Bill Affects College-Savings Plans

By Judith Earley

President Bush is expected to sign legislation that would give permanent tax-free status to a current law that allows families to withdraw funds from college-savings accounts, according to a report from The Chronicle of Higher Education.

This college-savings-account provision is part of a larger pension-reform bill under consideration, HR 4 . HR 4 was passed by the Senate without amendment by a vote of 93-5 on July 29. The bill was passed by the House of Representatives last week and will now head to the White House for the President's signature.

The bill ends the temporary status of the federal tax exclusion for 529 withdrawals. It also would preserve the tax exclusion at the state level that piggybacks on federal law in the many states. Supporters of the plans set their sights on preserving the exclusion, which had been set to expire on December 31, 2010. Their argument was that the uncertainty connected with the plan has discouraged families from investing in 529 accounts.

In addition to the tax exclusion, several other 529 benefits will now be made permanent; these provisions were originally introduced through the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Included are the rules allowing same-beneficiary rollovers, eliminating the state-imposed penalties on non-qualified distributions, giving 529 status to private-college prepaid-tuition plans (i.e., Independent 529 Plan), and including first cousins as eligible members of the family.

A 529 college savings plan is an investment account in which parents can set aside money for their child's education; this money is permitted to grow tax-free. The federal government does not tax any money taken out of the account as long as it goes toward higher education. The bad news is that if the money is withdrawn from a 529 plan for non-educational purposes, there is a 10-percent penalty assessed on the earnings, plus federal taxes due on the earnings.

The money in a 529 plan can be used at any accredited college or university in the country, whether it is public or private, graduate or undergraduate. The funds can go towards tuition, fees, room and board, books, supplies, and equipment. All 529 plans are administered by individual states; and although parents can select any state plan that works best for them, non-residents may face higher commission rates and limited investment options.

Monies placed in a 529 account are considered an asset of the parents and not of their child, so need-based financial aid will be less affected by a 529 plan than by any other type of asset or savings account. Additionally, 529 plans have no effect on merit-based scholarships, so any extra funds in the account that the student does not use because he or she received a merit-based scholarship are returned to the parents without penalty or taxation.