one state, ask each plan's administrator if contributions to other plans count against the state's maximum. Some plans may also have a contribution limit, both initially and each year.

Note: Generally, contribution limits don't cross state lines. Contributions made to one state's 529 plan don't count toward the lifetime contribution limit in another state. But check the rules of your state's plan to find out if that plan takes contributions from other states' plans into consideration when determining if the lifetime contribution limit has been reached.

### **How little can you start off with?**

Some plans have minimum contribution requirements. This could mean one or more of the following: (1) you have to make a minimum opening deposit when you open your account, (2) each of your contributions has to be at least a certain amount, or (3) you have to contribute at least a certain amount every year. But some plans may waive or lower their minimums (e.g., the opening deposit) if you set up your account for automatic payroll deductions or bank-account debits. Some will also waive fees if you set up such an arrangement. (A growing number of companies are letting their employees contribute to state savings plans via payroll deduction.) Like contribution limits, minimums vary by plan, so be sure to ask your plan administrator.

## Know your other contribution rules

Here are a few other basic rules that apply to most 529 plans:

- Only cash contributions are accepted (e.g., checks, money orders, credit card payments). You can't contribute stocks, bonds, mutual funds, and the like. If you have money tied up in such assets and would like to invest that money in a 529 plan, you must liquidate the assets first.
- Contributions may be made by virtually anyone (e.g., your parents, siblings, friends). Just because you're the account owner doesn't mean you're the only one who's allowed to contribute to the account.
- Contributions generally may not be directed toward particular investments of your choice. However, most state savings plans offer several different investment portfolios, and many let you choose one or more portfolios to invest your contributions. You make this choice at the time you make your contribution. Some states have also added two opportunities to change your investment choice. Savings plans in these states let you change your investment choice when you change the beneficiary of the account. These plans let you change the investment portfolio once each calendar year, as well.

## Maximizing your contributions

Although 529 plans are tax-advantaged vehicles, there's really no way to time your contributions to minimize federal taxes. (If your state offers a generous income tax deduction for contributing to its plan, however, consider contributing as much as possible in your high-income years.) But there may be simple strategies you can use to get the most out of your contributions. For example, investing up to your plan's annual limit every year may help maximize total contributions. Also, a contribution of \$11,000 a year or less qualifies for the annual federal gift tax exclusion (\$55,000 if you make no contributions for the next four years). This is something to keep in mind if you wish to remove assets from your taxable estate.

## Lump-sum vs. periodic contributions

A common question is whether to fund a 529 plan gradually over time, or with a lump sum. The lump sum would seem to be better because 529 plan earnings grow tax deferred--the sooner you put money in, the sooner you can start to generate earnings. Investing a lump sum may also save you fees over the long run. But the lump sum may have unwanted gift tax consequences, and your opportunities to change an investment portfolio are limited. Gradual investing may let you easily direct future contributions to other portfolios in the plan.

## Qualified withdrawals are tax free!

The Economic Growth and Tax Relief Reconciliation Act of 2001 made some important changes to 529 plans. The most significant change is that withdrawals from a 529 plan that are used to pay qualified higher education expenses are completely free from federal income tax. Qualified higher education expenses generally include tuition, fees, books, supplies, and equipment required for enrollment or attendance at an "eligible" educational institution (as defined by the Higher Education Act). In addition, the definition includes a limited amount of room-and-board expenses for students attending college on at least a half-time basis. The definition does not currently include the cost of transportation or personal expenses.

Why is this a significant change? Before the act, the earnings part of a withdrawal was subject to federal income tax, even if the funds were used to pay qualified higher education expenses. The tax was assessed at the beneficiary's rate, which was typically lower than the rate of the account owner. Still, depending on the growth of the account and the amount of the withdrawals, the beneficiary could end up losing many dollars to Uncle Sam. The tax act eliminated this drawback, making 529 plans all the more attractive. Plus, some states may also exempt plan withdrawals from state income tax.

Keep in mind, though, that the provisions of the Tax Relief Act of 2001 that made qualified withdrawals from a 529 plan tax free at the federal level will expire on December 31, 2010. This means that the tax-free treatment of qualified withdrawals will be lost unless a future Congress extends the tax provisions or provides other tax relief.

Note: A 529 plan must have a way to make sure that a withdrawal is really used for qualified education expenses. Many plans require that the college be paid directly for education expenses; others will prepay or reimburse the beneficiary for such expenses (receipts or other proof may be required).

### **Beware of nonqualified withdrawals**

By now, you can probably guess what a nonqualified withdrawal is. Basically, it's any withdrawal that's not used for qualified higher education expenses. For example, if you take money from your account to buy your son a new Porsche, that's a nonqualified withdrawal. Even if you take money out for medical bills or other necessary expenses, you're still making a nonqualified withdrawal.

One reason not to make this type of withdrawal is to avoid depleting your college fund. Another compelling reason is that these withdrawals don't enjoy tax-favored treatment. The earnings part of a nonqualified withdrawal will be subject to federal income tax, and the tax will typically be assessed at the account owner's rate, not at the beneficiary's rate. Plus, the earnings part of a nonqualified withdrawal will be subject to a 10 percent federal penalty, and possibly a state penalty too.

### **Is timing withdrawals important?**

As account owner, you can decide when to withdraw funds from your 529 plan and how much to take out--and there are ways to time your withdrawals for maximum advantage. For starters, it's important to coordinate your withdrawals with the Hope credit, the Lifetime Learning credit, and other tax credits you might qualify for. That's because the tuition that's used to generate a credit may reduce your available pool of qualified education expenses. A financial aid or tax professional can help you sort this out to ensure that you get the best overall results. It's also a good idea to wait as long as possible to withdraw from the plan. The longer the money stays in the plan, the more time it has to grow tax deferred.

Waiting to withdraw money from the plan can help your child qualify for federal financial aid, as well. That's because the earnings on distributions from a 529 state savings plan are included in your child's income for federal aid purposes and assessed at a rate of 50 percent (if owned by a parent, the account itself is considered the parent's asset for federal aid purposes and assessed at a rate of 5.6 percent).

Note: With a 529 prepaid tuition plan, the financial aid impact is different. The value of the contract itself is not considered an asset for federal aid purposes, but payments made from the program for tuition and other expenses will reduce your child's financial aid on a dollar-for-dollar basis.