529 plans: Fund college costs the tax-advantaged way

If you're a parent or grandparent, you're likely thinking about the children's future college educations and the best way to fund them. For many taxpayers, the answer is a Section 529 college savings plan, because of the potential tax advantages it offers.

The lowdown

529 college savings plans, sponsored by states, allow you to make cash contributions to a tax-advantaged investment account.

Although contributions to a Sec. 529 college savings plan aren't tax deductible at the federal level, earnings can grow tax-deferred and may be withdrawn free of federal and, generally, state income taxes, provided they're used for qualified higher education expenses. These include tuition, fees, books, supplies and equipment, and certain room and board expenses. Nonqualified withdrawals are subject to taxes and a 10% penalty on the earnings portion.

Although most college savings plans are open to both residents and nonresidents of the state sponsoring the plan, there may be advantages to opening an account in your home state: possible state income tax deductions or other state tax breaks or benefits.

Perhaps the biggest advantage of 529 plans is that their contribution limits are much higher than those for other tax-advantaged educational savings vehicles. The tax code doesn't specify a dollar limit; it simply requires plans to "prevent contributions ... in excess of those necessary to provide for the qualified higher education expenses of the beneficiary." Limits vary by plan, but in general, they range from $150,000 to more than $350,000 per beneficiary.

Other pluses

529 plans are designed to fund college expenses, but they also provide estate planning benefits. Contributions are considered completed gifts for purposes of gift and generation-skipping transfer (GST) taxes, but they're also eligible for the annual exclusion, which currently shields up to $14,000 per year ($28,000 for married couples) in gifts, to any number of beneficiaries, from gift and GST taxes without using up any of your lifetime exemptions.

What's more, a 529 plan allows you to "front-load" contributions. This means that you can use up to five years' worth of annual exclusions in one year. Suppose that a husband and wife open 529 plans for their two grandchildren, and that each plan has a $150,000 contribution limit. The couple can immediately contribute $140,000 (5 × $28,000) to each plan *free of gift and GST taxes*.

For estate tax purposes, 529 plans are a great tool because contributions and future earnings are excluded from your taxable estate despite the fact that you retain a great deal of control over the funds. Typically, you can't place assets beyond the reach of estate taxes unless you relinquish control (by placing them in an irrevocable trust, for example). But with a 529 plan, you retain the ability to time distributions, to change beneficiaries or plans (subject to certain limitations) or even to revoke the plan and get your money back (again, subject to taxes and penalties).

The drawbacks

As great as 529 plans sound, they do have some drawbacks. One is that you're limited to the investment options the plan offers. Another is that you can change investment options only twice a year or if you change beneficiaries. But anytime you make a *new* contribution, you can choose a different investment option for that contribution.

There are also a couple of estate planning drawbacks. First, if you front-load contributions, you can't make additional annual exclusion gifts to those beneficiaries for five years. Second, if you die within five years after making these contributions, a portion of them will be included in your taxable estate.

Right for your situation?

If you're interested in putting away money for your children's or grandchildren's college educations, 529 plans merit a look. They can be especially beneficial if income or estate taxes are a concern. Work with your attorney to choose the most appropriate plan for your situation.

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