



Investment Insights

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The Best Way to Save for College September 22, 2006

If one of your financial goals is to pay for your child's college education, the route to success just got a lot clearer. In most cases, the Section 529 college savings plans are by far the best way to accumulate money towards this goal. Recent tax law changes have made 529's an even clearer choice for reaching this goal.

The Basics

A 529 plan is an educational savings plan that lets families save toward the goal of paying for college. Contributions are made with after-tax dollars, and the money grows tax-deferred in the account. If money is withdrawn to pay for qualified educational expenses (usually considered tuition, room and board, and books), the money comes out tax-free. The child is named the beneficiary of the account, but the child doesn't own the account (usually, the owner is a parent). Thus, the owner remains in control of the money, and can ensure it's spent for the proper uses (unlike a UTMA or UGMA account, where contributions to the account are an irrevocable gift and the child has full ownership upon reaching age 18). Money in a 529 account can be used to pay for qualified expenses at any accredited institution, including out-of-state schools, private schools, some trade schools, and even some out-of-country universities.

Here's an example: John Doe sets up an account for his 4 year-old son, Joey. John names himself as the owner (his wife can be a contingent owner if John dies), and Joey is named the beneficiary. John makes a one-time contribution of \$15,000 to the account, and invests in among the options offered in the plan (usually a variety of mutual funds. If the account earns an 8% return over the next 14 years, there will be approximately \$44,000 available for Joey's college costs. When John withdraws money to pay the qualified expenses, none of the approximately \$29,000 in profits is taxed!

What if Joey doesn't go to college? In this case, there are a couple of options. First, John could withdraw the money and pay taxes plus a 10% penalty on the accumulation (much like a premature IRA withdrawal). Or, John could change the beneficiary to someone else in his immediate family (including himself) to be used for their education.

For more information on the workings of 529 plans, and ratings of the various plans available, check out www.SavingForCollege.com. Expert Joe Hurley has accumulated a wealth of information on 529 plans.

What's Changed?

One big issue that held parents back from using 529 plans was the tax benefits expired in 2010 (they had a “sunset” date like most of the provisions of the 2001 EGTRRA tax act). This uncertainty caused many to hold off from funding 529's to a great extent. However, the Pension Protection Act, signed into law on August 17th of this year, has made permanent the tax exemption of 529 plans. Now, people can save through 529's knowing the money will not be taxed if withdrawn for qualified college expenses. This change has made 529s a clearly preferable way to accumulate money for college.

Another big change that affects both 529 plans and UTMA/UGMA accounts is the treatment for financial aid calculations. 529 plans are considered an asset of the parent, and only 5.64% of parent's assets go into the Expected Family Contribution calculation when applying for Federal aid. However, UTMA/UGMA accounts are assets of the student, and 35% of the student's assets are included in this calculation. However, as a result of recent legislation, assets transferred from a UTMA/UGMA account to a 529 plan will be considered assets of the parents. This beneficial treatment greatly increases the chances of qualifying for aid.

Conclusion

Based on the changes recently enacted, it makes more sense than ever to check into 529 plans as a way of attaining the goal of paying for your child's college education. Even if you have other sources of money set aside, the tax benefits and control inherent in 529 plans make them a strong candidate for inclusion in your financial plan.

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