

## 529 College Savings Programs



### 2004

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All states now sponsor tax-advantaged college savings programs to help families save for future college costs.

There are two main types of 529 programs — *prepaid tuition plans* and *college savings plans* — and each state plan has its own terms and features. The specifics of each plan vary greatly. So before you sign on, get the details about the investments, fees, and restrictions, and consider all your other college funding options.

#### *Q: Who can contribute to a 529 plan?*

In general, 529 plans don't have any eligibility income limitations. Any adult — parents, grandparents, other relatives, and friends — can open an account.

The beneficiary qualifications depend on the type of 529 program. Most college savings plans allow anyone of any age to be the beneficiary of an account. But most prepaid plans impose limits on the age of the beneficiary.

#### *Q: What are the tax benefits?*

When you make qualified withdrawals from a 529 plan your earnings are free from federal income tax.

State rules governing 529 programs vary. Some allow state residents to deduct the full or a partial amount of their contribution from state income taxes. And most states allow residents to exempt earnings from state income tax.

Some plans are open to residents of all states, although out-of-state participants may not get the state tax

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breaks. For example, you may not qualify for the state tax deduction if you contribute to an out-of-state plan. And some states tax earnings withdrawn from out-of-state plans, generally at the student's state tax rate.

Along with the rest of the Tax Act of 2001, the provision that made 529 earnings free from federal tax is set to expire at the end of 2010. That means that earnings will revert to being taxed at the student's federal income tax rate, unless Congress extends the tax break or passes new legislation.

#### *Q: What are prepaid tuition plans?*

Prepaid tuition plans allow you to pay tuition in advance and lock in the cost based on today's tuition prices. These plans pool investments and aim to keep pace with tuition increases in the state.

You can use savings in these plans for tuition at any eligible public university or private college in the country. The amount, however, is based on tuition costs at a state's public universities.

Therefore, if your child doesn't attend an in-state school and there's a difference between the prepaid tuition plan price and the current out-of-state tuition cost, you'll have to pay the difference.

Some states back their prepaid tuition plans with a full-faith-and-credit obligation or statutory guarantee. Therefore, the state's Treasury is obligated to make up any difference in investment returns and future tuition bills. Some states, however, don't provide this guarantee.

**Q: *What are college savings plans?***

College savings plans allow you to save money in a special college savings account for a student's *qualified higher education expenses* at any *eligible educational institution*.

Qualified higher education expenses include tuition and fees, books and supplies, and room and board for students enrolled at least half time.

According to the IRS, the definition of *eligible educational institution* includes virtually all U.S. accredited public, nonprofit, and privately owned profit colleges, universities, and vocational schools.

Each state sets its own lifetime contribution limit per beneficiary, with limits generally ranging from about \$180,000 to \$300,000.

**Q: *How do college savings plans work?***

College savings plans provide variable rates of return based on the types of investments you choose from the available options. Therefore, your account value may increase or decrease based on the performance of your selected investments.

Investments generally include stock, bond, and money market mutual fund options, as well as age-based portfolios of mutual funds.

These investments provide no return guarantees and account values may be more or less than the amount you contribute. Investments are not insured or guaranteed by the state, any investment company, or any government agency.

Some plans also provide investment options designed to preserve your principal and provide a fixed minimum rate of return.

Importantly, you can only change investment options within the same plan once in a calendar year (assuming the plan permits this change). If you already made this annual change and you want to change your investments again, you can direct future contributions to different

investments if you open a separate account for the same beneficiary (subject to the plan's lifetime contribution limits).

Another way to change investments is to roll over your plan assets to another college savings plan for the benefit of the same beneficiary. You can make this rollover free from federal income taxes and penalties as long as you limit transfers to one within any 12-month period. Before you make this move, however, check into any state tax consequences.

**Q: *What if my child or grandchild doesn't attend college or I withdraw my money for non-college use?***

If the beneficiary of your account doesn't attend college, you may defer the account for later use or transfer it to another member of your family, which is defined broadly.

You can withdraw your savings for non-qualified higher education expenses, subject to each plan's rules, but you'll owe federal income taxes on the earnings, generally at your income tax rate. Plus, you'll incur a 10% federal penalty tax on earnings, unless an exception applies. The exceptions include a student's disability, death, or receipt of a scholarship.

**Q: *How do contributions to a 529 plan affect a student's financial aid eligibility?***

Assets in a 529 plan may reduce a child's future eligibility for needs-based financial aid. The specific impact depends on your financial situation, the type of plan — prepaid or college savings, the type of aid, and the plan owner.

Remember, though, most financial aid is awarded in the form of loans, and non-needs based aid is available if you don't qualify for needs-based aid.