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College Savings and 529 Plans

There are several options available to you when it comes to saving money for college and no matter which option you go with, one thing is for sure, it's never too early to start saving. As with most credits, there are some restrictions and income limitations, but we will help you utilize the saving plan, credit, and deduction options to give you the most benefit.

Credits: The American Opportunity Tax Credit is available for certain tuition and fees and it allows you to reduce taxes annually, up to $2,500 per student for four years of college. The credit is equal to 100% of the first $2,000 of qualified expenses and 25% of the next $2,000. There is also The Lifetime Learning Credit which covers any year of post-secondary education, with a maximum credit of $2,000 no matter how many students in the family are eligible. Each of these education credits phase out for taxpayers with higher incomes.

Education savings accounts: You may establish an education savings account (previously referred to as an education IRA) with a nondeductible contribution for any child under 18. The annual contribution limit is $2,000. Funds can accumulate and be paid out tax-free for qualified college expenses, including tuition, fees, books, supplies, equipment, and certain room and board costs. The funds can also be used to pay for elementary and secondary (K-12) school expenses at public, private, or religious schools. Eligibility for an education savings account starts phasing out at $110,000 of AGI for single taxpayers and $220,000 for married.

Individual retirement accounts (IRAs): Existing IRAs can also be a source of college funds. You may make withdrawals before age 59 ½ without penalty for amounts paid for college or graduate school tuition, fees, books, room and board, supplies, and equipment.

Education savings bond: Interest on Series EE and Series I bonds issued after 1989 is nontaxable when used to pay tuition and fees for you or your dependents. This tax break begins to phase out once income reaches certain levels.

Student loan interest deduction: Interest on certain student loans can be deducted whether or not you itemize your deductions. The maximum deduction is $2,500 per year over the loan repayment period.

Other tax benefits: Most scholarships remain tax-free. Nontaxable employer-paid tuition may be available and education expense related to your job may be deductible.

Section 529 Plans

These plans allow individuals to set up a tax-advantaged account to pay for college education. There are two types of Section 529 plans: prepaid tuition programs and college savings plans.

Prepaid tuition plan: Designed to hedge against inflation, these allow you to purchase tuition credits, at today's rates, that your child can redeem when he or she attends one of the plan's eligible colleges or universities. Both state and private institutions can offer prepaid tuition programs. Using tuition credits from these programs is tax-free.

College savings plan: This is the Section 529 that you've probably heard about. It is the most common college savings plan. State-sponsored plans allow you to build a fund to pay for your child's college education. Your contributions are not tax-deductible, but once in the plan, your money grows tax-free. Provided the funds are used to pay for qualified college expenses, withdrawals are tax-free. Qualified expenses include tuition, fees, books, supplies, and certain room and board costs. Private institutions are not allowed to set up college savings accounts.

How it works

Make a gift to set up an account: You start by setting up an account and naming your child (or anyone else) as the beneficiary. Your contribution is considered a gift and qualifies for the $15,000 annual tax-free exclusion ($30,000 for married couples making a joint gift). Special rules for 529 plans let you average your gift over five years. This means married couples can make a $150,000 joint gift ($75,000 for individuals) in a single year without incurring gift tax. However, you cannot make additional gifts to your child for five years or you may owe gift tax.

Your contribution is limited: You aren't permitted to make contributions to a 529 plan beyond what is necessary to pay for your child's college expenses. Each plan sets its own limit. Most plans allow you to make either a lump sum contribution or a series of monthly contributions. All contributions must be made in cash; you can't contribute share of stock or other property to these plans.

You remain in control: You cannot choose the investments in the fund – you must choose one of the plan's investment options. However, you do remain in charge of all withdrawal decisions. You can allow your child to make withdrawals to pay for college expenses. If your plan permits it, you can change the beneficiary to one of your other children. If you change your mind about maintaining the account, you can even request a refund (however, tax and penalties will apply).

You can allow your child to make withdrawals to pay for college expenses: Section 529 funds must be used for qualified higher education expenses such as: tuition, fees, books, and supplies. They can also be used to cover certain room and board expenses as long as your child attends school at least half-time. If your child receives a scholarship, you can request a penalty-free refund of up to the amount of the scholarship. In addition, you can withdraw the funds if your child becomes disabled or dies. If the funds are withdrawn for any other purpose, you (not your child) will have to pay tax on the earnings that have accumulated in the fund.

You can change plans: You can make a tax-free rollover to another plan with the same beneficiary. This allows you to move your child's plan to another state's plan without losing the tax benefits. This tax-free rollover treatment only applies to one transfer within any 12-month period.

Substantial penalties apply to nonqualified withdrawals: Any nonqualified distributions will be subject to withdrawal fees and penalties. You will also owe income tax on the distribution.

Do your homework

The same federal income tax rules apply to all Section 529 college savings plans. However, each plan has unique features. Here are some items you should compare when you evaluate different plans: state income taxes, investment return, enrollment fees, maximum contributions, flexibility in making contributions, withdrawal fees and penalties, transferability to another beneficiary or another qualified plan, choice of schools, participation by nonresident, beneficiary age restrictions, covered education expenses including restrictions on room and board, etc.

There is no perfect plan for everyone so give us a call if you are ready to explore college savings options further and we will be happy to help.