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Your 529 Account: Making Contributions and Withdrawals

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Introduction

Section 529 plans can be powerful college savings tools, but you'll need to understand how your plan works before you can take full advantage of it. Among other things, this means becoming familiar with the finer points of contributions and withdrawals.

Tip: Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.

How much can you contribute?

To qualify as a 529 plan under federal rules, a state program can't accept contributions in excess of the anticipated cost of a beneficiary's qualified education expenses. To comply, most states follow the federal "safe harbor" guideline that limits total contributions to a 529 plan based on the amount needed to fund five years of tuition, fees, and room and board at the costliest college under the plan. In most states, this amount is more than \$250,000, and the limit typically increases each year to keep up with rising college costs.

A state's limit will apply to either kind of 529 plan: prepaid tuition plan or college savings plan. For a prepaid tuition plan, the limit is on the amount of total contributions. For example, if the state's limit is \$300,000, you can't contribute more than \$300,000. A college savings plan limits the total value of the account, which includes contributions plus earnings. When the total value reaches the state's limit, no more contributions will be accepted. For example, assume the state's limit is \$300,000. If you contribute \$250,000 and the account has \$50,000 of earnings, you won't be able to contribute anymore--the total value of the account has reached the \$300,000 limit.

These limits are per beneficiary, so if you and another relative each set up an account for your child in the same plan, your combined contributions can't exceed the plan limit. If you have accounts with more than one state plan, ask each plan's administrator if contributions to other plans count against the state's limit.

Tip: At one time, contribution limits didn't cross state lines. In other words, contributions made to one state's 529 plan didn't count toward the lifetime contribution limit of another state's plan. But some plans now take contributions to other 529 plans into consideration when determining whether the lifetime contribution limit has been reached. Check the specific rules of your plan to see whether they count contributions to other plans.

How little can you start off with?

Some 529 plans have minimum contribution requirements. This could mean one or more of the following:

- You have to make a minimum deposit when you open your account
- Each of your contributions has to be at least a certain amount, or
- You have to contribute at least a certain amount every year

However, some plans may waive or lower their minimum contribution requirements (or their fees) if you set up your account for automatic payroll deductions or bank-account debits. Like contribution limits, minimums vary by plan, so be sure to ask your plan administrator.

Know your other contribution rules

Here are a few other basic rules that apply to most 529 plans:

- Only cash contributions are accepted (e.g., checks, money orders, credit card payments). You can't contribute stocks, bonds, mutual funds, and the like. If you have money tied up in such assets and would like to invest that money in a 529 plan, you must liquidate the assets first.
- Contributions to the account may be made by virtually anyone (e.g., your parents, siblings, friends). Just because you're the account owner doesn't mean you're the only one who can contribute to the account.

With college savings plans, your contributions are directed to the investment portfolios you've chosen. (College savings plans are federally authorized, but not required, to let you change your investment choice once per calendar year or when you change the beneficiary. And for 2009 only, states may permit 529 college savings plan investors to change the investment options for their existing contributions twice per year instead of once per year.)

Maximizing your contributions

Although 529 plans are tax-advantaged vehicles, there's really no way to time your contributions to minimize federal taxes. (If your state offers a generous income tax deduction for contributing to its plan, though, consider contributing as much as possible in your high-income years.) But there may be simple strategies you can use to get the most out of your contributions. For example, investing up to your plan's annual limit every year may help maximize total contributions. Also, a contribution of \$13,000 (for 2009, up from \$12,000 for 2008) a year or less (\$26,000 for joint gifts in 2009) qualifies for the federal annual gift tax exclusion.

Tip: You can also make a lump-sum gift of up to \$65,000 (for 2009, up from \$60,000 for 2008) in a single year (\$130,000 for joint gifts in 2009) and avoid federal gift tax if you spread the gift evenly over five years and make no other gifts to the beneficiary during that time. This is something to keep in mind if you wish to remove assets from your taxable estate.

Lump-sum vs. periodic contributions

A common question is whether to fund a 529 plan gradually over time, or with a lump sum. The lump sum would seem to be better because 529 plan earnings grow tax deferred--so the sooner you put money in, the sooner you start reaping this benefit. Investing a lump sum may also save you fees over the long run. But your ability to change the investment option on your contribution may be limited. And the lump sum may have unwanted gift tax consequences if you contribute more than \$13,000 in a single year (\$26,000 for joint gifts). Remember, though, that you can gift up to \$65,000 in a single year (\$130,000 for joint gifts) and avoid federal gift tax if you spread the gift evenly over five years and make no other gifts to the beneficiary during that time.

Gradual investing works best when it's done consistently every month or quarter (many plans offer automatic payroll deduction or debits from your bank account). One plus is that gradual investing may let you easily direct future contributions to other investment portfolios in the plan. But consider where you'd keep any other discretionary money in the meantime. How does that investment compare with your 529 plan in terms of expected return?

Is timing withdrawals important?

As the account owner, you can decide when to withdraw funds from your 529 plan and how much to take out--and there are ways to time your withdrawals for maximum advantage. For starters, it's important to coordinate your withdrawals with the Hope credit (renamed the American Opportunity credit for 2009 and 2010), the Lifetime Learning credit, and other tax credits or deductions you might qualify for. That's because the tuition expenses used to generate a credit may reduce your available pool of qualified education expenses, which can

impact whether your withdrawals from your 529 plan will be tax free. A financial aid or tax professional can help ensure that you get the best overall results. It's also a good idea to wait as long as possible to withdraw funds from the plan. The longer the money stays in the plan, the more time it has to grow tax deferred.

A quick review of federal tax rules on withdrawals

Withdrawals from a 529 plan that are used to pay the beneficiary's qualified higher education expenses are completely free from federal income tax. Qualified higher education expenses generally include tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution. The definition also includes a limited amount of room-and-board expenses for students attending college on at least a half-time basis. The definition does not currently include the cost of transportation or personal expenses. (Note: For 2009 and 2010, the definition of qualified higher education expenses for 529 plans is expanded to include computers, Internet access, and certain software while the beneficiary is in college.)

Some states may also exempt plan withdrawals from state income tax or allow a deduction for contributions. But states may limit their tax benefits to individuals who participate in the in-state 529 plan.

A withdrawal not used to pay the beneficiary's education expenses--called a nonqualified withdrawal--receives different tax treatment. The earnings portion of a nonqualified withdrawal is subject to federal income tax at the tax rate of the person who receives the distribution (typically the account owner, but possibly the beneficiary). Also, the earnings portion is subject to a 10 percent federal penalty.

Questions & Answers

You are the account owner of a 529 plan and your child is the beneficiary. If your mother makes a contribution to the plan, is that considered a gift to you or to your child?

It's considered a gift to your child. A contribution to a 529 plan is treated as a completed gift from the donor to the designated beneficiary of the account.

You'd like to make a lump-sum contribution to your grandchild's 529 account. Will you owe gift tax?

That depends on a few things, including the amount of your lump-sum contribution and the extent to which you've used your applicable exclusion amount of \$1 million.

All contributions to 529 plans are considered present interest gifts that qualify for the \$13,000 (for 2009, up from \$12,000 for 2008) annual federal gift tax exclusion. So, a gift of \$13,000 or less to your grandchild's 529 account will not cause a gift tax. A contribution of \$13,000 or less to your grandchild's 529 account is also excluded for purposes of the generation-skipping transfer tax (GSTT).

If your total yearly contribution to the 529 plan exceeds \$13,000, you can elect to treat your contribution (up to \$65,000) as if made evenly over a five-year period to avoid federal gift tax. You make this election on your federal gift tax return (which you must file if your gift is over \$13,000). Any amount over \$13,000 in a year to the same beneficiary is a taxable gift. Keep in mind that you must use up your lifetime credit before any gift tax is actually paid.

You'll also need to investigate the gift tax rules of your state, since state tax treatment can vary.

You're putting money into a 529 plan for your grandchild. But are the 529 assets subject to Medicaid spend-down requirements?

Very possibly. So far, state laws have largely ignored this issue. But until future legislation in your state exempts 529 plans from Medicaid rules, you'd be wise to assume that these assets will be subject to the state's grasp.

To be eligible for Medicaid, most states require that your assets and monthly income fall below certain limits. A state may count the assets and income that are legally available to you for paying bills. You can make assets unavailable by giving them away or by holding them in certain trusts. In some cases, though, such transfers may

create a period of ineligibility before you can collect Medicaid.

The potential problem with 529 plans is that your contributions are "revocable." This means that you can contribute money to your grandchild's 529 account today, and then take it back (subject to income taxes and a penalty) later. Since it's possible for you to get your hands on the money, your state Medicaid authorities may consider your 529 gift to be a countable asset when considering your eligibility for Medicaid. That might prevent or delay your eligibility for Medicaid.

In addition, your state has the right to "look back" at your finances 60 months from the date you apply for Medicaid. Contributions you've made to your grandchild's 529 account within this period may delay your eligibility for Medicaid.

For more information, consult a Medicaid planning attorney and keep abreast of changes in your state's laws with respect to Medicaid and 529 plans.

Can you make contributions to a 529 account and a Coverdell education savings account in the same year for the same beneficiary?

Yes, you can fund a 529 account and a Coverdell education savings account in the same year for the same beneficiary without giving rise to penalties. However, you must still be careful of gift tax consequences. Contributions to both a Coverdell ESA and a 529 plan are considered gifts from you to the beneficiary. The annual federal gift tax exclusion is \$13,000; if you give more than this in one year to the same beneficiary, you'll need to file a gift tax return.

And keep in mind that, unlike a 529 plan, your ability to contribute to a Coverdell ESA depends on your income level.

Your child is the beneficiary of a 529 plan. Can he or she use the 529 funds for graduate school?

It depends on the type of 529 plan--college savings plan or a prepaid tuition plan. Most college savings plans allow funds to be used for graduate school, while most prepaid tuition plans restrict funds to undergraduate costs only. Check the rules of any 529 plan you're considering to be sure.

What about vocational schools or foreign schools?

Under federal law, 529 funds can be used at any "eligible educational institution." This definition includes vocational schools and foreign schools, as long as they are approved by the U.S. Department of Education (DOE). The DOE maintains a list of schools eligible to receive student financial aid (available on its website). If a vocational school or foreign school appears on this list, then it's considered an eligible institution under federal rules.

A word of warning, though. States aren't required to follow federal eligibility guidelines (though most do), and some may prohibit the use of 529 funds for vocational schools or foreign schools. Check with the administrator of any 529 plan you're considering to be sure.

What about private elementary or secondary schools?

No, 529 funds can't be used to pay for private elementary or secondary school education. They can be used only for higher education expenses (college, graduate, or vocational school expenses). However, Coverdell ESA funds can be used for private school tuition, room and board, uniforms, transportation, computer equipment, and more.

Must funds in a 529 plan be used for tuition only, or can they be used for room-and-board expenses?

It depends on the state that sponsors the 529 plan, and whether you're talking about a prepaid tuition plan or a college savings plan. Under federal law, room-and-board costs are "qualified education expenses." But states aren't required to follow federal rules, and prepaid tuition plans typically won't allow 529 funds to be used for room-and-board expenses. Since most college savings plans follow federal rules, however, funds in a college savings plan can generally be used to pay for these costs as long as the student is enrolled in school on at least

a half-time basis.

Room-and-board costs for students living on-campus are limited to the actual amount charged by the school or to the amount most residents are charged, whichever is higher. Room-and-board costs for students living off-campus, including students living with their parents, are limited to the amount the school decides is reasonable. Each state's plan will spell out the guidelines that govern room-and-board expenses and what procedures to follow when requesting a withdrawal.

Are general living expenses considered qualified education expenses?

No. The federal definition of "qualified education expenses" that most colleges use doesn't include general living expenses (e.g., phone charges, transportation). To be covered, expenses must be for something required for enrollment and attendance (e.g., books, a computer), and most living expenses don't fit into this category. But gray areas exist. For instance, the grocery expenses of students living off-campus may qualify as board charges, so you should address questions like this to your plan administrator.

How do you prove that a distribution request is for your child's college expenses and not for some other purpose?

All 529 plans have procedures to ensure that a withdrawal is being used for the designated beneficiary's qualified higher education expenses. Some plans require that the expenses be paid directly by the plan to the educational institution. Others will prepay or reimburse the beneficiary for qualifying expenses paid out of pocket (as long as a receipt is provided). Your plan administrator can tell you what procedures you must follow when requesting a distribution. Remember, unless you can prove that the withdrawal is used for qualified higher education expenses, federal (and probably state) income taxes must be paid.

What happens to the funds in your 529 account if your child doesn't go to college or if there's money left over in the account after your child finishes college?

If your child decides not to go to college, you'll have several options. First, you can leave the funds in the account. It's possible that your child will change his or her mind about college at some point in the future. Just keep in mind that prepaid tuition plans generally require that you use the funds within 10 years (college savings plans usually allow you to keep the funds in the account indefinitely).

Second, you can change the beneficiary of the 529 account. As long as the new beneficiary is a qualified family member, there is no penalty for changing the beneficiary (although depending on the plan, there may be a fee for this service).

Third, you can withdraw the funds and use them for any purpose you choose. The drawback to this option, though, is that you will owe a 10 percent federal penalty tax on the earnings portion of the withdrawal (and possibly a state penalty). You will also owe federal income tax, and in most cases state income tax, on the earnings that you withdraw.



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