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Income Tax Planning and 529 Plans

The income tax benefits offered by 529 plans make these plans attractive to parents (and others) interested in saving for college. Qualified withdrawals from a 529 plan are tax free at the federal level, and some states also offer tax breaks to their residents. It's important to evaluate the federal and state tax consequences of plan withdrawals and contributions before you invest in a 529 plan.

Federal income tax treatment of qualified withdrawals

There are two types of 529 plans--college savings plans and prepaid tuition plans. The federal income tax treatment of these plans is identical. Your contributions to college savings plans and prepaid tuition plans are tax deferred. This means that you don't pay income taxes on the plan's earnings each year.

Then, if you take out money and use it to pay for qualified education expenses, the earnings portion of your withdrawal is free from federal income tax. This presents a significant opportunity to help you accumulate funds for college.

Qualified education expenses include tuition, fees, and books for college and graduate school. Room-and-board expenses are also considered qualified if the beneficiary is attending college or graduate school on at least a half-time basis.

State income tax treatment of qualified withdrawals

States differ in the 529 plan tax benefits they offer to their residents. For example, some states may offer no tax benefits, while others may exempt earnings on qualified withdrawals from state income tax and/or offer a deduction for contributions. However, keep in mind that states may limit their tax benefits to individuals who participate in the in-state 529 plan.

You should look to your own state's laws to determine the income tax treatment of withdrawals (and deductions). In general, you won't be required to pay income taxes to another state simply because you opened a 529 account in that state. But you'll probably be taxed in your state of residency on the earnings distributed by your 529 plan (whatever state sponsored it) unless your state grants a specific exemption. Also, make sure you understand your state's definition of "qualified education expenses," since it may differ from the federal definition.

Income tax treatment of nonqualified withdrawals (federal and state)

If you make a nonqualified withdrawal (i.e., one not used for qualified education expenses), the earnings portion of the distribution will usually be taxable on your federal (and probably state) income tax return in the year of the distribution. The earnings are usually taxed at the rate of the person who receives the distribution (known as the distributee). In most cases, the account owner will be the distributee. Some plans specify who the distributee is, while others may allow you (as the account owner) to determine the recipient of a nonqualified withdrawal.

You'll also pay a federal 10 percent penalty on the taxable amount of the nonqualified withdrawal (usually, that means on the earnings). There are a couple of exceptions, though. The penalty is usually not charged if you terminate the 529 account because the beneficiary has died or become disabled, or if you withdraw funds not needed for college because the beneficiary has received a scholarship. A state penalty may also apply.

Deducting your contributions to a 529 plan

Unfortunately, you can't claim a federal income tax deduction for your contributions to a 529 plan. Depending on where you

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live, though, you may qualify for a deduction on your state income tax return. A number of states now allow a state income tax deduction for contributions to a 529 plan, and several other states are considering such a measure. Again, keep in mind that most states let you claim an income tax deduction on your state tax return only if you contribute to your own state's 529 plan.

Most of the states that provide a deduction for contributions impose a deduction cap, or limitation, on the amount of the deduction. For example, if you contribute $10,000 to your son's 529 plan this year, your state might allow you to deduct only $4,000 on your state income tax return. Check the details of your 529 plan and the tax laws of your state to learn whether your state imposes a deduction cap.

Also, if you're planning to claim a state income tax deduction for your contributions, you should learn whether your state applies income recapture rules to 529 plans. Income recapture means that deductions allowed in one year may be required to be reported as taxable income if you make a nonqualified withdrawal from the 529 plan in a later year. Again, check the laws of your state for details.

Coordination with the Coverdell education savings account and education tax credits

You can fund a Coverdell education savings account and a 529 account in the same year for the same beneficiary without triggering a penalty.

You can also claim an education tax credit in the same year you withdraw funds from a 529 plan to pay for qualified education expenses. But your 529 plan withdrawal will not be completely tax free on your federal income tax return if it's used for the same higher education expenses for which you're claiming a credit. (When calculating the amount of your qualified higher education expenses for purposes of your Section 529 withdrawal, you'll have to reduce your qualified expenses figure by any expenses used to compute the education tax credit.)

Note: Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in the issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits. As with other investments, there are generally fees and expenses associated with participation in a 529 savings plan. There is also the risk that the investments may lose money or not perform well enough to cover college costs as anticipated.

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