Planning for College: Is a 529 Plan Right for You?

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If you have children one of the things that you have likely thought about is how are you going to afford to send your child to college. The cost of attending college continues to rise, and as we continue to hear horror stories of young adults crushed by student debt, parents are looking for ways to help foot the bill. One option available is known as a 529 Plan, but what is a 529 Plan and is it right for you?

A Qualified State Tuition Program is commonly referred to as a 529 Plan after the section of the Internal Revenue Code that allows such plans to exist. 529 Plan is used to help finance higher education costs and are available in all fifty states. There are two different types of 529 Plans: (1) prepaid tuition plans and (2) qualified savings plans. Prepaid tuition plans allow parents to purchase a future four year college education using current-year dollars. Typically the prepaid tuition plan only covers tuition and not fees, books or other expenses and generally only applies to in-state schools. As of 2020 only eleven states still have prepaid tuition plans, and not all are accepting new enrollees. Qualified savings plans allow you to contribute funds into a plan to be used for qualified education expenses in the future. Since qualified savings plans are set up by each state there is significant variation among the plans and you should investigate each plan before deciding which one is best for you. Since the dominant 529 Plan is the qualified savings plan, this article will focus on those plans.

Contributions to a qualified savings plan are made with after-tax dollars. Each state sets its own maximum plan balance which will limit the amount of contributions that can be made. For example, the aggregate amount that can be contributed to the Arkansas 529 Gift Plan is currently $366,000.

Although there is no income tax issue when contributing to a qualified savings plan, there may be a gift tax issue. Contributions to a qualified savings plan are considered taxable gifts; however, your annual gift tax exclusion can be applied to the gift. As such in 2020 you can contribute $15,000 to a qualified savings plan gift tax free. If both parents contribute to the plan then they can each contribute $15,000 gift tax free, for a total gift of $30,000. In addition, there is a special provision in the law that allows you to contribute five years of annual gifts at one time to a qualified savings plan. That means you can contribute $75,000 at one time to the plan, or $150,000 if both parents contribute. If such a lump sum contribution is made then you will not be able to make any more non-gift taxable contributions to the plan for the next five years. The advantage of making the larger current contribution is that those funds begin to earn money immediately. Of course, you can contribute more than the gift tax annual exclusion amount, but the portion that exceeds the annual exclusion will be subject to gift tax.

Some states will also allow an income tax deduction to their residents on their state income tax returns if they contribute to that state’s 529 Plan. For example, Arkansas allows a taxpayer to deduct up to $5,000, or $10,000 for a married couple, of a contribution to the Arkansas 529 Gift Plan from their adjusted gross income for Arkansas income tax purposes.

The state that you use to set up the 529 Plan determines the investment options, and as such, investment options will vary from state to state. It is important to remember that as with any investment the investor bears the risk on a qualified savings plan and there is not a guaranty that the investments will not lose money.

The earnings generated by the plan are not taxed while they remain in the plan. Distributions from the plan, including the earnings, are not taxable if they are used to pay for qualified educational expenses. If the distributions are not used for qualified educational expenses then the earnings portion is taxed and an additional ten percent (10%) penalty is assessed on the earnings.

Qualified educational expenses include tuition, fees, supplies, equipment and room and board. Tuition must be paid to a qualifying institution, which generally includes almost all accredited post-secondary institutions.

Parents with very young children are often concerned about what happens to the money in the 529 Plan if their child does not need it for college expenses. If you child earns a scholarship to pay for the schooling and does not need the 529 Plan, you are able to withdraw the amount of the scholarship from the 529 Plan and use it for any purpose. The withdrawal will not be subject to the ten percent (10%) penalty, but the earnings will be subject to normal income tax. If your child does not attend college at all then you have a few options. One option is to change the beneficiary of the 529 Plan to another member of the family, for example a younger sibling. You can also leave the fund in place and wait for a new beneficiary to arrive, for example a grandchild. You can also elect to remove the money from the plan. When you remove the money, you will be assessed the ten percent (10%) penalty on the earnings in addition to having to pay income tax on the earnings. Some states may impose a tax penalty on the earnings as well.

If you are not sure that a 529 Plan is right for you there are some other alternatives to save for college. One alternative is a Coverdell Education Savings Account. Whereas there is no annual income limit for a contributor to a 529 Plan, Coverdell Education Savings Accounts are only available to those whose modified adjusted gross income is under a certain amount. Unlike the 529 Plans on which there is no annual limit to contributions, only $2,000 a year can be contributed to a Coverdell Education Savings Account. Distributions from a Coverdell Education Savings Account are not taxable if they pay for qualified education expenses. Whereas 529 Plans are established by the state, a Coverdell Education Savings Account is set up at a brokerage or financial institution by the donor. This means that the donor can elect and direct the investment options.

As you can see there are options available to assist in saving for a college education, but you should review all of your options to make a choice that is right for you and your child.