529 Prepaid Tuition Plan

Federal law[1] allows the states and qualifying private schools and colleges to establish tax-advantaged prepaid tuition plans. Under these plans, contributions are made into a qualified trust to prepay, at today's prices, some or all of a beneficiary's tuition costs. There are two general types of prepaid plans:

- Contract plans: Most prepaid plans are contract plans, which commit the account owner to purchase a specified number of years of tuition in exchange for a lump-sum or periodic payments. Generally speaking, contract plans offer lower prices for younger beneficiaries since the state or school will have more time to invest the money.

- Unit plans: Unit plans allow the account owner to purchase a fixed percentage of tuition. In a typical unit plan, one unit represents 1% of a year's tuition. All participants in the plan pay the same price for a unit.

Independent 529 Plan

A number of private colleges and universities have joined together to form the Independent 529 Plan. Under this arrangement, an account owner purchases tuition certificates (similar to units in a state-run plan) guaranteeing payment of a specified percentage of future tuition. These certificates can be "redeemed" at a participating college or university when the beneficiary reaches college age.

[1] "529" refers to Section 529 of the Internal Revenue Code, the section of federal law which authorizes these plans.

Key Definitions Under IRC Sec. 529

- **Qualified educational expenses:** For post-secondary education, generally, tuition, fees, books, supplies, and equipment required for attendance qualify. Computers, software, peripheral equipment, and internet access also qualify if they are to be used primarily by the beneficiary while the beneficiary is enrolled at an eligible educational institution. Reasonable costs of room and board are also included if the student is attending school at least half time. Additionally, qualified expenses include costs incurred to allow a special needs beneficiary to enroll at and attend an eligible institution.

  Beginning in 2018, under the provisions of the Tax Cuts and Jobs Act of 2017 (TCJA), qualified educational expenses also include expenses for tuition incurred in connection with the enrollment or attendance of the beneficiary at an elementary or secondary public, private, or religious school.

- **Eligible educational institution:** Generally, accredited post high-school institutions offering associates, bachelors, graduate level, or professional degrees qualify as eligible. Certain vocational schools are also included. Beginning in 2018, under the TCJA, elementary or secondary public, private, or religious schools also qualify.

Contributions

Contributions to a prepaid plan must be in cash. Broadly speaking, anyone (parents, grandparents, friends, etc.) can contribute to a plan. Many state plans require that either the account owner or beneficiary be a state resident, either at the time an account is opened, or at the time the beneficiary begins school. Under federal law, contributions are not tax deductible and any growth in an account is tax-deferred:

- Contributions may be made to both a prepaid plan and a Coverdell Education Savings Account (Coverdell ESA) for the same beneficiary in the same year.

- For federal gift tax purposes, contributions are considered completed gifts of a present interest. Generally, no federal gift tax will be payable if a contribution is limited to the annual gift tax exclusion amount. For 2018, this amount is $15,000. A married couple can elect to "split" gifts for a total annual contribution of $30,000.

- If a contribution for a single beneficiary in one calendar year exceeds the annual gift tax exclusion amount, the donor may elect to treat the contribution as having been made ratably over a five-year period.[2] Thus, for 2018, an individual could contribute up to $75,000 for a single beneficiary in one calendar year. If a married couple elects gift splitting, $150,000 could be contributed.

[2] If the donor dies before the end of the five years, a pro-rate portion of the contribution is included in his or her estate.

Distributions

For federal income tax purposes, distributions used to pay for qualified educational expenses are excluded from gross income if the amount distributed does not exceed the amount of qualified educational expenses. If the distribution from a prepaid plan is greater than the amount of qualified educational expenses, a portion of the earnings may be subject to federal income tax and a 10% penalty tax may also apply.

Tax-free distributions in connection with the enrollment or attendance of a designated beneficiary at an elementary or secondary public, private, or religious school are limited to $10,000 per year. This limitation applies on a per-student basis, not a per-account basis. Any distribution in excess of $10,000 is subject to tax.

- Distributions due to the death or disability of the beneficiary, or the receipt of certain scholarships: The earnings portion of the distribution is taxable as ordinary income to the recipient of the payment.

- Rollover distributions: If there is a change of beneficiary within the same family,[3] the rollover must be completed within 60 days or the earnings portion will be subject to tax. If a new beneficiary is not part of the same family as the original beneficiary, the earnings portion of the transfer is subject to current income tax. Funds may be rolled from a 529 prepaid tuition plan to a 529 education savings plan and vice versa.

- ABLE account rollovers: TCJA, for 2018 – 2025, allows amounts from 529 plans to be rolled over to an ABLE account, provided that the ABLE account is owned by the beneficiary of the 529 account or a member of the beneficiary's family. Such rolled- over amounts count toward the annual limitation $15,000 in 2018) that can be contributed to an ABLE account. Any amount rolled over in excess of this limit will be included in the beneficiary's gross income.

- Other distributions: If a distribution is made from a plan for any other reason, the earnings portion of the distribution is included in the taxable income of the recipient. A 10% penalty tax is also applied against the distributed earnings.

- State and local law can vary: State and local law can vary widely from federal law with regard to the income tax treatment of both contributions and withdrawals.

- Coordination with other programs: A beneficiary may generally also claim either the American Opportunity Credit or Lifetime Learning Credit (not both in the same tax year), receive a distribution from a Coverdell ESA, or claim the tuition and fees deduction, as long as the qualifying educational expenses are not the same.

[3] Generally, siblings, children, grandchildren, parents, grandparents, nieces or nephews, uncles or aunts, their spouses, and first cousins are considered members of the same family.

Other Issues to Consider

- Limited use of funds: Although the federal law governing prepaid plans has a very broad definition of qualified educational expenses, most prepaid tuition plans are limited to paying for tuition and required fees for undergraduate study; in a few programs, room and board is also covered. Costs that are not covered by the prepaid tuition plan must be paid for from other resources.

- Increased tuition costs: Many prepaid plans agree to cover all future increases in tuition costs. However, some plans limit that promise; if tuition costs increase more than the limit, will you have to contribute more money to the plan?

- No guarantees: A prepaid tuition plan does not guarantee that a beneficiary will be admitted to a particular school or college, nor that an educational funding goal will be completely met.

- Change in plans: If the beneficiary does not attend school, or does not complete the full course of study, what does it cost to cancel or withdraw from a prepaid plan? Does the plan allow the account owner to "roll over" the funds to another beneficiary? If a beneficiary attends an out-of-state school, what amount of tuition credit is allowed at the out-of-state school?

- Home state plans: Prepaid plans will vary widely from state to state. Consider whether the plan in your (or the beneficiary's) home state offers any tax or other benefits that are only available to participants in that particular state's plan.

- Effect on financial aid eligibility: Assets in a 529 prepaid tuition plan are considered in the "Expected Family Contribution" calculations. Tax-free distributions from a 529 prepaid tuition plan (those used to pay for qualified educational expenses) are not counted as income to either the parent or student in the financial aid process.[4]

- Ownership: The donor is generally the owner of the funds. However, funds in a custodial account (set up under the Uniform Gifts to Minors Act, UGMA, or the Uniform Transfers to Minors Act, UTMA), become the property of the beneficiary when he or she reaches the age of majority, or the age specified in state law.

[4] See the US Department of Education "Dear Colleague" letter of January 22, 2004, GEN-04-02.

Internet Resources

- The College Board – https://www.collegeboard.org
- FinAid! The SmartStudent® Guide To Financial Aid – http://www.finaid.org
- College Savings Plan Network – links to state-run web pages on prepaid tuition or college savings plans, at: http://www.collegesavings.org
- U.S. Department of Education – student aid website – https://studentaid.ed.gov/sa/

Seek Professional Guidance

Individuals considering a prepaid tuition plan are faced with a number of income tax, gift tax, estate tax, and financial aid issues. The guidance of appropriate tax and financial professionals is highly recommended.