

529 Plans: Helping Employees Save for Education

Most employers recognize that, for many of their employees, saving for a child's education is a top priority. With the cost of a private four-year college education ranging upwards of \$120,000 (Source: Trends in College Pricing—2005, The College Board), saving early has become paramount in helping to ensure a child's schooling, and for many employees, their own continuing education. In particular, **529 college savings plans**—named for Internal Revenue Code 529—are a popular way to set aside money for college and graduate school.

Reconciliation Act of 2001 (EGTRRA), employers seeking innovative ways to attract and retain a qualified workforce have begun offering the 529 plan as an incentive in their benefits packages. Furthermore, to ease the process for employees, and to encourage a disciplined approach to saving, many companies allow contributions to be easily made through payroll deduction.

Tax Advantages

529 college savings plans, not to be confused with **pre-paid tuition** plans, are state-sponsored investment accounts that offer two distinct tax advantages: 1) the potential for earnings to grow free of federal income tax; and 2) the opportunity for withdrawals to be made free of federal income tax, if funds are used for qualified education expenses, such as tuition, fees, room, and board. Certain state taxes may apply, though. Nonqualified withdrawals may be subject to a 10% federal income tax penalty. Prior to EGTRRA, beneficiaries of a 529 plan had to pay federal income tax on any earnings. However, this provision is scheduled to "sunset" on December 31, 2010, and if Congress does not act in the interim, regulations governing 529 plans revert back to tax year 2001.

Contribution limits vary by state and in most states exceed \$200,000. As an employer-sponsored payroll deduction, employees contribute a percentage of their pay (similar to a **401(k) plan**) to a 529 account. While contributors are not eligible for any federal income tax deductions, some states allow for certain state income tax deductions. A person's residency status in the state sponsoring the plan generally affects his or her state tax benefits, which may affect employees of companies with offices in different regions. For example, suppose a company has an east coast office and a west coast office. The main office, which is on the east coast, offers a 529 college savings plan from that east coast state. This would allow east coast employees to reap state tax benefits, as well as federal tax benefits. However, employees from the west coast office, while sharing the potential for earnings free of federal income tax, would not qualify for any state tax benefits.

For contributors in all states, federal **gift taxes** may also apply, but a special provision applies to 529 plans. Any individual may gift \$12,000 per year in 2006 (\$24,000 for married couples) to another individual without incurring gift taxes. However, individuals contributing to a 529 plan are allowed to make a **lump-sum contribution** of \$60,000 (\$120,000 for married couples), using five years' worth of gifting. While this method limits tax-free gifting for the next five years, it may allow funds a longer time for potential compound earnings.

Investment Options

Investment options vary by plan, but often include a selection of **mutual funds**. Generally, **diversification**—a strategy used to manage risk and maximize potential earnings—of the portfolio's assets is based on the beneficiary's age or number of years until the beneficiary begins college. Remember that mutual funds are subject to market risk, and shares, when redeemed, may be worth more or less than the original investment. The portfolio's investment strategy may be changed once

during a calendar year without incurring any federal income tax penalties. Also, the account holder may change the designated beneficiary at any time without incurring federal income tax penalties.

Before Beginning

In addition to understanding the federal and state tax issues affecting 529 plans, it is also important to understand the associated fees and expenses. These vary by state and plan, but often include enrollment fees, maintenance fees, sales charges, management fees, and fund expenses.

For many employees, sending children to college or continuing their own education is a significant life goal. Offering a 529 plan, with payroll deduction as part of a benefits package, may boost employee satisfaction and may help the business owner retain a valuable workforce.