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# 529 College Savings Plans





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## What is it?

A college savings plan is a type of qualified tuition program (the other type is a prepaid tuition plan ) established under Section 529 of the Internal Revenue Code. College savings plans are established by states and typically managed by an experienced financial institution designated by the state.

A college savings plan lets you save money for a child's college or graduate school education in an individual investment account. Although the details of college savings plans vary by state, the basics are the same:

- You, a grandparent, or anyone else open an account with a particular plan and name someone as beneficiary. The beneficiary does not need to be related to you. The person who opens the account is called the account owner (or sometimes the participant). As account owner, you decide when contributions and withdrawals are to be made. A college savings plan account can have only one account owner and one beneficiary at a time.
- Once the account is open, you (or anyone else) can contribute as much money to the account as you wish, subject to the plan's specific limits. Some plans may require a minimum amount to open the account or a minimum amount per contribution. Plans may also restrict the total contributions allowed in one year. All plans have total lifetime contribution limits.
- When you make a contribution, your money goes into one or more of the plan's investment portfolios (each portfolio typically consists of several mutual funds). Depending on the college savings plan's specific rules, you either select your investment portfolio at the time you open your account (in which case you can consider your risk tolerance and time horizon) or you are automatically assigned an investment portfolio based on your child's age (called an age-based portfolio). With an age-based portfolio, the portfolio's investments automatically grow more conservative over time as your child ages.
- Your rate of return depends on how your specific investment portfolio performs. There is no guaranteed rate of return. The plan's professional money manager (designated by the state) is responsible for controlling the assets that make up each investment portfolio
- When you need funds for the beneficiary's college or graduate school expenses, you notify the plan administrator that you'd like to make a withdrawal. Funds in your college savings plan account can be used at any college in the country or abroad that is accredited by the U.S. Department of Education.

**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.

## Strengths

College savings plans have proven extremely popular due to their unique combination of advantages. These benefits are listed below.

### **Contributions grow tax deferred**

The money you contribute to your college savings plan account grows income tax deferred at both the federal and state level. This means that instead of paying income tax each year on the money the account earns (if any), income taxes are deferred until the time you make a withdrawal.

### **Withdrawals used for the beneficiary's qualified education expenses are income tax free at the federal level**

Earnings on money invested in a college savings plan are completely free from federal income taxes if the funds are used to pay the beneficiary's qualified education expenses. (But contributions aren't deductible at the federal level.)

**Tip:** Qualified education expenses include unreimbursed college and graduate school expenses for tuition, fees, books, supplies, required equipment, and computers, software, and internet access while the beneficiary is in college. Room-and-board expenses are also considered qualified if the beneficiary attends school at least half-time.



## **Contributions receive favorable federal gift and estate tax treatment**

Contributions to a college savings plan are considered completed, present-interest gifts for federal gift tax purposes. This means that they qualify for the \$14,000 federal annual gift tax exclusion. And by making a special election, you can contribute up to \$70,000 in a single year and spread the gift equally over five years to avoid gift tax.

Also, your plan contributions aren't considered part of your estate for federal estate tax purposes, even though you retain control of the account while you're alive. There is one exception: If you contribute more than the \$14,000 annual gift tax exclusion amount in a calendar year, spread the gift over five years using the special election, and then die within the five-year period, a portion of the gift is added back to your estate. For more information, see the Tax considerations section below.

## **States may offer their own state tax incentives**

In addition to the federal tax benefits, states are free to offer tax incentives on college savings plan contributions and withdrawals. Examples include a deduction for contributions, an income tax credit for contributions, or a full or partial exemption of earnings from state income tax when a withdrawal is used to pay the beneficiary's qualified education expenses. However, some states may limit their tax benefits to individuals who participate in the in-state college savings plan.

**Tip:** *If your state does tax the account's earnings (even if the earnings are used to pay the beneficiary's qualified education expenses), they will likely do so at the beneficiary's (child's) tax rate. For more information, see the Tax considerations section below.*

## **Funds can be used at virtually any college**

The money in your college savings plan account can be used to pay for tuition, books, equipment, fees, and, if the beneficiary attends school at least half-time, room-and-board expenses at any college in the country and abroad that is accredited by the U.S. Department of Education. This includes a wide variety of schools--undergraduate colleges, graduate and professional schools, two-year colleges, technical and trade schools, and foreign colleges. This is a notable advantage over prepaid tuition plans, which typically offer maximum benefits only if your child attends an in-state public college or a college that otherwise participates in the prepaid tuition plan.

## **Participation is not restricted by income level**

College savings plans are open to all individuals, regardless of income level. This is a distinct advantage over Coverdell education savings accounts, which limit participation based on income.

## **Total lifetime contribution limits are high**

The total amount you can contribute to a college savings plan is high. Most states generally have limits over \$300,000.

## **You get professional money management**

For college investors who are too busy or inexperienced to choose their own investments (or to change the asset allocation over time), college savings plans offer professional money management.

**Caution:** *Returns are not guaranteed, however.*

## **Opening an account is easy**

It's simple to open a college savings plan account. You fill out a short application, designate a beneficiary, and contribute the required minimum amount. Most plans offer automatic payroll deduction or electronic funds transfer to make future saving even easier.

## **Most college savings plans are open to residents of any state**

All states offer college savings plans, and the majority of plans are open to residents of any state. This means you can shop around for the plan with the best money manager, overall performance record, investment options, fees, and customer service. But keep in mind that many states limit their tax benefits to residents who participate in the in-state college savings plan.

## **You have a rollover option once every 12 months**



You can roll over your existing college savings plan account to a new 529 plan account (college savings plan or prepaid tuition plan) once every 12 months without any federal tax penalty and without having to change the beneficiary. (But the state sponsoring the plan may impose a cost or penalty, so check the plan's rules before you do the rollover.) This option lets you leave a plan with few investment choices or one that has earned poor returns for a plan with more investment flexibility or a better track record.

### ***You may be able to change your investment portfolio once per calendar year***

If you're unhappy with the investment performance of your current investment portfolio but don't want to switch plans completely (like the rollover option described above), you may have another option. College savings plans are federally authorized (but not required) to let you change the investment portfolio for your existing contributions once per calendar year. (This is different from allowing you to pick a new investment option for your future contributions, which many plans allow.) Before joining a college savings plan, check to see if it offers this flexibility.

### ***College savings plans are continually evolving***

College savings plans are a creature of federal law, but the states are the ones that interpret the law and implement the plans. As Congress periodically revises the law on college savings plans, states will continue to refine and enhance their plans (and their tax laws) in order to make their plans as attractive as possible to investors from all over the country.

## **Tradeoffs**

If you're a college investor, college savings plans offer more advantages than disadvantages. But there are some tradeoffs.

### ***Returns aren't guaranteed***

A college savings plan doesn't guarantee you a minimum rate of return. In fact, the plan's money manager may make investment decisions that lag behind the market or cause you to lose money. By contrast, a prepaid tuition plan generally guarantees you a minimum rate of return tied to the rate of college inflation.

### ***Withdrawals not used for the beneficiary's qualified education expenses are taxed and penalized***

If you make a nonqualified withdrawal--a withdrawal used for something other than the beneficiary's qualified education expenses--the earnings portion of the withdrawal will be taxed at the federal level at the rate of the person who receives the distribution (usually the account owner). State taxes will likely apply, too.

You'll also be penalized. Specifically, the earnings portion of the withdrawal will be subject to a 10 percent federal penalty.

This federal tax treatment is the same for prepaid tuition plans.

### ***The plan's investment portfolios are managed exclusively by the plan's money manager***

Though you may be able to choose your investment portfolio at the time you open a college savings plan account (or else one will be chosen for you based on your child's age), you can never choose the portfolio's underlying investments. This job is solely for the plan's professional money manager, who is designated by the state. If you're unhappy with your portfolio's investment performance, your only options are to rollover your account to a new 529 plan or to change your investment option if your plan allows it (see the Strengths section above).

### ***Fees and expenses***

Fees and expenses are typically associated with opening and/or maintaining a 529 account (e.g., annual maintenance and administration fees, and investment expenses based on a percentage of your total account value)

## **Opening an account**

Opening a college savings plan account usually requires following a few easy steps.



## **Select a plan**

The majority of states offer college savings plans, and most are open to residents of any state. So, before choosing a 529 plan you may want to research the plan with the best money manager, investment options, flexibility, and historical performance, customer service, and fees. Most college savings plans can be researched on-line.

## **Complete an account application**

After you review the materials in a plan enrollment kit, fill out and sign the application. You can request an application by phone or mail from the plan administrator. Alternatively, nearly every state now has a downloadable version of its application available on-line (some states may even let you complete the application on-line). Generally, you can open a college savings plan account at any time during the year. Here's some basic information you'll be expected to provide on your application:

- Name, address, and phone number of the account owner
- Name and address of your beneficiary
- Social Security number (or tax ID number) for you and your beneficiary
- Birth date and school grade of beneficiary
- Relationship between you and your beneficiary
- What is your funding schedule for the account?
- Do you want to set up automatic payments?
- What investment option (or options) do you wish to choose?
- Who will be the successor owner (in the event of your death)?

## **Designate a beneficiary**

The beneficiary of the account is the person who will receive the plan proceeds. You can generally name anyone as the beneficiary--your child, your grandchild, niece, nephew, or other relative or friend. Some plans even allow you to name yourself. But keep in mind that rules vary by plan.

## **Choose an investment portfolio**

Most college savings plans offer several investment portfolios from which you can choose (other plans will pick one for you based on your child's age). These include equity funds, where 70 to 100 percent of the holdings are in stock mutual funds; fixed income funds, containing 70 to 100 percent bond and money market instruments; and balanced funds, which include a mixture of equity and fixed income assets.

Choose a fund based on your beneficiary's age, your risk tolerance, and your overall financial plan. If you can handle volatility in your investments, you may want to go with the higher growth potential of equities. But if your main goal is to preserve your investment, you may want to stick with fixed-income funds. If an age-based portfolio is automatically selected for you, your money will be placed into higher-return, higher-risk investment when you child is young and then gradually shifted to lower-return, lower-risk investments as he or she approaches college age. However, keep in mind that all investing involves risk, including the possible loss of principal, and there can be no assurance that any investment strategy will be successful.

## **Make a cash contribution to open the account**

Most plans require you to make an initial contribution when you open an account, for example \$25, \$50, or \$100. Federal rules require all contributions to a college savings plan to be made in cash (or cash alternatives like checks). So if you have stock you want to put in your account, you must first sell it (which may result in a capital gain) and then contribute the proceeds.

## **Make additional contributions and withdrawals as you wish**

After your account is open, you can make additional contributions as often as you wish (lump-sum or installment contributions), subject to the plan's specific limits. Each plan limits an account's total value. When the plan's total account limit is reached (contributions plus earnings), no more contributions will be accepted for that beneficiary. Find out what your plan's total account value limit is--limits typically are \$300,000 or more. Also, keep in mind that some plans may require a minimum amount per contribution or restrict the total contributions allowed in one year.



When it's time to make a withdrawal, follow your plan's specific instructions for notifying the plan's administrator of your intention to make withdrawals.

## ***Continue to manage your account***

Once your account is open, make sure to periodically check on how the college savings plan is working. Not only should you monitor the progress of your account's growth (even though a professional fund manager will handle day-to-day investment decisions) but also you should review plan's overall rules from time to time. A periodic review of your choice of beneficiary also makes sense.

## **Making changes to your account**

College savings plans can accommodate a variety of changes. For example, what if the beneficiary decides not to go to college, or gets a scholarship?

### ***Changing the beneficiary***

If the beneficiary you have chosen no longer needs the funds in the account, you can designate a new beneficiary (you may be charged an administrative fee). And if the existing beneficiary needs only some of the funds in the account, you can do a partial change of beneficiary. This involves establishing another 529 account (college savings plan or prepaid tuition plan) for the new beneficiary and rolling over some funds from the old account into the new account.

**Tip:** *To avoid penalties and taxes when you change the beneficiary, the new beneficiary must be a family member of the old beneficiary. Pursuant to Section 529 of the Internal Revenue Code, "family member" includes children and their descendants; stepchildren; siblings; parents; stepparents; nieces; nephews; aunts; uncles; in-laws; and first cousins. However, states are free to impose additional requirements, such as age and residency requirements.*

**Caution:** *States are free to impose additional restrictions on who may be a beneficiary, such as age, residency, or other requirements. For example, a state may prohibit a beneficiary switch once the original beneficiary has begun making withdrawals from the 529 account.*

If the beneficiary dies, look to the rules of your plan. Generally, the account owner retains control of the account, and he or she may be able to name a new beneficiary (which may create gift tax or estate tax consequences). If the beneficiary dies with a balance in his or her account, the balance may be included in the beneficiary's taxable estate. Or the account owner might make a withdrawal from the account. If so, the earnings portion of the withdrawal will be taxable.

### ***Changing the account owner***

Most college savings plans allow a change in owner. And unlike a change in beneficiary, there is usually no requirement that the new account owner have any particular relationship with the original account owner. Many states, however, allow a change in account owner only when the original account owner dies or in certain circumstances, such as divorce. Check with your plan administrator for more details.

If the account owner dies, the terms of the plan will control who becomes the new account owner. In the plans that permit the account owner to name a contingent account owner, this contingent owner will assume all ownership rights when the original owner dies. In other states, account ownership may pass to the beneficiary. Alternatively, the account may be considered part of the account owner's probate estate and pass according to a will (or through the state's intestacy laws if there is no will).

### ***Changing your investment option***

If you're unhappy with the market performance of your investment portfolio, or if your financial situation changes, you may want to change the investment portfolio you previously chose. But plans differ in their flexibility on this issue. Most plans will let you direct future contributions to a different investment option.

But if you want to change the investment option on your existing contributions, you'll need to check the rules of your individual plan--plans are now authorized, though not required, to allow this once per calendar year. If you discover that your plan doesn't allow such a change, you still have the option once every 12 months of rolling over your account to a different 529 plan (college savings plan or prepaid tuition plan) whose investment choices and flexibility you like (see the Strengths section above).



## Tax considerations

Before you invest in a college savings plan, you should evaluate the federal and state tax consequences of plan contributions and withdrawals.

### ***Income tax consequences for beneficiary (child)***

Withdrawals from a college savings plan used to pay the beneficiary's qualified education expenses are completely income tax free at the federal level.

However, the beneficiary may still be taxed on the earnings portion at the state level at his or her own tax rate. And if a withdrawal is not used for the beneficiary's qualified education expenses (a nonqualified withdrawal) and the beneficiary receives the withdrawal, then the beneficiary will owe federal income tax (and probably state income tax, too) on the earnings portion. A 10 percent federal penalty will also apply, as well as any applicable state penalty.

### ***Income tax consequences for account owner***

Generally, the person who owns the college savings plan account and contributes money is not taxed on the plan's earnings. The exception is when the account owner receives a withdrawal that is not used to pay the beneficiary's qualified education expenses (a nonqualified withdrawal). In most cases where a nonqualified withdrawal is made, the account owner is the person who receives the distribution. However, some plans may let the account owner specify the recipient of a nonqualified withdrawal. The person who receives the nonqualified withdrawal will be responsible for the federal (and any state) income taxes and penalties.

### ***Income tax deduction for plan contributions***

There is no federal income tax deduction for contributions made to a college savings plan. However, states may offer a state income tax deduction for contributions made by in-state residents to their own state's plan. Most of the states that do provide a deduction, though, impose a deduction cap, or limitation, on the amount of the deduction. Be sure to check the tax laws of your state to see whether a deduction is allowed, and if so, whether there is a deduction cap.

**Caution:** *If you plan to claim a state income tax deduction for your contributions, you should learn whether your state applies income recapture rules to college savings plans. Income recapture means that deductions allowed in one year may be required to be reported as taxable income in a subsequent year if you make a nonqualified withdrawal from the plan in that later year.*

### ***Interaction with education tax credits***

You can claim the American Opportunity credit or the Lifetime Learning credit in the same year you withdraw funds from your college savings plan to pay the beneficiary's qualified education expenses. But your withdrawal will not be completely tax free on your federal income tax return if it's used for the same higher education expenses for which you're claiming a credit. When you calculate the amount of the beneficiary's qualified education expenses to determine the amount to withdraw, you must reduce the qualified expenses figure by any expenses used to compute the credit.

### ***Gift tax consequences for plan contributions***

All contributions to a college savings plan are considered present interest gifts (as opposed to future or conditional gifts) to the beneficiary that qualify for the federal annual gift tax exclusion. This means that you can contribute up to \$14,000 per calendar year to the account (\$28,000 per year for married couples making joint gifts) without incurring federal gift and estate tax.

If your contribution is over \$14,000 in a single year (\$28,000 for joint gifts), there is a special election you can make to treat the contribution as if it were made evenly over a five-year period. You make the election on your federal gift tax return (Form 709), which you must file if your gift is over \$14,000. The result is that you can gift up to \$70,000 in one calendar year (\$140,000 for joint gifts)--reduced by any other gifts you make to the beneficiary in that year--and avoid federal gift and estate tax.

**Example(s):** *Mom makes a \$70,000 contribution in 2014 to her daughter's college savings plan account. Mom files a federal gift tax return and makes the special election, which treats her gift as if it were made evenly over five years. The result is that Mom is considered to have made five annual contributions of \$14,000 each in the years 2014 through 2018, and, if Mom makes no other gifts to her daughter in those years, no gift and estate tax is owed. In 2019, Mom can make another \$70,000 contribution and make the special election again.*



If you contribute more than \$70,000 to your account (\$140,000 for joint gifts), the averaging election applies only to the first \$70,000 (or \$140,000); the remainder is treated as a gift in the year the contribution is made.

Even if you are subject to gift tax, you must first use up your applicable exclusion amount before you will actually pay any tax. The applicable exclusion amount allows you to pass a certain amount of property free from federal gift and estate tax during your life and/or at your death.

Finally, since state tax treatment may differ from federal tax treatment, check your state's laws to see how your college savings plan contribution will be treated.

## ***Gift tax consequences for contributions by grandparent***

Grandparents need to keep the federal generation-skipping transfer (GST) tax in mind when contributing to a grandchild's college savings plan account. The GST tax is imposed on transfers made during your life and at your death to someone who is more than one generation below you, like a grandchild. The GST tax is imposed in addition to (not instead of) federal gift and estate tax. Like the applicable exclusion amount, there is a lifetime GST tax exemption amount.

So if you contribute \$14,000 or less to your grandchild's account during the year (\$28,000 for joint gifts), there are no federal transfer tax consequences--the gift qualifies for the annual federal gift tax exclusion, and it is also excluded for purposes of the GST tax.

If you contribute more than \$14,000 (\$28,000 for joint gifts), you can elect to treat the contribution as if it were made evenly over a five-year period (as discussed above). Only the portion that causes federal gift and estate tax will also result in a GST tax. But before you'll need to write a check, you must use up your applicable exclusion amount and you can use your GST tax exemption.

## ***Estate tax consequences for account owner***

Contributions you make to a college savings plan aren't usually considered part of your estate for federal tax purposes when you die, even though you retain control of the account (as account owner) during your lifetime. (Instead, the value of the account will be included in the beneficiary's estate.) There is an exception to this general rule. When you (or any other contributor) make a contribution, elect to spread the gift over five years (as described above), and then die before the end of the five years, only the portion of the contribution allocated to the years after your death is included in your gross estate.

***Example(s):*** Dad makes a \$35,000 contribution to a college savings plan in Year 1 and elects to treat the gift as if it were made over five years. Under the election, Dad is considered to have made a gift of \$7,000 each year (\$35,000 divided by 5 years). He dies in Year 2. The result is that his total Year 1 and Year 2 contributions (\$14,000) are not included in his estate. The remaining \$21,000 (\$35,000 - \$14,000) is included in his gross estate.

As for the states, some states have an estate tax system like the federal estate tax, but many states calculate estate taxes differently. Check your state's laws or talk with a tax professional.

## **Financial aid considerations**

The federal government treats 529 plans (college savings plans and prepaid tuition plans) as assets of the parent for financial aid purposes if the parent is the account owner, if the student is the account owner, or if the 529 plan was funded with UTMA/UGMA custodial account funds.

## **Questions & Answers**

### ***How long have 529 plans been around?***

Section 529 plans, officially known as qualified tuition programs, or QTPs, were created by the federal government with the passage of the Small Business Job Protection Act of 1996, a piece of legislation that actually had little to do with college savings. These plans were later modified by the Taxpayer Relief Act of 1997, the Economic Growth and Tax Relief Reconciliation Act of 2001, and the Pension Protection Act of 2006.

### ***Can you invest in any state's 529 plan, or are you limited to your own state's plan?***

529 college savings plans are typically open to residents of any state, while 529 prepaid tuition plans are typically limited to state





residents. For states that let nonresidents join their 529 college savings plan, they may have different rules for residents and nonresidents (such as higher annual fees and higher minimum contribution requirements for nonresidents). And keep in mind that some states may limit their tax benefits to individuals who join the in-state college savings plan.

## ***How do you know whether to choose a college savings plan or a prepaid tuition plan?***

Your investment preferences and the college you think the beneficiary (let's assume it's your child) might attend will affect your choice.

A prepaid tuition plan generally guarantees you a minimum rate of return to ensure that you keep up with college inflation. Essentially, by contributing to such a plan, you lock in tomorrow's tuition at today's prices. This can certainly bring you peace of mind. However, if the stock market enjoys an extended period of high returns, you'll generally still be limited to the return that your plan promises--the entire surplus won't trickle down to you. Also, to receive the maximum benefits under a prepaid tuition plan, your child must attend a college in that plan. If your child chooses a different school, you may pay a penalty.

By contrast, a college savings plan doesn't guarantee you any minimum rate of return. When you invest your money in a plan's portfolio (whether it's an age-based portfolio geared to your child's age or another portfolio), you take your chances. If your portfolio earns a high rate of return, you're entitled to all of it. But if it earns little or nothing (or even loses money), you may end up with less than you need to pay for your child's education. The good news, though, is that your child can use the funds in a college savings plan at any college in the country or abroad that is accredited by the U.S. Department of Education.

If you're a fairly conservative investor and believe that your child will attend a specific college or will choose from among a number of public colleges located in the same state, then a prepaid tuition plan may be the appropriate choice (assuming one is offered). But if you don't want to restrict your child's college options or you believe that you can earn a better rate of return than what is promised by a prepaid tuition plan, then a college savings plan that offers a range of investment options may be the right choice.

## ***Is there an age limit on who can be a beneficiary of a 529 plan?***

There is no beneficiary age limit specified in Section 529, but a few states do impose one. You'll need to check the requirements of each plan you're considering. Also, some states may require that the account be open for a specified minimum length of time before funds can be withdrawn. Otherwise, a fee or penalty may be imposed by the state. This is important if you expect to make withdrawals quickly because the beneficiary is close to college age.

## ***Can you open a 529 account and name yourself as beneficiary?***

Under many 529 plans, you can be both the owner and beneficiary of the account. This can be useful if you are older and plan to attend college or graduate school in the future, or if you are planning for your future children. However, you may lose the estate tax benefits of a 529 plan by naming yourself as the designated beneficiary. And some plans don't allow the owner and beneficiary to be the same person, so check the terms of the plan you're considering.

## ***Can you open a 529 account in anticipation of your future grandchild?***

You can open an account before the birth of a child, though you have to go about it in a roundabout way.

First, you need to know the two key players involved in any 529 account. One is the account owner, who controls when the money is paid out and to whom. That may be you. (The account owner is usually the person who establishes the account and who puts money into the account.) The other key person is the designated beneficiary, who will use the money to pay for qualified education expenses. The account owner selects the designated beneficiary.

Since the person you want to name as the beneficiary is not yet born, you'll need to take two steps. First, you'll need to open an account and name a beneficiary who is a family member who will be related to your grandchild. Next, when your grandchild is born, you (the account owner) can change the beneficiary to your grandchild.

Check the details of each state's plan carefully, because some plans impose age restrictions on the beneficiaries (such as being under age 21). That may pose a problem if you plan to name your adult son or daughter as the initial beneficiary. Other plans may require that the funds be spent within a certain time period, such as within 10 years of when the original beneficiary would be expected to enter college.

## ***Can a non-U.S. citizen open a 529 account?***



Yes, with a few limitations. Section 529 plan account applications generally ask for the Social Security number of the account owner and the beneficiary. If you will be the account owner and you don't have a Social Security number, check with the administrator of the 529 plan before you send any money to see how you'll be handled. Some 529 plans allow resident aliens to be the account owner, but normally these plans still require a Social Security number.

Another issue can be state residency. Some 529 plans require the account owner to be a resident of their particular state (for a certain time period) before an account can be opened. Alternatively, some plans require that either the owner or the beneficiary be a resident. So if the beneficiary is a resident, you may still be able to open an account even if you're not a U.S. citizen or resident.

You may expect the beneficiary to attend a foreign college or university. Some foreign colleges and universities are recognized by the U.S. Department of Education as "eligible educational institutions"--a key factor in the income tax treatment of withdrawals from the 529 plan. You should still check the requirements of the 529 plan you are considering to make sure a particular foreign college is an eligible institution.

### ***Can more than one account be opened for the same child?***

Yes. You (or anyone else) can open multiple 529 accounts for the same beneficiary, as long as you do so under different 529 plans (college savings plan or prepaid tuition plan). For instance, you could open college savings plan accounts with State A and State B for the same beneficiary, or you could open a college savings plan account and a prepaid tuition plan account with State A for the same beneficiary. But you can't open two college savings plan accounts in State A for the same beneficiary.

Also, keep in mind that if you do open multiple 529 accounts for the same beneficiary, each plan has a limit, and contributions can't be made after the limit is reached. Some states consider the accounts in other states to determine if the limit has been reached. For these states, the total balance of all plans (in all states) cannot exceed the current year's maximum contribution amount.

### ***Does it make sense to open a 529 account if your child is only two years away from college?***

Even if you've waited until your child is a sophomore or junior in high school to open an account, this strategy can still make sense because you'll have at least a few years of potential tax-free growth on your money. But check one issue carefully before you open an account this close to college. Some plans impose a minimum holding period, such as one or two years, before any withdrawals can be made (without penalty). If you're going to need this money for the first year of college expenses, plans with withdrawal restrictions would not make sense. Check the individual 529 plans for more details.

### ***What happens if you open a 529 plan in one state and then move to a different state?***

Essentially nothing if you have a college savings plan. (Most prepaid tuition plans require that either the owner or the beneficiary be a resident of the state operating the plan, so if you move to another state, you may have to cash in the prepaid tuition plan.) You can leave the account assets in your former state's college savings plan with no penalty. Alternatively, you can roll the assets over from your old state's plan to a new 529 plan if both plans allow it. Check the details of each plan carefully before you start any transfers.

You can keep the same beneficiary when you do the rollover, but there is a restriction: You can roll the assets over from one 529 plan to another only once every 12 months. If you want to immediately get out of the 529 plan you're in now and avoid this restriction, you'll need to change the account beneficiary when you request the transfer.

Some 529 plans also require a minimum time period, such as one year, before withdrawals (including rollovers) can be made from an account for any reason. Again, check both plans to make sure there are no withdrawal limitations.

One advantage of a rollover is that you can reallocate your 529 funds to a different investment portfolio (or portfolios) when you join the new plan. So, you might be able to invest more or less aggressively, depending on your personal situation and market factors.

### ***Should you invest a lump sum, or is there a way to use dollar cost averaging when investing in a college savings plan?***

If you want to contribute to your college savings plan and use dollar cost averaging at the same time, you can simply invest a fixed



amount in your account at regular intervals (e.g., \$100 a month). One way to do this may be to arrange for automatic payroll deductions or bank account debits to be invested in your college savings account. But assuming you have a lump sum of money to invest, is dollar cost averaging better than making a single large contribution? That's a more difficult question, and the answer depends on your particular circumstances.

According to the experts, the benefit of dollar cost averaging is that it helps you ride out the ups and downs of the market--you buy more shares when the prices are low, and fewer shares when the prices are high. But your decision may be more complicated than it seems. Let's say you have \$100,000 that you'd like to invest in your college savings plan over time using dollar cost averaging. Where will you keep the money in the meantime (e.g., money market fund), and how does your expected return on that investment compare with your expected return on your college savings plan? If you expect to do better with the college savings plan, it might make more sense to invest the lump sum. Remember to compare after-tax return figures, since college savings plan investments grow tax free.

Other factors may also enter into this decision. Fees imposed by your college savings plan may decrease as you contribute more money, so investing a lump sum may save you fees over the long run. But a lump-sum contribution may have gift tax consequences that could be avoided by gradually investing the money. Gradual investing might also help you better diversify your college savings plan holdings, since many plans let you direct new contributions to a different investment option. However, a recent IRS notice has given states the discretion to allow you to change the investment option on your existing (lump-sum) contribution once per calendar year, so check with your specific plan for more information. Also, be sure to consult a financial planner or other professional before making this decision.

**Caution:** *Dollar cost averaging does not ensure a profit or protect against a loss in a declining market. You should consider your ability to invest continuously when the market is down.*

### ***You know you can borrow against your 401(k), but can you borrow against the value of your 529 account?***

No. Section 529 plans do not allow loans against an account's assets.

### ***Can you use the money in your 529 account as security if you apply for a loan?***

No. According to IRS rules, a 529 account cannot be offered as collateral or security to get a loan from either the investment company managing the account or an outside bank or other financial institution.

### ***Can the funds in a 529 plan be used for college expenses if your child is attending only part-time?***

Ordinarily, yes. In most states, both part-time and full-time students can use 529 funds for qualified college expenses--check with the administrator of your plan. But remember, in all states your child must be enrolled at least half-time to use 529 funds for room and board.

### ***Can 529 funds be used for general living expense while at college?***

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 or your tax advisor.

### ***Your child got a scholarship to college--now what?***

If your child receives a college scholarship, you can withdraw--without penalty--funds in your 529 account equal to the amount of the scholarship. In each withdrawal from your 529 plan, you receive some earnings and some of the contributions that were made to the account. Generally, a penalty is imposed on the earnings portion of each withdrawal that you don't use to pay qualified education expenses. Your child's scholarship creates an exception--as long as your withdrawals during the year don't exceed the amount of the scholarship for the year, you will not owe a penalty. But you will owe federal and state income taxes on the earnings portion of each withdrawal.

Withdrawing the funds isn't your only option. You can leave the funds in the 529 account for your child's future use (some plans



allow 529 funds to be used for graduate school). Or, you can change the beneficiary of the 529 account. If the new beneficiary is a "family member" of the original beneficiary (as defined by Section 529 of the Internal Revenue Code), you won't owe federal income taxes or a penalty when you make the change.

### ***What happens to the funds in your 529 account if your child doesn't go to college?***

If your child decides not to go to college, relax--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 to another family member who will use the funds for college. And finally, you can withdraw the funds and use them for any purpose you choose. The drawback to this option, though, is that you may owe a 10 percent federal penalty tax on the earnings that have accumulated (a state penalty may apply as well). You may also owe federal, and in some cases state, income taxes on the earnings that you withdraw.

### ***What happens if you open a 529 account for your child, and he or she later becomes disabled and doesn't go to college?***

Hopefully this won't happen, but if it does, you have a couple of options. First, you could withdraw the funds from your 529 account and use them for any purpose you choose. Since your child is disabled, you would not owe the 10 percent federal penalty tax that normally applies to nonqualified withdrawals (although you would owe federal, and maybe state, income taxes on the earnings portion of the withdrawal). Or, you could leave the funds in the 529 account and change the designated beneficiary to another qualified family member who will be attending college.

### ***What happens if your child finishes college and there is money left over in the account?***

If you withdraw the money that is left over in your 529 account and don't use it to pay for the beneficiary's qualified education expenses, you'll have to pay a federal penalty tax of 10 percent on the earnings portion of the withdrawal (and possibly a state penalty). You may also have to pay federal, and in some cases state, income taxes on the earnings portion of the withdrawal.

However, if you have money left over in your account, withdrawing it and paying a penalty isn't your only option. All 529 plans allow the account owner to change the beneficiary without penalty (although depending on the plan, there may be a fee for this service). In addition, you may be able to receive a "rollover" distribution from your 529 plan and then contribute these proceeds within 60 days to the same or a different state's program with a new beneficiary. Keep in mind that in both instances the new beneficiary must be a qualifying family member (as defined by Section 529 of the Internal Revenue Code), or taxes and a penalty will be due.

### ***What happens to your 529 plan if your child wants to postpone going to college for a year or two after high school?***

A delay of 1 or 2 years shouldn't matter, but if your child postpones college indefinitely, you should read the details of the 529 plan. Look to see if the plan you own (or are considering) has any time limits. Most prepaid tuition plans require that the funds in the plan be paid out within 10 years of the date the beneficiary is scheduled to attend college. College savings plans generally have no such requirement, and in most states, money in the account can be left indefinitely.

### ***You intend to make tuition payments directly to your grandchild's college, and you know this will reduce your estate. But would it be better to contribute to a 529 plan instead?***

Direct payment of tuition to an educational institution is not considered a taxable gift. Therefore, you're able to "give away" more than \$14,000 per year for your grandchild's college education and not worry about gift taxes. The money used to pay the tuition also will not be part of your estate.

With 529 plans, all contributions are considered gifts, so you want to use your federal annual gift tax exclusion. This exclusion lets you give to another person, like your grandchild, up to \$14,000 per year without any gift and estate tax consequences. If you contribute more than \$14,000 to the same beneficiary during a given year, though, you can avoid gift and estate tax if you elect to



treat your contribution (up to \$70,000) as if made evenly over a five-year period. However, informational gift tax returns must be filed. In any case, no gift and estate tax must be paid out of pocket until you've used up your gift and estate tax applicable exclusion amount.

Section 529 plans offer certain advantages over the direct payment of tuition. First, withdrawals from 529 plans can be used to pay for tuition, fees, books, and even room and board for college and graduate school. The exclusion for direct payment of educational expenses, on the other hand, applies only to tuition. Your grandchild might need significantly more financial assistance.

You should also consider the possibility that you may not live long enough to pay your grandchild's tuition in the future. In such a case, nothing will be removed from your taxable estate (and the money your grandchild needs for education may not be available). If you contribute money to a 529 plan now, though, your contributions will be considered present interest gifts, and the value of your gifts to the plan will be taken out of your estate. (That is, unless your total gifts in one year are more than \$14,000, you elect to treat the gifts as if made over a five-year period, and then you die within the five years. In such a case, the portion of the contribution allocated to the years after your death will be included in your gross estate.)

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

Very possibly. So far, state laws have largely ignored this issue. But unless 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.

You may want to consult a Medicaid planning attorney and keep abreast of changes in your state's laws with respect to Medicaid and 529 plans.

### ***Does it make sense to cash in your prepaid tuition plan and contribute the money to a college savings plan instead?***

It might. College savings plans offer some advantages over prepaid tuition plans, for example, withdrawals can be used for expenses not allowed under a prepaid tuition plan and the value of your college savings plan account may increase greatly, depending on how well your investments do.

On the other hand, prepaid tuition plans provide a measure of security. In effect, they allow you to buy future tuition at today's prices.

Most prepaid tuition plans require that either the owner or the beneficiary be a resident of the state operating the plan. So if you move to another state, you may have to cash in the prepaid tuition plan. And if you do cash in the plan, you will receive only your contributions (and possibly a low rate of interest).

### ***Can you transfer funds from your Coverdell ESA to a 529 plan?***

Generally, yes. You may withdraw funds from your Coverdell ESA and not pay federal income taxes on the withdrawal if you use the funds for qualified education expenses. The rules for Coverdell ESAs consider a rollover contribution to a 529 plan (for the same person who is the beneficiary of the Coverdell ESA) as a qualified education expense. So, the transfer will usually be a nontaxable transfer from the Coverdell ESA to the 529 plan.

### ***Can you transfer your child's UTMA/UGMA custodial account to a 529 plan?***



There are two ways to explore this rather tricky question. The first way is to examine whether it's possible to liquidate an UTMA/UGMA account and invest the proceeds in a 529 plan. The second way is to see whether it's possible to transfer existing UTMA/UGMA assets to a 529 plan.

Before looking at these two questions, it's helpful to know some basics about UTMA/UGMA (which, by the way, stands for Uniform Transfers (Gifts) to Minors Act) accounts. All gifts to an UTMA/UGMA account are considered irrevocable gifts to the child named as the beneficiary of the account. Once a gift is made, the custodian (usually the parent) can withdraw funds only if the money is used for the child's benefit. This may include things like private elementary or secondary school, summer camp, a computer, violin lessons, a secondhand car, and so on.

This requirement that the money must be used for the child's benefit also includes making an investment in a 529 plan (college savings plan or prepaid tuition plan), as long as the 529 plan is established for the same beneficiary as the custodial account. You can liquidate the investments in the UTMA/UGMA account and invest all of the proceeds in a 529 plan (though you may incur tax liability). The key is that the proceeds must be used for the benefit of the same beneficiary. So, you wouldn't be able to invest the UTMA/UGMA proceeds in a 529 plan established for a different beneficiary.

The question of keeping your child's UTMA/UGMA account intact and transferring the assets to a 529 plan is more difficult. Whether this is allowed usually depends on the rules of the 529 plan. In either case--liquidating the UTMA/UGMA account or transferring the assets in the UTMA/UGMA account--there are important things to keep in mind.

First, federal law requires that all contributions to 529 plans be made in cash. Therefore, all assets in an UTMA/UGMA account would first need to be converted to cash if they were not already (e.g., stocks, real estate, certificates of deposit). So, even if the 529 plan accepts the transfer of assets, you will be required to turn those assets into cash. Keep in mind that this may trigger income tax liability.

Second, because the cash will now be held within the UTMA/UGMA account, which, in turn, is in the 529 plan (sort of a cup within a bucket), you are still bound by the rules of UTMA/UGMA accounts. This means that you can't change the beneficiary of the 529 plan, because gifts to an UTMA/UGMA account are considered irrevocable gifts to the beneficiary. In addition, you must relinquish control of the 529 plan to your child when he or she reaches the age of majority (18 or 21, depending on state law), because this is what happens with an UTMA/UGMA account. And all future contributions you make to the 529 plan will be treated as UTMA/UGMA contributions, meaning that they will be considered irrevocable gifts to the beneficiary. Third, some 529 plans might require that you name the child as the owner (as well as the beneficiary) of the 529 plan after UTMA/UGMA funds are contributed.

### ***If you cash in Series EE U.S. savings bonds you purchased 10 years ago and contribute the proceeds to a 529 plan, can you still avoid paying tax on the proceeds?***

Yes. You can roll over the U.S. savings bonds into a 529 plan if you meet all of the requirements for income tax-free use of the savings bonds. If you own certain Series EE savings bonds (which may also be called Patriot bonds) or Series I bonds, you may redeem them and exclude the interest from your income if you use the proceeds for qualified education expenses (tuition and fees) and if your MAGI is below a certain level in the year of the redemption.

Rolling the proceeds over to a 529 plan is considered equivalent to using the proceeds for qualified education expenses. So, meeting the income limitations in the year of rollover will be the key to avoiding tax on the proceeds of the savings bonds.

### ***How do 529 plan fees and expenses compare to those associated with other savings alternatives?***

Some 529 plans may charge high fees, but virtually all college savings options involve fees and expenses of some kind. It's important to take fees and expenses into account when considering the ways to save for college because they can make a big difference in your total savings over time.

### ***Your child will be going to college next year and using 529 funds to pay expenses--what do you need to do?***

Now would be a good time to review the terms, conditions, and procedures of your 529 plan. Not all plans are alike. Don't assume, therefore, that the procedures your sister follows for her Iowa college savings plan will be the same for your Rhode Island college savings plan (or prepaid tuition plan). At a minimum, you should investigate the following issues.



First, bear in mind that you'll probably have to notify the 529 plan administrator that your child will be making a withdrawal for college expenses. In most prepaid tuition plans, the payout procedures are standardized. For example, some prepaid tuition plans require that all plan withdrawals must occur within 10 years of the time the beneficiary starts college. College savings plan procedures can differ considerably from plan to plan, though. No matter what your plan, consider the following questions:

- What education expenses does the plan consider "qualified"?
- When must you notify the plan administrator that you wish to withdraw funds from the plan?
- How do you document that the withdrawal has been used to pay qualified education expenses? How soon must you provide this documentation?
- Are college expenses paid directly from the plan to the educational institution, or is the beneficiary reimbursed for expenses? How long will reimbursement take?
- Is a minimum withdrawal amount required, or is there a limit on the number of withdrawals per semester?
- Does the state's definition of "eligible educational institution" differ from the federal definition, and does your child's college satisfy the definition?
- Does the plan require a minimum level of attendance (e.g., half-time enrollment) for qualified expenses other than room and board?

Second, make sure you understand how a qualified withdrawal from a 529 plan will affect your child's state income taxes. Some states exempt a plan's earnings from income tax if used to pay qualified education expenses. Other states tax the earnings. And remember--you're entitled only to the state tax benefits (if any) offered by the state in which you reside.

Third, explore how a withdrawal from a 529 plan will affect your child's eligibility for financial aid from the college as well as federal financial aid.

Finally, investigate how to coordinate a 529 plan withdrawal with the American Opportunity credit and Lifetime Learning credit (which you may be able to claim on your federal income tax return) to maximize your income tax benefit. Although you may now claim one of these education credits in the same year you withdraw funds from a 529 plan, your 529 plan withdrawal may not be completely tax free on your federal income tax return that year.

## IMPORTANT DISCLOSURES

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