Estate Planning

529 plans: The basics.

By Eva Stark, JD, LL.M.

With the rising cost of higher education, education funding has become one of the most important areas of planning for the parents and grandparents of future students. Many look to 529 plans as an important planning tool to address and help mitigate increasing educational expenses.

A 529 plan is a tax-advantaged savings plan designed to encourage saving for future education costs. 529 plans, legally known as "qualified tuition plans," are sponsored by states, state agencies, or educational institutions and are authorized by Section 529 of the Internal Revenue Code.

Background

While nearly every state now has some type of 529 plan, the plans differ greatly, and individuals should research the features, benefits, cost and other attributes of plans before making a planning decision. Some factors to consider include the child's age and number of years left before enrollment would commence, potential residency requirements, and specific educational and familial preferences related to the selection of a postsecondary institution. In addition to the more immediate funding considerations, potential tax benefits also should be considered.

Federal income tax considerations

Contributions to a 529 plan are typically not deductible for federal income tax purposes. Distributions are generally tax free as long as the distributions are used for qualified educational expenses. Whether a distribution from a 529 plan constitutes a qualified educational expense may also vary depending on the type of 529 plan selected.

State income tax considerations

Unlike the federal income tax regime which offers no immediate tax benefit for individuals who contribute to a 529 plan, many states reward donors with state income tax deductions or credits. While some states limit such tax benefits to donors contributing to the state's own 529 plans, other states provide a tax benefit regardless of which state's plan is selected. States also may differ from the federal income tax regime when it comes to distributions that are excludible from income. For example, while some distributions from certain types of 529 plans may be federal income tax free, they may be subject to state income tax.

Federal transfer tax considerations

Contributions to a 529 plan may trigger gift taxes; however, contributions are generally treated as completed gifts which may be eligible for the annual gift tax exclusion. If a donor gifts more than the annual gift tax exclusion amount, the donor may elect to take the contributions into account over a five-year period.

Effect on financial aid

Having a 529 plan may impact a student's eligibility for financial aid. What, if any, effect a 529 plan will have on financial aid could depend on a number of factors including who owns the plan, how much is distributed from the account and when the distribution is made, the institution attended and what type of aid the student may be applying for, among others.

Effect on other tax benefits for education

While a taxpayer may be eligible for other tax benefits such as the American Opportunity Credit or Lifetime Learning Credit while simultaneously excluding 529 plan distributions from income for the same student, "double dipping" is not allowed. In other words, qualified expenses covered by a 529 plan do not otherwise permit an individual to claim an education tax credit.

Flexibility

It may also be possible to change the designated beneficiary of an account without triggering federal income taxes if the new designated beneficiary is a family member of the designated beneficiary. A non-exhaustive list of family members generally includes a child, descendant of a child, a sibling, a parent, a niece or nephew, an aunt or uncle or a first cousin.

Changing a beneficiary or rolling over a 529 plan can have significant tax as well as non-tax consequences. Individuals should always consult with their tax and other advisors before opening, contributing to or making any change to a 529 plan.

Eva Stark, JD, LL.M., joined The Nautilus Group in 2014 to assist with the development of estate and business plans. She also performs advanced tax research. Eva graduated summa cum laude with a BS in economics and finance from The University of Texas at Dallas. She earned her JD, with honors, from Southern Methodist University, where she served as a student attorney and chief counsel at the SMU Federal Taxpayers Clinic. She received her LL.M. in taxation from Georgetown University Law Center. Prior to joining Nautilus, Eva worked in private practice in tax controversy, business law, and litigation.