

# IRC Section 529 Qualified Tuition Plan

Qualified tuition programs<sup>1</sup> (QTPs) allow a person<sup>2</sup> to either prepay a student's tuition or contribute to a savings account established to pay the student's qualified higher education expenses. Both prepaid tuition plans and savings account plans may be established by the various states. Beginning in 2002, eligible private institutions were also authorized to establish prepaid tuition plans.

**\*Prepaid tuition plans:** Cash contributions are made to a qualified trust that invests the funds so as to offset increasing future costs of tuition. The contract allows one to purchase a number of course units or academic periods that are redeemed when the beneficiary is old enough to attend college.

**\*Higher education savings account plans:** Cash contributions are made to an account established for a named beneficiary. An investment management firm typically directs the investments. The amount available for higher education expenses depends on growth in the account between contribution and withdrawal.

Contributions to these programs are not tax deductible.<sup>3</sup> However, the earnings in the accounts grow tax deferred.

## Contributions

Contributions to a QTP must be in cash and may not exceed the amount necessary to provide the beneficiary's qualified higher education expenses. See IRC Secs. 529(b)(2) and 529(b)(6). Program sponsors will specify maximum total contribution amounts based on factors such as the beneficiary's current age, current education costs, projected inflation and anticipated investment returns. In some programs, up to as much as \$240,000 may be contributed for a beneficiary. Other considerations include the following.

\*For federal gift tax purposes, contributions are considered completed gifts of a present interest. See IRC Sec. 529(c)(2)(A)(i). Contributions in any one calendar year that exceed certain limits may be subject to a federal gift tax. Generally, no federal gift tax will be payable if a contribution is limited to the annual exclusion amount discussed in IRC Sec. 2503(b). For 2003, this is \$11,000.<sup>4</sup> A married couple can elect to "split" gifts for a total annual contribution of \$22,000.

\*If a contribution for a single beneficiary in one calendar year exceeds the annual exclusion amount, the donor may elect to treat the contribution as having been made ratably over a five-year period.<sup>5</sup> See IRC Sec. 529(c)(2)(B). Thus, for 2003, an individual could contribute up to \$55,000 for a single beneficiary in one calendar year. If a married couple elects gift splitting, \$110,000 could be contributed.

\*Beginning in 2002, contributions could be made to both a QTP and a Coverdell Education Savings Account<sup>6</sup> (C-ESA) for the same beneficiary in the same year.

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<sup>1</sup> These were known as Qualified State Tuition Programs before 2002 and are authorized by IRC Section 529.

<sup>2</sup> An eligible account owner may include an individual, a trust or estate, a partnership or LLC, an association, a corporation, or a 501(c)(3) charitable organization.

<sup>3</sup> The rules discussed here concern federal law. State and local law may vary. Depending on the state, contributions may be tax deductible or distributions may be tax exempt.

<sup>4</sup> The annual gift tax exclusion (\$11,000 in 2003) is indexed for inflation in increments of \$1,000.

<sup>5</sup> If the donor dies before the end of the five years, a pro-rata portion of the contribution is included in his or her estate

<sup>6</sup> Certain income limits apply to contributors to Coverdell ESAs.

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## Key Definitions

QTPs established under the provisions of IRC Sec. 529 provide a tax-favored framework within which funds may be accumulated to pay for a beneficiary's qualified higher education expenses at an eligible educational institution.

\***Qualified higher-education expenses:** Generally, tuition, fees, books, supplies, and equipment required for attendance qualify. Reasonable costs of room and board are also included if the student is attending school at least half time<sup>1</sup>. Beginning in 2002, qualified higher-education expenses also included costs incurred to allow a special needs beneficiary<sup>2</sup> to enroll at and attend an eligible institution.

\***Eligible educational institution:** Generally, accredited post-high school educational institutions offering associate's, bachelor's, graduate level, or professional degrees qualify as eligible. Certain vocational schools are also included.

## Account Characteristics

QTPs have a number of characteristics which a potential contributor should understand.

\*The beneficiary must be identified at the time an account is created.<sup>3</sup> As a general rule, the individual or entity who contributes to the account is the owner.

\*The account owner may change the beneficiary. If the new beneficiary is a member of the same family as the original beneficiary, there is generally no current federal income tax. Qualifying family members include the beneficiary's spouse and the individuals listed in the table below.

### Who Is a Family Member?

2002 and Later
Son or daughter, or their descendants
Stepson or stepdaughter
Brother, sister, stepbrother, or stepsister
Father or mother or ancestor of either
Stepfather or stepmother
Son or daughter of a brother or sister
Brother or sister of father or mother
Spouse of any person listed above
First cousins

\*Contributing to a QTP involves investment risk, including the potential to lose money. If certain requirements are met, a net loss from an investment in a QTP account may be deducted as a miscellaneous itemized deduction on Schedule A (Form 1040) subject to the 2% of adjusted-gross-income limit. See IRS Publication 970, Tax Benefits for Higher Education.

<sup>1</sup> The school concerned can provide the dollar amount of qualified room-and-board costs.

<sup>2</sup> Generally, a special needs beneficiary is an individual who, because of a physical, mental or emotional condition, needs extra time to complete his or her education.

<sup>3</sup> An exception exists for organizations accumulating funds for future scholarships. See IRC Sec. 529(e)(1)(C).

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- \*A QTP will usually require that funds in a custodial account become the property of the beneficiary when the beneficiary reaches his or her majority. Other restrictions may apply. A custodial account is one set up under the Uniform Gifts to Minors Act (UGMA), the Uniform Transfers to Minors Act (UTMA) or the local state version.
- \*Neither the beneficiary nor the account owner is permitted to direct the investments in the account. See IRC Sec. 529(b)(4). Account owners are, however, permitted to choose among broad investment strategies established by the program sponsor. A change in investment strategy is generally permitted at least once each year or if a new beneficiary is named.
- \*The fees, expenses and features of QTPs will vary from state to state and from institution to institution. Amounts accumulated in a QTP operated by one state generally may be used at educational institutions in a different state.
- \*For federal estate tax purposes, funds in a QTP that are considered completed gifts are not generally includable in the donor's estate. However, any amounts in a QTP when a beneficiary dies will generally be includable in the beneficiary's estate.

### Distributions

Each distribution from a QTP consists partly of after-tax contributions and partly of earnings.<sup>1</sup> Depending on the year of distribution, the type of QTP and the purpose for the distribution, the earnings portion may or may not be taxable. In some situations, a 10% penalty also applies to the earnings portion of the distribution.<sup>2</sup>

- \***Distributions used to pay qualified higher-education expenses:** In 2001, the earnings portion of the distribution was taxable to the beneficiary as ordinary income. Beginning in 2002, the earnings portion of distributions from state-sponsored QTPs was excluded from the beneficiary's taxable income. For 2002-2003, the earnings portion of distributions from prepaid tuition plans of eligible private institutions is taxed as ordinary income to the beneficiary. Beginning in 2004, the earnings portion of distributions from eligible private institution plans will also be excluded from income.
- \***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:** Federal law allows one tax-free transfer every twelve months, from one QTP to another QTP, for the same beneficiary. If there is a change of beneficiary within the same family (as defined above), 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.

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<sup>1</sup> See IRS Publication 970, Tax Benefits for Higher Education, for a discussion of how the earnings portion of a QTP distribution is calculated.

<sup>2</sup> The rules discussed here concern federal law. State or local law may vary.

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- \***Other distributions:** If a distribution is made from a QTP 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.
- \***Coordination with other programs:** A QTP beneficiary may generally also claim the Hope or Lifetime Learning credits, or take a tax-favored distribution from a Coverdell Education Savings Account (ESA), as long as the qualifying educational expenses are not the same.

### Other Issues to Consider

- \***Effect on financial aid eligibility:** Assets in a QTP may affect a student's eligibility for financial aid. The U.S. Department of Education has advised that assets in a savings account plan are considered assets of the parent for the purposes of the Free Application For Federal Student Aid (FAFSA), if the parent is the account owner. To the extent paid out, assets in a prepaid tuition plan are generally considered to reduce a student's need on a dollar-for-dollar basis. Private institutions may also take QTP assets into account when considering financial aid.
- \***Effect on Medicaid:** Ownership of assets may also affect eligibility for Medicaid. State law will vary as to how QTP assets will be treated.
- \***Future federal legislative changes:** A number of the provisions in federal law affecting QTPs came into being with the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001. Unless the law is changed, most of the provisions of the EGTRRA, including those affecting QTPs, will expire after 2010, when prior law will be reinstated.

### Web Resources

There are numerous web sites which provide information on QTPs, as well as on college planning in general.

- \***National Association of State Treasurers:** Links to state-operated web sites on QTPs at <http://collegesavings.org/>.
- \***U.S. Department of Education:** Located at <http://www.ed.gov/>.
- \***National Association of Student Financial Aid Administrators:** Located at <http://www.finaid.org/>.
- \***The College Board:** Located at <http://www.collegeboard.com>.

### Seek Professional Advice

Individuals considering a qualified tuition plan are faced with a number of income, gift and estate tax issues, as well as investment planning questions. Contributing to a QTP does not ensure that one's college funding goals will be met. The advice of appropriate tax, legal and investment advisers is highly recommended.