A Quick 529 Tax Tip That Could Save You Big Money

**Question**: My son will be entering college in the fall, and I own a 529 college-savings account in his name. Rather than pay tuition directly to the school, can I add the money to the 529 so I can claim the state tax deduction and then withdraw it to pay tuition?

**Answer**: At first blush your idea might strike some readers as far-fetched. Surely states wouldn’t give someone a tax break just for putting money into a 529 account for a few days, right? But the surprising answer is that many states do allow this, imposing no waiting period on 529 withdrawals and allowing account holders to deduct contributions from their state income taxes regardless of how long the money is held in the account. For families with near-term college expenses, this 529 tax loophole can be a relatively easy way to lower their state income tax bill in the process of paying tuition, room and board, and other college-related costs.

The idea is rather straightforward. Let’s say a family with a child attending school in the fall plans to pay all or a portion of tuition out of pocket. Rather than paying the school directly, the family instead adds the funds to an existing or newly opened 529 account in the student’s name and then withdraws them shortly thereafter to cover the tuition payment. This allows the family to deduct the amount of the contribution from their state income taxes, assuming their state offers a tax break on 529 contributions, they haven’t already maxed out their 529 deduction limit for the year, and their plan has no waiting limit for withdrawals.

The higher the state income tax rate and the higher its 529 tax-deduction limit, the more this strategy is likely to pay off. For example, Illinois allows residents to deduct up to $20,000 per year in contributions to its 529 plans (for a couple filing jointly, or $10,000 for an individual) and has a flat income tax rate of 5%. If a family contributed $20,000 to one of the state’s 529 plans and then withdrew the money for tuition this fall, it would gain a tax break of $1,000 ($20,000 x .05).

**First, Know the Rules**

But before embarking on this strategy, it is important to remember a few key considerations. First, it’s important to check with the 529 plan to find out what its rules are regarding when contributions may be withdrawn. Plans may impose a waiting period of a few days or weeks before withdrawals may be made to ensure that the contributed funds have cleared.

The decision as to whether to allow tax breaks for 529 contributions that are withdrawn after only a short time in the account varies from state to state, but most states do not impose a waiting period, according to FinAid.org, a college-savings website. Some states impose a one-year waiting period before 529 contributions may be withdrawn or limit the tax deduction to the amount of contributions minus withdrawals.

For residents of the 34 states that offer state income tax breaks for contributing to a 529 plan (usually for in-state plans only), this loophole could amount to tax savings of hundreds or even thousands of dollars.
Keep in Mind Federal Tax Breaks, Other Considerations

Once you've confirmed that your state does not impose a waiting period before withdrawing 529 contributions, and that you are eligible for a state income tax break on contributions, there are a few more details to keep in mind.

- Money in a 529 college-savings plan must be used for qualified college expenses, which include tuition, fees, room and board (if enrolled at least half time), books, supplies, and computer equipment used for educational purposes.
- Expenses paid for by using a 529 plan are not eligible for federal tax breaks such as the American Opportunity Tax Credit or Lifetime Learning Credit. The first of these, which is available to singles with modified adjusted gross incomes lower than $90,000 and joint filers with incomes lower than $180,000, could save you up to $2,500 on your federal taxes if you qualify, which is likely far more than you’d save on your state taxes by paying for the same expenses using money added to a 529. Therefore, before using the 529 strategy described above, think about how you can coordinate federal and state tax breaks to maximize your savings or ask a tax professional for help.
- Pay attention to your state’s tax-deduction limit on 529 contributions. Some states allow residents to deduct $20,000 or more per year in 529 contributions--Colorado's annual limit is a staggering $350,000--while others have very low annual limits--Maine only allows a deduction of $250 per beneficiary. The lower the limit (and the lower the tax rate you pay), the lower your potential savings.
- The state tax break is only for the year the 529 contribution is made. If you add money this year in anticipation of withdrawing it in 2015, the tax break for your contribution will only apply to this year.
- Invest short-term 529 contributions safely. Even for a holding period as short as a few days, make sure any money earmarked for near-term college expenses is invested in a cash-equivalent investment such as a money market offered by the plan. The last thing you want is for your tax-saving move to result in the loss of principal if the stock market happens to take a dip while your funds are invested in the 529.
- Finally, keep an eye on plan fees. If you are opening a new account or choosing a new investment option within the plan, there could be maintenance fees associated with the move, so factor those into your calculations. Likewise, paying a sales load for an advisor-sold plan probably doesn’t make sense in this instance.

Not all college savers will be able to take advantage of the 529 tax-savings loophole involving short-term contributions. But for those who can, doing so can provide at least a little relief when it comes to paying college expenses. Whether you save enough to cover a few textbooks or even just a few nights of pizza at the dorm, you might find the payoff well worth the effort.

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Before investing, carefully consider the 529 plan’s investment objectives, risks, charges, and expenses. This information and more about the plan can be found in the plan’s disclosure document, available from the plan provider, and should be read carefully before investing. Consider before investing whether your or the beneficiary’s home state offers a 529 plan that provides its taxpayers with state tax and other benefits not available through an out of state plan. As with any investment, it is possible to lose money by investing in a 529 plan.

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