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Taxation of 529 Plans



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Since their introduction over a decade ago, 529 plans have become to college savings what 401(k) plans are to retirement savings--an indispensable tool for helping you amass money for your child's or grandchild's college education. Yet it wasn't until 2006, with the passage of the Pension Protection Act, that the most important federal tax benefit relating to 529 plans--tax-free qualified withdrawals--became permanent. This article takes a look at the overall tax treatment of 529 plans.

We believe that a successful wealth management relationship starts with clarity of purpose.

Before embarking on any plans or strategies with our Client, we first seek to develop a clear understanding of your personal and financial goals.

We then work with you to select and implement strategies that will help you move toward your goals.

Federal tax treatment

Income tax--The federal income tax treatment of 529 plans is straightforward. There is no income tax deduction for contributions, but contributions to a 529 plan (prepaid tuition plan or college savings plan) grow tax deferred, which means you don't pay taxes on the earnings (if any) each year. And, in 2006, withdrawals used to pay qualified education expenses (called qualified withdrawals) were made permanently tax free--a huge tax advantage, considering the large sums of money that all 529 plans accept.

What's a qualified education expense?

In the context of 529 plans, it's payment for tuition, fees, books, supplies, equipment, and room and board. However, room and board qualifies only if the student is enrolled at least half time, and computers count only if the college requires (and not just recommends) one to attend.

However, if you have to withdraw money from your 529 plan for reasons other than qualified education expenses (for medical, housing, or emergency purposes, for example), you'll face a double consequence--the earnings portion of the withdrawal will be taxed at the marginal tax rate of the recipient (either the account owner or the beneficiary) and be subject to an additional 10% penalty.

Gift tax--Contributions to a 529 plan are considered "present interest gifts" that qualify for the annual gift tax exclusion, currently \$12,000 per recipient per year. So, annual contributions of less than this amount won't trigger gift tax. And there's a favorable twist: Under special rules unique to 529 plans, you can make a lump-sum contribution up to \$60,000, elect to spread the gift evenly over five years (effectively making the gift a series of smaller gifts each \$12,000 or less), and completely avoid gift tax, provided no other gifts are made to the same beneficiary during the five-year period.

This feature has made 529 plans a popular tool for estate planning purposes, particularly for grandparents. That's because a married couple can make a lump-sum gift to a 529 plan of up to \$120,000 (\$60,000 from each spouse), elect to spread the gift

over five years, and avoid gift tax--all while removing the money from their estate for estate tax purposes. Plus, if one member of the couple also happens to be the account owner of the 529 plan, they'll have the added bonus of being able to retain control over their money.

State tax treatment

Income tax--Unlike the federal government, 31 states offer an income tax deduction (typically capped at a certain amount) for 529 plan contributions--Arizona (starting in 2008), Arkansas, Colorado, Connecticut, Georgia, Idaho, Illinois, Iowa, Kansas, Louisiana, Maine, Maryland, Michigan, Mississippi, Missouri, Montana, Nebraska, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Utah, Virginia, West Virginia, and Wisconsin. Kansas, Maine, and Pennsylvania allow a deduction for contributions to any 529 plan; all other states require that the contribution be made to the in-state plan.

As for tax-free qualified withdrawals, all states follow the federal government and offer this tax benefit (except for the nine states that have no income tax). But one state, Alabama, requires that the withdrawal be made from an in-state 529 plan.

Regarding nonqualified withdrawals--those made for purposes other than qualified education expenses--state laws vary, so consult a tax professional who is familiar with the laws of your state. You may owe income tax on the withdrawal. Also, at one time, before the 10% federal penalty was imposed, states levied their own penalties. If a state's penalty isn't officially "off the books," you might be subject to a state penalty too. Finally, gift tax rules differ from state to state, so make sure you understand your state's rules before making a large contribution to a 529 plan.

	Federal	State
Deduction for contributions	No	31 states offer a deduction
Tax-deferred growth	Yes	Yes
Tax-free qualified withdrawals	Yes	Yes, all states (but Alabama requires in-state plan)
Penalty for nonqualified withdrawals	Yes, 10% penalty on earnings, and taxed at recipient's rate	Depends if state penalty still on books, also possible income tax ramifications

Important note

Before investing in a 529 plan, you should consider the investment objectives, risks, charges, and expenses associated with such plans. More information about specific 529 plans is available in each issuer's official offering statement, which should be read carefully before investing.

Our total wealth management services can help you with these very important questions. For more information, please contact your Stage 2 Consultant.

Warmest Regards,

Stage 2 Planning Partners

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