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Section 529 Plans: A Smart Way to Save for College

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Section 529 plans are a very user- and taxfriendly way of saving for college for a child or grandchild. The beauty of 529 plans is that they allow for the money invested to grow free of any taxes on income or capital appreciation. These dollars can then be used to pay for the costs of education without being subject to federal income tax when they are withdrawn. Maryland donors also enjoy state income tax deductions for funds contributed to Maryland 529 plans.[1]

Overview

Transfers to a 529 plan are made free of gift tax if the transfers are under the $12,000 (or $24,000 for married couples) per donee annual gift tax exclusion. Contributions to the plans can be "gift tax forwarded" for five years, which means that a donor can give up to $60,000 in one year with no gift tax implications. Transfers to these plans also have estate tax benefits because the property contributed (and future appreciation) is removed from the donor's taxable estate.[2] For example, a grandparent with a taxable estate could contribute up to $60,000 to as many of his grandchildren's 529 plans as he would like. That means a grandparent with five grandchildren could get $300,000 out of his estate without paying gift tax and save as much as $105,000 in federal estate taxes.

Another tax benefit is a hedge against the recent increase in the "kiddie tax," which now applies to all children under the age of 19 and full-time college students under the age of 24 who do not earn more than half of their income. If children under the age of 19 or full-time students under the age of 24 have an unearned income of over $1,700 per year, that income will be taxed at the parent's marginal rate, which could be as high as 35%. That means that if a college fund is established for a child in the child's name, the income earned on the investments in the account will be subject to the parents' tax rate. Conversely, if the funds are deposited into a 529 plan, there is no tax at all on the investment income.

Maryland 529 Plans

In Maryland there are two types of 529 plans: the Prepaid College Trust and the College Investment Plan.

Prepaid College Trust

When a donor decides to participate in the Prepaid College Trust, the donor commits to making fixed payments in return for a future benefit. The donor chooses among several payment options based on how much college the donor wishes to fund, the type of college the donor wishes to pay for and the age of the child. The donor makes these payments to the Prepaid College

Trust. When the child eventually goes to college, the Prepaid College Trust will pay the full in-state tuition (or the amount of college the donor has prepaid for) and mandatory fees at any Maryland public college. If the child attends a private or out-of-state college, the Prepaid College trust will pay a predetermined amount that is based on the costs of a Maryland college toward the costs of the private or out-of-state college.

College Investment Plan

The College Investment Plan operates just like other investment accounts and offers donors/investors the flexibility of investing assets in portfolios managed by private investment managers. The Maryland-sponsored 529 plan is managed by T. Rowe Price, but other states' plans are open to investors from Maryland as well. For example, a Maryland resident may invest in a New Hampshire 529 plan managed by Fidelity Investments, instead of the Maryland T. Rowe Price plan.

When choosing a plan from another state, a Maryland donor would lose the Maryland income tax deduction, but there may be other benefits to choosing a plan from outside of Maryland to offset the loss of deduction. For example, each plan has a different fee structure and it may be worth a loss of deduction for a reduction in fees. Additionally, some states' plans provide creditor protection, which would offer a significant benefit for investing in an out-of-state plan under certain circumstances.

Pros and Cons

There are advantages and disadvantages of the Prepaid College Trust and the College Investment Plan. The advantage of the Prepaid College Trust is that donors are actually pre-paying for a certain number of years or semesters at a college or university. (The amount of college funded depends on the payment option the donor chooses.) The Prepaid College Trust is comforting for donors in that the donor knows and is guaranteed that if the payments to the trust are made, the costs of attending an in-state college will be paid, even if the tuition increases. One disadvantage is that if a child decides to go to a private or out-of-state college, the costs of the more expensive college will not be met.

The College Investment Plan operates more like a 401(k) or other investment account. When a donor decides on a particular state's 529 plan, the donor is given several investment options, and then the donor can decide to invest aggressively or conservatively within those investment portfolios. The donor is not locked into making prescribed contributions and has some control of the way investments are made. The downside of the College Investment Plan is that a donor is not guaranteed that he or she has saved enough money to actually pay for college.

Conclusion

Section 529 plans are an attractive, fairly user-friendly way to save for college. They have both income and estate tax benefits. Gifts to 529 plans qualify for the annual gift tax exclusion and remove assets from the donor's taxable estate. The plan's investments can grow income tax-free, as long as the funds are used to pay for college and the onerous "kiddie tax" is avoided. Also, contributions to one of the Maryland plans generate a Maryland income tax deduction for the donor.

In addition to 529 plans, there are many other methods of saving for the costs of college, such as education IRAs and education trusts. Each should be analyzed in light of a donor's overall estate-planning, tax-planning and college-savings goals. When all of the tax benefits are added up, it is clear that 529 plans should be seriously considered by those saving for a child's (or grandchild's) college education.

NOTES

[1]Maryland taxpayers can deduct the first $2,500 (per account) contributed to the Maryland Prepaid College Trust or the Maryland College Investment Plan. Payments in excess of $2,500 can be carried over and deducted in future tax years.

[2]Donors can contribute up to $250,000 of cash per student into a 529 plan.