



CARNICK & COMPANY

PERSONAL FINANCIAL ADVISORS

COLORADO SPRINGS, COLORADO

Frequently Asked Questions About 529 Plans

What is a 529 plan?

It's an investment plan operated by a state designed to help families save for future college costs. As long as the plan satisfies a few basic requirements, the federal tax law provides special tax benefits to you, the plan participant (Section 529 of the Internal Revenue Code).

It's up to each state to decide whether it will offer a 529 plan (or possibly more than one), and what it will look like. Every state has made this commitment, although a few are not yet up and in operation.

Why should I invest in a 529 plan when I can't be sure that my kid will attend a public university in my state?

There's a misconception that 529 plans are only geared to families that send their kids to a state school. That's just not true. There are two general types of 529 plans: prepaid tuition plans and college savings plans. The states offering prepaid tuition contracts covering in-state tuition will allow you to transfer the value of your contract to private and out-of-state schools (although you may not get full value depending on the particular state). If you decide to use a college savings plan, the full value of your account can be used at any accredited college or university in the country (along with some foreign institutions). You can look up eligible institutions on the Education Department's school code search page.

What's so great about 529 plans?

You're looking at four main advantages.

First, you get unsurpassed income tax breaks. Your investment grows tax-free for as long as your money stays in the plan. And when a withdrawal is taken to pay for the beneficiary's college costs, the earnings portion of that withdrawal is taxed to the student. Assuming that the student isn't earning hundreds of thousands of dollars running a dot-com company out of her dorm room, you should save taxes with her lower income tax bracket. The recent tax law changes make this even better starting next year 2002; qualified withdrawals are entirely exempt from federal taxes. Your own state may offer some tax breaks as well (like an upfront deduction for your contributions or income exemption on withdrawals) in addition to the federal treatment.

Second, you the donor stay in control of the account. With few exceptions, the named beneficiary has no rights to the funds. You are the one who calls the shots; you decide when withdrawals are taken and for what purpose. Most plans even allow you to reclaim the funds for yourself any time you desire, no questions asked. (There is a penalty, however, any time you make a "non-qualified" withdrawal.) Compare this level of control to a custodial account under the Uniform Transfers to Minors Acts (UTMA).

Third, a 529 plan can provide a very easy hands-off way to save for college. Once you decide which 529 plan to use, you complete a simple enrollment form and make your contribution (or sign up for automatic deposits). Then you can relax and forget about it if you like. The ongoing investment of your account is handled by the plan, not by you. Plan assets are professionally managed either by the state treasurer's office or by an outside investment company hired as the program manager. You won't even receive a Form 1099 to report taxable or nontaxable earnings until the year you make withdrawals.

Finally, everyone is eligible to take advantage of a 529 plan, and the amounts you can put in are substantial (over \$200,000 per beneficiary in many state plans). Generally, there are no income limitations or age restrictions. Thinking about going back to college or graduate school in the future? Then set up a plan for yourself! There is no reason why you cannot be the beneficiary of your own account.

How will a 529 plan affect my child's chances to qualify for financial aid?

Guidance from the U.S. Department of Education says that your 529 savings account is treated as an asset of the parent or other account owner in determining eligibility for federal financial aid. This means that your expected contribution towards your child's college costs will include 5.6%, or less, of the value of your account for each academic year. This is much better than the 35% assessment against assets owned in your child's name or in a custodial account.

However, the amount of income shown on your child's prior year tax return is assessed at a 50% rate on the current year's application. So if you withdraw 529 account earnings to pay this year's college expenses, it will hurt eligibility next year.

Example: You file the FAFSA aid application when your child is a senior in high school. Let's say you have a 529 savings account with \$20,000 in it, of which \$10,000 represents your original contribution and \$10,000 is earnings. Your eligibility for federal financial aid this year will decrease by as much as 5.6% of the account value, or \$1,120. Assume there is no further appreciation in the account and you withdraw \$5,000 in the Fall to pay for the first semester college bills. If you have \$15,000 left in the account when you apply for aid for sophomore year, you will again be assessed up to 5.6%, or \$840, of the account value. But your child's tax return for the previous year now shows \$2,500 of income because the \$5,000 withdrawal brought \$2,500 of taxable income with it. Based on a 50% assessment rate, your eligibility for federal aid decreases by another \$1,250. The federal aid formula is actually a bit more complicated than what is described here.

A 529 prepaid tuition plan works differently in the federal financial aid formula. Here your investment doesn't show up at all on the FAFSA. But the benefits paid out will be considered by the institution as a resource that reduces your child's overall financial "need". The bottom line effect for most families is a dollar-for-dollar offset in eligibility. That is, if your prepaid tuition contract pays out \$5,000 in tuition benefits this year, you will be considered as having \$5,000 less need for financial aid. Low income families that qualify for the Federal Pell grant will generally not be affected by a prepaid tuition plan (but they will be affected by a 529 savings plan).

It is too early to tell how the new tax law will impact the financial aid treatment of 529 plans. The income tax exemption for qualified withdrawals beginning in 2002 will likely lead to an upward adjustment to student's income computed on the FAFSA for those aid applicants who in the prior year used withdrawals from a 529 savings plan to pay for college. We may see no change in how prepaid tuition plans are treated.

Sound complicated? It is. Also consider that the financial aid rules are subject to frequent change. Finally, remember that most financial aid comes in the form of loans, not grants, and so you end up paying it back anyway.

What's this I hear about a penalty on refunds? What happens if my child doesn't go to college or if I simply end up with more in the account than he needs for college?

Federal law requires that the 529 plan charge you a penalty if a withdrawal is not used to pay qualified higher education expenses. Based on IRS guidance, most states will collect a penalty of 10% of the earnings portion of a "non-qualified" withdrawal. This means that you will get back 100% of your principal and 90% of your earnings. The penalty is usually not charged if you terminate the account because the beneficiary has died or become disabled, or if you withdraw funds not needed for college because the beneficiary has received a scholarship.

Beginning in 2002, a new 10% federal penalty on earnings will apply if you receive a non-qualified withdrawal. The states are permitted to remove their own penalties, and most presumably will do so, although it may take a while for the change to be made in some states.

You can change the beneficiary at any time in order to keep the account going and avoid (or at least delay) taking non-qualified withdrawals when the original beneficiary doesn't need those funds.

That penalty doesn't sound so bad. Am I missing something?

What could be worse than the penalty is the fact that the earnings portion of a non-qualified withdrawal is generally taxed to you, the account owner, and not to the student. In addition, if you were able to deduct your original contributions on your state income tax return, you will probably have to report additional state "recapture" income.

Why do you keep saying "generally" and "usually"?

Assuming you are not questioning my grammar, the answer is that for almost every generality discussed you can find at least one state that does things differently. Some states do have age restrictions. Some states do not allow rollovers to any member of the family at any time. Some states do give the beneficiary certain rights. Some states do not allow you to be the beneficiary of your own account.

Can I transfer my existing Education IRA and U.S. savings bonds into a 529 plan?

Yes, you can accomplish these rollovers without triggering tax, but you should be careful about ownership issues. For instance, the Education IRA is owned by your child and so it may not be proper to transfer the funds into a 529 account that is owned by you. Also, at least until the end of 2001, the untaxed earnings transferred into the 529 plan will be subject to tax when withdrawn from the 529 plan (the new law grants you tax exemption on qualified withdrawals beginning in 2002). Also note that the tax-free rollover of U.S. savings bonds into a 529 plan requires that you meet all the qualification requirements for the education exclusion, including the income limits in the year of the redemption/rollover.

Can I transfer my child's existing Uniform Transfers to Minors Act (UTMA) account into a 529 plan?

Many (but not all) 529 plans accept funds coming from an existing UTMA or UGMA. However, because these funds belong to the minor under a custodial arrangement, any

withdrawals from the UTMA/529 account must be for the benefit of that minor only. Program rules and state laws will generally prevent you from making any beneficiary changes to the UTMA/529 account, and the minor will assume direct ownership of the account when the custodianship terminates at the age of majority. Parents who are nervous about a child getting their hands on money in an UTMA account, and who may be looking to "regain control" of the money by transferring the funds to a 529 account, may be disappointed to learn that they are not able to accomplish that objective without violating state laws (see your attorney). Still, the placement of UTMA funds in a 529 account can provide all the tax and investment benefits associated with 529 plans. Remember, however, that a 529 plan can only accept cash and so any appreciated securities in the UTMA would first have to be sold and capital gains would be reportable on the minor's tax return.

I thought there were some gift and estate tax advantages with 529 plans, but you didn't mention that as a benefit. Am I wrong?

The gift and estate tax treatment of an investment in a 529 plan is a good news, bad news situation.

The bad news is that your contribution is treated as a gift to the named beneficiary for gift tax and generation-skipping transfer tax purposes and so you need to be aware of this exposure particularly if you are making other gifts to the beneficiary during the same year.

The good news is that your contribution qualifies for the \$10,000 annual gift tax exclusion and so most people can make fairly large contributions without incurring the gift tax.

The better news is that if you make a contribution of between \$10,000 and \$50,000 for a beneficiary, you can elect to treat the contribution as made over a five calendar-year period. This allows you to utilize as much as \$50,000 in annual exclusions to shelter a larger contribution. The money (and the growth of your account) gets out of your estate faster than if you made contributions each year.

And the best news is that the asset leaves your estate but doesn't leave your control. This is a truly remarkable benefit when you compare it to the "normal" gift and estate tax laws. Anyone who is being advised to reduce their estate tax exposure through gifting, but cannot stand the thought of irrevocably giving away their assets, can now have their cake and eat it too. Of course, if you later revoke the account its value comes back into your estate. Your estate will also have to include a portion of any contribution made with the five-year averaging election if you don't live to the fifth year.

Can I invest for one beneficiary in more than one state's 529 plan?

Sure, no problem. There are a couple dozen states that have 529 plans without any state residency requirements. You can open accounts in as many of these states as you want, although in most cases there is little reason to have accounts in more than two or three states.

Can I contribute the maximum amount in more than one state if I want to?

The IRS currently does not require that states count your investment in other state 529 plans when applying their own contribution limits. And there are no "contribution police" out there looking for people who are intent on using multiple states to stuff hundreds of thousands of dollars into 529 plans as a kind of tax shelter. But you are looking for trouble if you contribute more on an aggregate basis than you can reasonably argue might be needed for your beneficiary's future higher education costs. Of course, between a pricey private college, medical school, and then business school you might be able to support a pretty hefty sum. A state will not want to see its program misused as a tax shelter (its tax status as a 529 plan could be threatened) and if a state determines that you have made contributions without the intent to use the account for college it will terminate your account and perhaps assess an extra penalty.

For additional questions please contact CARNICK & COMPANY directly at (719) 579-8000 or toll free at (800) 447-8181. Please visit our web site at www.WealthAdvisory.com.