Always Have a Plan for Leftover 529 Plan Money

With the high cost of education, it's hard to envision that there might be money left over, but it does happen. Kids get scholarships; they might finish early; sometimes they quit school never to return.

In the case of 529 college savings plans, it's particularly important to have a backup plan for the possibility of leftover funds, not only to support another family member's educational goals, but as a potential addition to your estate planning.

As a refresher, a 529 college savings plans – named for the federal law that created them in 1996 – allow a parent to open a tax-deferred college savings plan with as little as $25 to start in some states. You should know that a 529 college savings plan is NOT the same thing as a 529 prepaid college tuition plan. Prepaid tuition plans are just that – tax-deferred savings plans that allow you to save for tuition for in-state schools [though some plans allow you to transfer out a portion of those assets to out-of-state schools]. Also, it's important to note that prepaid tuition plans are not an automatic guarantee a student will get into that college.

As part of sweeping pension reform signed into law by President Bush in 2006, withdrawals from 529 plans are now permanently tax-free. In some states, contributions may also be deductible on state tax returns. All 50 states now have 529 plans college savings plans, and a majority of them provides additional incentives, such as a state-tax deduction to in-state residents who invest in their respective plan.

It's a good idea to have your financial adviser help you sort through the details of various state plans. There are various services – including Morningstar Inc. – that now rank the offerings of each state's plan. SavingforCollege.com and finaid.org are leading sites to help educate you in how these plans work.

So, if you've made all these moves, how should you handle surplus 529 funds? There are a few options:

Change the beneficiary: If Student #1 doesn't spend out the funds, you can replace the beneficiary with another blood relation – that means brother, sister, first cousin, even you or your spouse – to continue spending down those funds for educational expenses. Also, if you have a grandchild headed for college, you can arrange for your 529 plan to make the withdrawal payable to your grandchild as the beneficiary.

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Take a penalty and spend the money on whatever you want: This isn't the most sensible financial option, but you do have the option to take leftover funds as a nonqualified distribution for your own non-educational use. However, you'll owe ordinary federal tax with an additional 10 percent on the earnings portion of the distribution. Don't forget state tax, either.

Let your successor owner make the decisions. When you apply for the account, you are asked to name a successor owner. When you die, you can simply trust the successor owner or the beneficiary of the funds to do what they want with the money.

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This column is produced by the Financial Planning Association, the membership organization for the financial planning community, and is provided by Angel McCall, CFP, a local member of FPA. You will find additional informative articles at www.AngelMcCallCFP.com .