The 529 College Savings Plan offers unique benefits not found elsewhere in current law or tax rules. Since their creation under the Economic Growth and Tax Relief Reconciliation Act of 2001, these flexible and tax-advantaged savings programs quickly have become an investment platform of choice, and not just for upper-bracket taxpayers. Total 529 plan assets had surpassed $65 billion by January 2006; they increased by 31 percent in 2005 alone. These college savings plans can appeal to anyone seeking to retain control over gifts, reduce potential estate tax, maximize financial aid eligibility, or just plain put tax-free money aside for college.

For estate and gift-tax purposes, 529 plans allow donors to contribute up to $60,000 per beneficiary’s account (or $120,000 for a married couple filing jointly) and have the gift sheltered by five years’ worth of the annual gifting exclusion ($12,000 per year for 2006). This front-loading strategy allows considerable sums to be transferred out of an estate quickly. If the donor does not survive for the five-year sheltering period, the unamortized amount will be included in the donor’s gross estate. Also, in the event of the donor’s death, earnings on the funds are excluded from the grantor’s estate.

Investors may choose among 529 plans offered by any state, and differences among states can make shopping around a valuable exercise. Particular features worth comparing include maximum contribution limits (around $250,000), state taxation of withdrawals, deductibility of contributions, investment choices, and plan expenses. Investors generally are limited to available investment choices within a particular 529 plan; however, the ability to roll over plans from state to state can provide a degree of investment flexibility.

New Financial Aid Treatment for 529 UTMA

Prior to the introduction of 529s, Uniform Transfer to Minors Act (UTMA) accounts were a popular choice used to transfer assets to minor children. UTMAs provide restricted tax benefits and, at majority, become fully controlled by the child. Note: The older statutory form of a minor’s account was called a UGMA, Uniform Gift to Minors Act. UGMAs were repealed in all states (except South Carolina and Vermont) and UTMA was substituted. Existing UGMAs were grandfathered and have no special tax treatment and otherwise are used interchangeably with UTMAs, herein.

A new incentive to transfer UTMA accounts into 529 plans was introduced in July 2006. UTMA provides for statutory trusts in similar format in every state (except South Carolina and Vermont), Guam, the Virgin Islands, and Washington, DC. Before July 2006, the main economic motivations for transferring existing UTMAs into 529 plans were to take advantage of the qualified tax-free withdrawal provisions or, in some states, creditor protection.

Now UTMA assets held within a 529 plan no longer are considered as student-owned assets for the purpose of federal financial aid eligibility. Instead, the new formula treats UTMAs held in 529 plans as assets attributed to the account holder, who often is a parent. This attribution rule always has applied to non-UTMA 529 plans and is good news for UTMA owners seeking financial aid.

Most educational institutions process financial aid applications using the U.S. Department of Education’s standardized calculation to determine an applicant’s ability to afford college expenses. This calculation generally considers student-owned assets such as UTMAs about 35-percent available for education funding.

In contrast, only 5.7 percent of parental assets generally are considered available for education funding, providing a potential counter-incentive for students to save or for relatives to make financial gifts directly to the student.

As a result, well-intentioned gifts and employment savings in UTMAs create the unintended result of reducing financial aid awards—and perhaps the student’s potential to afford higher education. For example, consider two students applying for a $10,000 first-year needs-based...
Elimination of Certain Taxable Income Categorizations

Financial aid applications examine a student's taxable income as well as financial assets. Because qualified 529 plan distributions are not taxable, the amounts are not reported as income for federal tax purposes and generally are not required to be reported on the financial aid application. Caveat: Financial aid departments may change their criteria for reporting of 529 plan distributions.

Additionally, and of even greater benefit, prepaid tuition plans now also are classified as parental assets. Before July 2006, the Department of Education interpreted the Higher Education Act of 1965 as requiring that prepaid tuition plans and 529s be treated as a student-owned resource that could reduce a student’s financial need on a dollar-for-dollar basis. Where the student was beneficiary of a 529, the old formula significantly reduced eligibility for subsidized loans, work study, and certain grants.

Significant 529 Plan Tax Advantages

529 plan withdrawals, when used for qualified educational expenses, are not subject to federal income taxation. This can provide a significant economic advantage over the previously popular UTMA programs. For example, consider the following hypothetical example. Assume a $5,000 annual contribution over an 18-year period with a hypothetical 10-percent annual return. Under this scenario, the 529 plan grows to nearly $278,000. But the same contributions to an UTMA or other taxable account will have a final value of only $219,000 to $233,500, depending on the tax bracket. As a planning step, many custodians choose to transfer UTMA assets earmarked for education into 529 plans to avoid further taxation.

The above example does not include potential benefits available at the state level, such as a state income tax deduction for 529 plan contributions. Before investing, investors should consider whether the investor's or designated beneficiary’s home state offers any state tax or other benefits. The availability of such benefits may depend upon meeting certain requirements. Note that most states offering tax deductions for 529 plans also have recapture provisions if you change states or make nonqualified withdrawals.

Take-Backs and Beneficiary Changes

Although a 529 plan is considered a “completed gift” for tax purposes, grantors can retain the ability to change beneficiaries, control distributions, keep creditors at bay, and even take the money back for their own use. Beneficiaries can be substituted with other family members at will, just like transfers from state to state or to private prepaid tuition programs.

Beneficiary changes, also referred to as rollovers, can be made at any time as long as the new beneficiary is a family member of the previous beneficiary. Permissible family-member rollover beneficiaries include sons, daughters, brothers, sisters, nephews, nieces, certain in-laws, and any spouse. First cousins also are considered family members for the purpose of beneficiary switches.

Avoiding Taxation

When used for “qualified higher education purposes,” contributions and gains in a 529 plan avoid taxation, whether they are used at public, private, or vocational schools, and whether they are used at in-state or out-of-state schools. Qualified higher education expenses include tuition, room and board, student fees, equipment including computers, and books, plus most anything the financial aid office includes under its definition of expense. Room and board withdrawals are permitted up to the amounts considered for federal financial aid purposes for on-campus accommodations—even if the student lives at home or off-campus.

As a note aside, scholarship funds and grants that exceed the cost of tuition, fees, and certain required items generally are considered income. Common taxable elements of many scholarships generally include room, board, and suggested (but not required) books.

If funds are withdrawn for non-qualified purposes, the recipient is assessed a 10-percent federal tax penalty on the amount of gain, which then is taxed as ordinary income in the year of withdrawal. The 10-percent penalty is waived on withdrawals of gains in cases of the beneficiary’s death or disability, though distributed plan gains will be considered taxable income. In the case of 529 withdrawals, any gains are considered to be distributed first.

Consider, however, that for many investors the long-term tax benefits of compounded tax deferral may outweigh the 10-percent earnings penalty on nonqualified 529 plan withdrawals. This is because there is no age or time limit on 529 plan withdrawals—unlike the Education IRA, which requires distribution or beneficiary change at age 30. As a result, assets remaining in a 529 plan after all qualified education expenses are paid may still be competitive investments.

The newly enacted Pension Protection Act of 2006 also repealed the 2010 sunset provision and...
Pension Protection Act of 2006

The Pension Protection Act of 2006 was signed into law by President Bush on August 17, 2006. This Act relates to the reform of funding rules for single-employer defined benefit pension plans and funding rules for multiemployer defined benefit plans. The Act also makes changes to the rules governing 401(k) and other defined contribution plans, nonqualified deferred compensation plans, individual retirement accounts (IRAs), and health and welfare benefits. In addition, the Act contains a number of significant changes to the Employee Retirement Income Security Act (ERISA) fiduciary rules and prohibited transaction exemption for provision of investment advice.

Title VI: Investment Advice, Prohibited Transactions, and Fiduciary Rules, adds a new category of prohibited transaction exemption under ERISA and the Internal Revenue Code in connection with the provision of investment advice through an “eligible investment advice arrangement” to participants and beneficiaries of a defined contribution plan who direct the investment of their accounts under the plan and to beneficiaries of IRAs. If the requirements under the provision are met, the following are exempt from prohibited transaction treatment: (1) the provision of investment advice; (2) an investment transaction pursuant to the advice; and (3) the direct or indirect receipt of fees or other compensation in connection with the provision of the advice or an investment transaction pursuant to the advice.

An eligible investment advice arrangement is an arrangement that either: (a) provides that any fees for the investment advice do not vary depending on the basis of any investment option selected; or (b) uses a computer model under an investment advice program (as defined in the Act). An eligible investment expert must certify that the computer model meets the requirements of the Act prior to its use.

In the case of an eligible investment advice arrangement with respect to a defined contribution plan, an independent audit of the arrangement must be conducted annually to ensure compliance with these requirements. In the case of an eligible investment advice arrangement with respect to IRAs, an audit is required at such times and in such manner as prescribed by the Secretary of Labor.

The provisions of this Act are effective for investment advice provided after December 31, 2006.