Future College Education Costs Got You Down?

Part 1

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The cost of a college education can be staggering. Expenses at private universities currently average more than $22,000 a year. The annual cost for state colleges averages about $10,000. For many families, qualified tuition programs — also called Section 529 education savings plans — are an attractive way to help meet future education expenses. Now, the Economic Growth and Tax Relief Reconciliation Act of 2001 has made them even more appealing by allowing tax-free withdrawals.

How Section 529 Plans Work

Section 529 plans are education savings programs sponsored by most states under Section 529 of the Internal Revenue Code. Beginning in 2002, private educational institutions also will be able to sponsor prepaid tuition programs. You can contribute to a Section 529 plan regardless of your annual income or your age, and your contributions can be for the benefit of a grandchild, niece, or nephew, as well as your own child.

With a 529 plan, you either invest a lump sum or make periodic contributions to an account set up for a designated child. While different programs do place limits on lifetime contributions, most limits are in excess of $100,000, and some are greater than $200,000. The plan account is professionally managed according to an investment program you set up when you make your initial contribution. When the child is ready for college, generally you — not the child — withdraw the amount needed to pay qualified education expenses, such as tuition, room and board, supplies, and equipment.

Tax Advantages

Money invested in Section 529 plans grows free of federal income tax and possibly state income tax for participating residents in many states. Some states also allow you to deduct investments in Section 529 plans for state income-tax purposes, up to certain limits, if you participate in your own state's program. In addition, the plan investment managers can move money between different investments as needed with no capital gains tax consequences, something you can't do with a regular investment account.

In 2004 payouts from *all* Section 529 plans are excludable from income. These tax benefits are scheduled to expire at the end of 2010, unless further action by Congress is taken. (Note that after 2001 tax-free withdrawals cannot be used for the same expenses for which HOPE or Lifetime Learning Credits are claimed.) Withdrawals for anything other than qualified education expenses are subject to income taxes and may be subject to an additional 10% federal tax penalty.

Investments in Section 529 plans qualify for the federal gift-tax annual exclusion. This exclusion lets you make tax-free gifts of up to $11,000 a year ($22,000 if your spouse agrees to join in your gifts) to each of as many people as you choose. And, there is a special tax provision…

Next week we'll continue the discussion on tax advantages of Section 519 plans. We will also cover other aspects of the 529 plans you need to know before choosing a plan.

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