TAX-FREE COLLEGE SAVINGS

By Jane M. Winand, Chief, Legal Assistance Division

Known officially as the Qualified Tuition Program, and commonly referred to as 529 college savings plans, these investment plans allow for earnings to grow tax free while being professionally managed. Withdrawals to pay for college (tuition, room, board, books) are tax-free. Parents, grandparents and friends are eligible to participate and tax-free distributions for qualified higher education expenses may be made from these funds until 2010, under current legislation. Unless the tax law is modified, earnings withdrawn after December 31, 2010 will be taxable to the beneficiary. 529 plans are state-sponsored savings plans. All states and the District of Columbia currently have plans and a majority of these state plans allow non-residents to participate. Contributions to a 529 plan may be deductible on your state income tax. Currently, five states offer a full income tax deduction and twenty states offer a partial income tax deduction.

Since college expenses are on the rise, it makes sense to save now for your child's college education. The 529 plans allow you to save and then take the money out to pay for college without having to pay federal income tax on the earnings. Some state plans even allow withdrawals that are state income tax-free. If non-qualified withdrawals are made, the earnings are taxed at regular income tax rates with a 10% additional penalty tax. Although the federal law does not require income or age requirements for investors in these plans, the states may impose such limits so it is important to check for such provisions in a plan before you invest. The federal law requires the states to set a maximum allowable contribution limit, but the states determine that limit. The maximum amount for college savings plans currently varies from $146,000 to $305,000 per beneficiary. Each state plan has a professional financial manager such as a well-known investment company. The money may be invested in mutual funds of different kinds. Some account holders prefer spreading money between funds of different risk levels. Other account holders select an age-based investment option which concentrates monies in high-risk funds while the child is young and gradually transfers monies to lower-risk funds as the child gets closer to enrolling in college. Many plans allow the account holder to shift monies to other funds, although this shift may be limited to one or two changes per year. The investor may change the beneficiary of a fund, so long as the new beneficiary is a member of the investor's family, as defined in the tax law.

529 plans should have less of an impact on federal financial aid eligibility for parents than other college savings plans. Eligibility for federal financial aid is based on income for the year in which withdrawals are taken. Colleges typically count about 6% of the parent's savings and 35% of the child's savings when determining financial aid. The value of the 529 plan is generally counted as owned by the account owner, who is usually the parent. Thus, usually only 6% of the 529 plan is included in the financial aid eligibility calculation.

There are many 529 plans available. A consumer should consider the different investment funds available in a given plan, the past growth rates, administrative support available, and enrollment and other administrative fees. You should read the fine print to determine unique restrictions and features such as state tax benefits and maximum contribution limits. Should you have any additional questions regarding consumer issues, you may call the Fort Meade Legal Assistance Division and make an appointment to speak with me. The number is (301) 677-9536.