COLLEGE

Thoughts Before Funding a 529 College Savings Plan

Watching your college savings grow tax-free with a 529 college savings plan feels great, but failing to follow the rules could come with penalties and taxes that you'll regret. To avoid that, take a moment to learn the basics.

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College costs have outpaced inflation. Looking back at the last decade, the 10-year historical rate of increase has been approximately 5% per year, according to The College Board. Luckily, there's a tax-advantaged way to save for these growing college expenses: the 529 college savings plan.

529 basics

When it comes to saving for college, opening a regular savings account/custodial account for your child is an option, but you'd miss out on the benefits of a 529 plan, such as the tax-free growth on earnings if the funds are used for qualified college expenses. Deposits to a 529 plan up to $15,000 per individual per year ($30,000 for married couples filing jointly) will qualify for the annual gift tax exclusion (for 2021). You can also front-load your investment in a 529 plan with $75,000 ($150,000 if joint with your spouse) and use this toward your gift tax exemption for five years, providing there have been no other gifts to that child. This is something that is not possible for a regular savings/custodial account for your child (you would only be able to gift $30K jointly). By adding a large amount up front, you allow the lump sum to grow over a longer time horizon vs. making smaller contributions over time. Contributions to a 529 plan do not have to be reported on your federal tax return.

Contributions to a 529 plan are not tax deductible (although some states do offer tax benefits), but the earnings grow tax free and are not taxed if used to pay for education. Another

advantage compared to a custodial account is control; the named beneficiary has no legal rights to the funds, so you can ensure the money will be used for education.

Also on the plus side, a 529 account owned by someone other than the parent (such as a grandparent) is not considered an asset for financial aid purposes. In addition, the value of a 529 account is removed from your taxable estate, yet you retain full control over the account.

How to choose a 529 plan?

Research the underlying expenses of the mutual funds and review the investment options available compared to other plans. The age-based models may be the easiest to manage, as the plan shifts to more conservative investments as the student gets closer to college age. You can choose any state plan no matter where you live, but if you reside in a state that provides tax breaks for using your state plan, you would likely want to start there. For example, New York residents get tax benefits for using their state plan. Keep in mind that you have the ability to move your 529 to another provider, but only one rollover is permitted per 12-month period.

How much to fund?

The amount to contribute to a 529 plan depends on several assumptions, such as whether you expect your child will attend a public college or a private college, the returns during the investment time horizon, and future college inflation. Funding goals vary widely depending on what you would like to achieve and the assumptions involved — and of course there is no right answer.

If the beneficiary does not go to college, you can transfer the 529 plan to a sibling in the future or to another family member, such as a cousin or grandchild. If you don't have any eligible family members, the worst-case scenario is that you would have to pay tax and a 10% penalty on the earnings to take the money out for another purpose. Withdrawals from a 529 plan that are not used for the beneficiary's qualified education expenses are taxed and penalized (subject to a 10% federal penalty and taxed at the income tax rate of the person who receives the withdrawal). If the beneficiary gets a scholarship, then the penalty is waived.

Considerations if you have more than one child

If you have several children, it may make sense to fully fund the first plan for the oldest child, and if the funds are not used, they can be transferred to the next child in line. You probably want to avoid fully funding all the plans in the event one child does not end up going to college, gets a scholarship, or starts a business. Some schools and some trade schools/programs do not qualify for 529 funds (for example, if a grandchild wants to go to a specific acting or cooking school). You can find out if your school qualifies by using this link: http://www.savingforcollege.com/eligible_institutions/.

Avoiding tax penalties on 529 Plan funds – not all expenses are qualified

Avoid overfunding the 529 if possible, as "qualified education expenses" do not cover all expenses related to college. Qualified expenses include:

- Tuition and fees.
- On-campus room and board.
- Books and supplies.
- Computers and related equipment.

On the other hand, several costs related to college aren't considered qualified expenses. These costs can easily add up, so it may make sense to save outside of a 529 plan to help cover them. Funds from a 529 plan cannot be used for:

- The purchase of a car, fuel costs or public transportation costs to and from school.
- Any insurance (car, health etc.) cannot be paid with 529 funds either.
- If your child is a member of a school club or involved in a sports activity, any related fees and costs are also not qualified.
- It might seem intuitive that, if you have a student loan, you can use funds from a 529 to pay off the balance, but this is also not permitted.

If your child is planning to live off-campus, in housing not owned or operated by the college, you are unable to claim expenses in excess of the school's estimates for room and board for attendance. It is important to confirm room and board costs with the school's financial aid office, in advance, so you know what to expect. Also, keep in mind that, in order for room and board to qualify, your child must be enrolled half time or more.

Finally, if your child is studying abroad, check with the school to find out if the study abroad program qualifies for 529 funds.

If you inadvertently use funds for the wrong expenses, you will end up being taxed on the earnings, as well as face a 10% penalty on that amount. Although 529 plan accounting tends to operate on the honor system, as you have to track your own expenses, using funds for the wrong items could have consequences in the event of an IRS audit.

Paying for college is a large expense for many families. 529 plans are a tax-advantaged way to save for college, but they come with some complex rules and restrictions — so understanding how these accounts operate before investing could save you from incurring unexpected tax penalties in the future.

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