Q's and A's on Section 529 Plans
How to help pay for college education

By Jeremy Smith, CPA
(480) 839-4900 ~ JeremyS@hhcpa.com

Section 529 plans may provide significant benefits to cash-strapped parents who intend to help pay for their children's college education. Here is a quick Q-and-A session on this intriguing option.

Q. What exactly is a Section 529 plan?

A. It is a type of educational savings plan generally operated by individual states. Section 529 plans are designed to encourage families to set aside funds for the future education of the younger generation. If certain requirements are met, there is no tax due on the contributions to the plans, no tax due on the accumulation of earnings and no tax due on distributions when the funds are paid out for qualified distributions.

There are two main types of Section 529 plans: the prepaid tuition plan and the college savings plan.

Q. How does a prepaid tuition plan work?

A. Essentially, the plan is guaranteed to keep pace with the rising cost of college tuition. For instance, let's say it currently costs $10,000 annually to send a child to a state university. You pay $10,000 now to buy shares for a youngster. When the child is ready to go to school, your shares can pay for an entire year of tuition, no matter what it costs at that point.

This type of plan is often attractive to parents because it offers peace of mind. There's no risk of loss of principal, and the investment is usually guaranteed by the state.

Q. How does a college savings plan work?

A. As opposed to a prepaid tuition plan, there is no guaranteed lock on future tuition costs under a college savings plan. In fact, the savings may not be enough to cover all of the costs. But there's a bigger potential upside as well because it is possible to generate a better return with this type of plan. (Of course, there are no guarantees concerning the returns on the investments.)

Usually, the plan will offer an asset allocation strategy geared to the current age of the child or the year he or she will enter school. For example, the plan may provide more aggressive investments in the early years and switch over to more conservative investments as college approaches. Most college savings plans also offer a wide variety of risk-based asset allocation portfolios. The funds are managed by professionals.

Q. What are the restrictions on contributions?

A. Anyone can contribute to a Section 529 plan on behalf of a named beneficiary. Each state is responsible for setting its own limits on the amount of contributions allowed to a college savings plan. Check the limits in the applicable state.

In the event a child decides to not attend college or attends school in another state, you may be able to transfer funds to another plan or "roll over" funds for the benefit of a successor beneficiary (e.g., a younger child).

Finally, be aware that this type of plan is not for everyone. Investigate the options carefully to determine if a Section 529 plan suits your family's needs.

Jeremy Smith, CPA, is a Partner in the Tempe office of Henry & Horne. His areas of expertise include tax and consulting work for businesses and individuals. Contact Jeremy at (480) 839–4900 or JeremyS@hhcpa.com.