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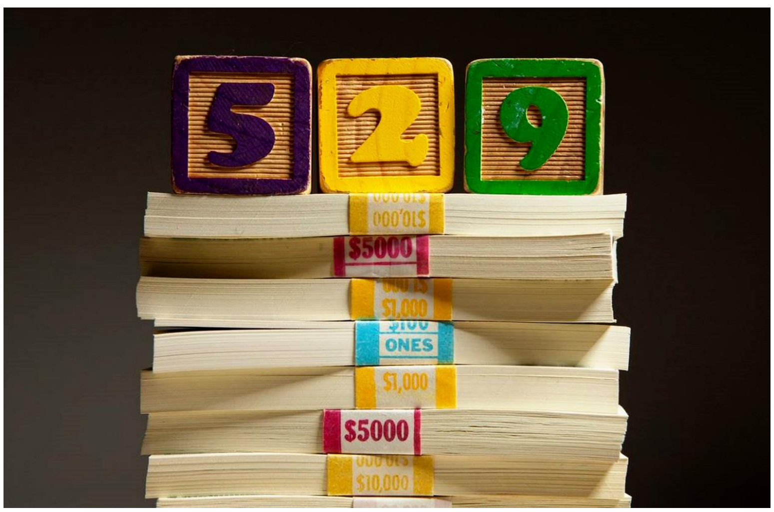
Is Starting a ‘529’ Worth It?

Experts answer this and other questions about strategies for college savings



Experts say there is no need to choose between saving in a 529 or qualifying for financial aid. You can do both.
PHOTO: JAN COBB/GETTY IMAGES

By CHANA R. SCHOENBERGER
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Readers continue to send in questions about how best to use tax-advantaged “529” savings plans to put away money for college and graduate school. The state-sponsored plans, which invest in mutual funds, aren’t the only way to save for college, but they dominate the attention of readers. We answer several of the queries with the help of experts.

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How can I determine whether it’s worth it to start a 529? If we will have only $15,000 in the account when the student goes to college, are we better off not opening a 529 and instead relying on financial aid, which should exceed $15,000?

ASK US A UESTION

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“There is really very little potential downside to opening a 529, especially when you expect its account value when it’s time to go to college to be only around $15,000,” says Paul Winter, president of Five Seasons Financial Planning in Salt Lake City. That isn’t enough money to pay many tuition bills over four years, so you aren’t likely to have funds left over. But if you do, you can change the beneficiary to any direct relative of the original beneficiary. You’ll also reap tax benefits: Earnings within the fund grow tax-free, and if you spend the money on qualified higher-education expenses, you’ll never pay federal taxes on it. You also may be able to get state-tax benefits in certain states.

As for financial aid, there’s no need to choose between saving in a 529 or qualifying for aid, he says. If the parent or dependent student owns the account, the money is considered as a parental asset in financial-aid calculations—meaning it is assessed at a maximum 5.64% rate in determining a student’s expected family contribution instead of 20%, the rate at which some other assets are assessed. And distributions from the 529 aren’t considered income.

“Funding a 529 account may be beneficial for financial-aid awards in comparison to some other ways to save for college, such as gifting cash to the student or establishing a UGMA/UTMA for him or her,” Mr. Winter says, referring to referring to accounts held in minors’ names.

You might want to compare a 529 with federal education tax credits to see which is the better deal in your situation, since the IRS prohibits taxpayers from taking a double tax benefit of tax-deferred growth of a 529 account and claiming a tax credit on those same dollars, says Jack McCloskey, a financial adviser at Vintage Financial Services in Ann Arbor, Mich. The most beneficial credit is the American Opportunity tax credit, which tops out at $2,500 a year for four years. You need to have modified adjusted gross income of $80,000 or less if single, or $160,000 or less if married and filing jointly, to claim the credit.

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Can 529 funds be used for physical-education classes or sports clubs at a college?

You can use 529 distributions for any qualified higher-education expense, which includes any fee required as a condition of enrollment, Mr. Winter says. According to SavingForCollege.com, sports and club activity fees aren't considered qualified expenses.

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"I would think that fees or tuition for physical-education classes made necessary by the college for the attainment of a degree would qualify," Mr. Winter says. For instance, if you were a kinesiology major, you might be required to take physical-education classes as a condition of your program, and that could count.

Make sure you get credit for the class, however. Students aren't permitted to spend 529 money on noncredit courses without incurring the penalty, Mr. McCloskey says.

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If my student gets a scholarship, I understand I can withdraw the equivalent amount of money from my 529 without penalty, but have to pay taxes on any earnings. Is the distribution considered ordinary income or a capital gain?

If you decide to withdraw 529 money because your student has earned a scholarship, the earnings portion of your distribution is taxed as ordinary income, just like the earnings portion of IRA distributions. However, "the student's receipt of a scholarship is one of the few situations in which the additional 10% penalty on the earnings portion of nonqualified 529 plan distributions is waived," Mr. Winter says.

What you can do to mitigate the tax bill in some 529 plans is to distribute the money to the beneficiary—your student—rather than the owner of the account. This means the beneficiary will pay the taxes, at what's often a lower tax rate, Mr. McCloskey says. Check with your 529 plan to see if it allows this.

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Other than a private student loan, how can a foreign student studying in the U.S. with no green card fund graduate school here? His family can't afford the cost and, while he has a job, he can't save that much.

The U.S. military has programs that can help foreign students in this situation, including the Military Accessions Vital to the National Interest, Mr. McCloskey says. According to the Army’s website, this is a “recruiting program that allows legal noncitizens with in-demand skills to join the Army in exchange for expedited U.S. citizenship.” Once the student is in the military, and certainly once he is a citizen, he will be eligible for various kinds of college aid.

Some foreign countries also may have rules similar to those of U.S. 529 plans, which allow plan money to be spent on overseas universities as long as they meet certain criteria, Mr. Winter says. Check if this is the case in your student’s home country; if so, he may be able to use funds saved at home to study here.

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