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How 529 Plans Can Help Reduce Taxes And Pay For College

Mark Avallone, CONTRIBUTOR

I help people on their path to Financial Freedom. **FULL BIO**

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Whatever the time of year, paying for college is usually on the minds of parents. For the middle class it is especially daunting. The wealthy usually have the means to afford the $50,000 to $60,000 annual cost at some private colleges. And, if a talented student is from an impoverished background, there are ways (grants, scholarships, need-based financial aid) to get some or even most of the tab covered. But it is the middle class who are squeezed with the high cost of college.

Against this backdrop, a working family often has to sacrifice to set aside funds for this potential future expense. With wage growth slowing over recent decades and health care costs rising at a rapid pace, it is getting harder for millions of Americans to save money for retirement or college. Fortunately, there is section 529 of the tax code which offers attractive tax advantages and other benefits.

Picking The Right 529 Plan:

<u>Tax-Free Growth.</u> The gains inside a 529 plan can be exempt from both federal and state income taxes provided they are used for a qualified higher education purpose. You must adhere to the rules and guidelines spelled out in the federal tax code, but for many, this is easily accomplished. Of course, as with any tax matter, you should consult with your tax advisor for final tax advice, but I find this portion of the tax code relatively easy to follow. Simply use the funds for college tuition, books, room and board and you should be in good shape.

From a state income tax perspective, currently 41 states tax earned income and 2 others tax dividends and interest. So for the purposes of saving for college, 43 out of 50 states will join the federal government in taxing the gains on your investment accounts. For a list of those states, click here.

Inside a 529 plan, however, all investment growth, whether it is from interest, dividends, or capital gains is tax exempt as long as the funds are used for qualified higher education expenses. Gains and dividends generated inside a 529 plan avoid federal dividend and capital gains taxes which can be as high as 28%. The interest earned inside this account can also avoid ordinary income taxes which can otherwise be as high as 39.6%. In addition, investment income in a 529 plan avoids the 3.8% investment tax high earners are subject to in the Affordable Care and Patient Protection Act. And, for states with income taxes, the 529 plan may help you avoid those as well.

<u>State Income Tax Deduction.</u> Many states offer a state income tax deduction for contributions into their state specific 529 plan. Each state has its own set of rules for the amount of your 529 plan contribution that they will allow you to deduct off your state income tax. Some states also let you 'front-load" a large contribution and carry-forward any unused tax deductible portion into future years. This part can get tricky so please review your states rules carefully – and talk with your tax advisor about which plan is best for you. To benefit from a possible state income tax deduction, make sure you use a plan provider that your state partners with.

<u>No Income Limits.</u> There are no income limits or phase outs in order to be eligible to participate and benefit from the federal tax advantages. As a result, it is one of the very rare tax planning tools available for middle class and wealthy families. Please check with your own state's rules as the contribution limits may vary and be sure to check with your tax advisor for specific advice.

Areas of Concern With 529 Plans:

Penalties for non-education purposes. It is important to remember that investing should be guided by your unique situation including your current income and financial situation, your life and investment goals, risk tolerance, liquidity needs, and other factors. This is especially true with 529 plans as non-qualified distributions will be taxed and the gains that are withdrawn will also be hit with a 10% IRS penalty. It is heartbreaking to hear of stories where hardship hit and people needed to withdraw money for living expenses. Despite their hardship, these withdrawals can still incur a 10% penalty. So be careful and only allocate money into a 529 plan that you can commit for higher education.

Costs. Some articles scare investors and write about the high costs of a 529 plan. I find this to be not always be accurate, but check it out for yourself. Investors have many competing plans to pick from so don't automatically be discouraged when you read an article complaining about 529 plan costs.

Limits. There may be limits to how much you can contribute to a 529 plan when the balances get to a certain level and that limit varies by state. So once you start having a sizable amount in the plan you will want to keep an eye on the maximum limits (usually north of $200,000 per account).

Overall, the 529 plan may be a tax-smart way for parents (or any friend or relative) to save for a young person's college. With good planning and regular contributions, when it comes time to start paying for college, hopefully the only tears will be for the joy of watching your child move forward with their life – and not because you had to take out a home equity line of credit to pay the tuition!

Contributor's Bio

Mark Avallone is the author of Countdown To Financial Freedom, and founder and President of Potomac Wealth Advisors, LLC a financial advisory firm serving clients through holistic financial planning and wealth management. Avallone writes on a variety of financial topics, and his contributions have appeared in the Wall Street Journal as well as in Forbes where he is a regular contributor. He has appeared on CNBC and has been a repeat guest on the Fox Business Network. His insights have also appeared in USA Today, U.S. News & World Report, The Washington Post, and other leading publications.