The Continuing and Compelling Case for 529 Plans

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Nothing seems to be stemming the rise in college costs, which is occurring alongside a growing body of research about the importance of a college education. Studies confirm that a bachelor’s degree helps improve employability, earning power, job satisfaction, and more (see figure 1).

Yet, with income growth generally failing to keep pace with tuition, investors intent on providing loved ones with the benefits of higher education face a daunting challenge. This is especially the case for those who, spooked by market volatility, may have made ill-timed retreats from investments in recent years.

They’re playing catch-up on an investing challenge so widely known and monumental that it manages to be both familiar and shocking: For a child born in 2013, the cost to attend four years of public university—based on extrapolations using recent annualized college-cost inflation—will be around $229,000; four years of private university are expected to cost more than $510,000. (Source for tuition data: The College Board, 2013. Projections assume a 7-percent annual inflation rate.)

Such expenditures test all but the wealthiest Americans. For others, maximizing investment progress while not imperiling other key objectives—principally retirement—won’t be easy. Loans can help, and with more than $1 trillion in student loans outstanding, they’re obviously accessible. But in addition to acting as a financial drag on new grads, with interest rates on some student loans now floating, borrowing costs could rise if interest rates do.

Though financial advisors are employing a multitude of strategies to address increasing costs, here we’ll examine why the benefit profile of 529 plans makes them an attractive option, particularly for tax-sensitive, higher-net-worth investors with ambitious savings goals, estate-planning objectives, and a desire to allocate money specifically for higher education.

529 Benefits: Examined but Untouched

Signed into law in 1996, 529 college savings plans provide everyone, regardless of income, a tax-advantaged higher education savings vehicle that allows for substantial contributions and considerable flexibility.

In recent years, concerns arose that lawmakers might try to scale back the benefits of 529 plans. In the face of federal and state budget woes, the combination of universal availability, high contribution limits, tax advantages, and estate-planning opportunities were thought to be an easy target for lawmakers seeking to close budget gaps. It was not hard to imagine a scenario in which contribution limits were lowered or income limits were imposed. Yet the benefit profile of 529 plans has remained virtually unchanged.

In fact, it might be argued that 529 plans became more attractive, as additional states offered tax benefits and tax parity rose. And now more states are offering state-tax benefits for contributions to plans sponsored by other states.

With the states acting as powerful protectors of these programs and lawmakers wary of rolling back any benefit that promotes education—and, by extension, economic health and competitiveness—529 college savings plans in their current form likely will be around for some time.

Compare and Contrast

Despite widespread adoption of 529 plans since their creation a decade and...
a half ago, a number of other higher-education funding strategies remain in use. And for those with aggressive college-savings approaches, as well as estate-planning needs, it’s valuable to examine the benefits they offer.

Covered Education Savings Accounts
Covered Education Savings Accounts offer tax-free growth, and withdrawals can be used to pay qualified expenses in elementary and high school, as well as college. Covered accounts also feature considerable investment flexibility, allowing one to invest in mutual funds, individual stocks, exchange-traded funds, etc.

However, several factors may make them less than ideal for an investor whose goal is a sizable share of the college bill. These include relatively low income limits and contribution maximums. Only individuals earning less than $190,000 a year ($220,000 for couples) can contribute to a Covered account. The contribution limit is $2,000 per tax year per beneficiary. For example, if a parent contributed $1,500 to Account A that they established for a child, the child’s grandparents could contribute a maximum of $500 to Account B, which they established for the same child.

Every invested dollar helps, but these contribution limits—together with an abbreviated time horizon and a portfolio that should rightfully become more conservative as enrollment nears—means a Covered account alone likely wouldn’t come close to covering a beneficiary’s college costs. For those facing private school costs prior to college, however, a strategy involving both Covered and 529 accounts may make sense.

UGMA/UTMA Accounts
Historically, many higher-net-worth individuals have employed Uniform Gifts to Minors Act or Uniform Transfers to Minors Act (UGMA/UTMA) accounts as college savings vehicles because such accounts could be funded heavily enough to meet the challenge. Yet slowing growth among such accounts suggests their function has been significantly usurped by 529 plans.

Though UGMA and UTMA accounts have estate-planning benefits, as college savings vehicles they come with some significant drawbacks in that their assets—relative to 529 plan assets—generally are not treated as favorably in financial aid calculations (see sidebar). That’s because assets regarded as the property of the student (as UGMA/UTMA assets are) are considered less favorably in financial aid calculations than assets considered the property of a parent (as 529 assets most often are).

Also, an UGMA/UTMA-based approach doesn’t offer tax-free growth or officially earmark assets for higher-education purposes; it ultimately cedes control of assets to the account owner when he or she reaches the age of majority. So UGMA and UTMA accounts offer neither assurance nor recourse to those aiming to allocate assets for a specific purpose such as college education.

Roth IRAs
Another strategy getting wider use is the Roth individual retirement account (IRA). This approach takes advantage of the fact that withdrawals of contributions from Roth IRAs are tax-free. It’s successful because it eliminates the need for investors to choose between funding retirement or funding college. By intentionally channeling education savings into a Roth IRA, the argument goes, the investor can avoid locking assets into a single use and deploy money as needed. That said, a Roth IRA-based strategy has meaningful drawbacks.

For one, income limits make many higher-net-worth individuals ineligible for Roth IRAs. And those who meet the eligibility requirements face contribution limits, because Roth IRA contributions are capped at $5,500 per year ($6,500 for those age 50 or older). This is significantly lower than $14,000 per year ($28,000 per married couple), the amounts one can contribute annually to a 529 account without gift-tax considerations. It’s also far below the $70,000 ($140,000 per couple) one can contribute in a single year using the 529 plan’s accelerated gifting provision.

With respect to income limits, some argue they are moot given that the Internal Revenue Service recently began to allow anyone to convert a traditional IRA to a Roth IRA. However, close
examination of the rules governing such conversions reveals intricacies and tax consequences that may sharply curb the Roth IRA's appeal.

Moreover, though withdrawals of earnings made from a Roth prior to age 59½ that are used to pay qualified educational expenses generally aren’t subject to the 10-percent tax penalty, in general they are subject to income tax. And because the children of parents in their 30s typically reach college age before their parents turn age 59½, younger investors using Roth assets to fund higher education will not sidestep taxation on earnings. True, Roth contributions—as opposed to earnings—can be taken out tax-free before age 59½, but contributions alone may not be sufficient to meet college expenses.

Some believe that putting educational assets in a Roth IRA in effect shields them from financial aid calculations, which could result in a more attractive aid package than if assets were held in a 529 account. However, the federal student-aid formula does count Roth IRA distributions as untaxed income for financial aid purposes.

Perhaps most importantly, those without access to employer-sponsored retirement plans or whose employer-sponsored plans offer unappealing options likely will need IRA investments for their intended purpose—accruing retirement savings.

**Taxable Investments**

Lastly, some may wish to avoid restrictions altogether by saving for the goal in a taxable account.

This approach may hold appeal for those who wonder what will happen if they need the money for other purposes or who worry about the implications should their child get a scholarship or opt not to attend college. These are legitimate questions, but it’s important to acknowledge that although 529 plans have restrictions, they’re far from restrictive. For one, they allow beneficiary changes within families, so assets not used for one child can be used by other family members. Moreover, there’s no deadline for using account assets, so owners who can’t find qualified educational expense for leftover 529 assets will not be forced to make a taxable withdrawal.

In the end, the benefits and estate-planning potential offered by 529 plans present a compelling alternative to investors worried over the worst-case scenario of paying taxes on gains (a certainty with taxable strategies) and a federal tax penalty.

### One Benefit That Sets 529 Plans Apart

When you compare and contrast college savings options, each has appealing aspects. But in addition to intrinsic benefits such as flexibility, tax-free growth, and high contribution limits, the estate-planning potential of 529 plans is unique. That’s because, for estate-planning purposes, 529 plan contributions are considered completed gifts yet they allow the contributor to retain control of how the assets are invested as well as when, and in what amount, they’re withdrawn.

Consider that those looking to transfer sizable sums out of their estates can use an accelerated funding provision to give as much as $70,000 ($140,000 per couple) at one time by combining up to five years of gifts into a single contribution without incurring gift-tax consequences. (Note that if the contributor dies within five calendar years of making the accelerated gifting election, the portion of the contribution [not earnings] allocable to the years after the year of the contributor’s death will be included in the contributor’s estate for estate-tax purposes.) And the number of beneficiaries they can contribute to is unlimited. Thus, grandparents seeking to transfer money out of their estate and make a huge contribution to their seven grandchildren’s higher-education savings goals could contribute nearly $1 million instantly (7 × $140,000 = $980,000).

Furthermore, if the contributor is allocating assets specifically for higher education, 529 plans are the only option that allows one to “take back” the gifted assets if the beneficiary chooses not to attend college. (If 529 assets are taken back, however, earnings become taxable and there is a 10-percent tax penalty.) With UGMA/UTMA accounts, gifts become the recipient’s property when the recipient reaches the age of majority, at which point the account assets can be spent however the beneficiary chooses. Coverdell accounts also become the beneficiary’s property if they’re unused by the time the beneficiary reaches age 30.

### The Total Package

In the final analysis, the benefits and features of 529 plans that have drawn so many investors remain highly appealing:

- **High contribution limits.** Many plans allow contributions until the account value reaches as much as $400,000.

- **Beneficiary flexibility.** You can change beneficiaries as often as you wish, and there are no tax consequences when the new beneficiary is a member of the previous beneficiary’s family.

- **Financial aid treatment.** Though there is no single answer to the question of how 529 plan assets affect financial aid calculations, assets that are considered the property of the account owner (most often the parents) rather than the beneficiary may be treated more favorably than assets in some other savings strategies.

- **Lack of income restrictions.** Anyone can open a 529 account regardless of how much money they make.

- **Tax-free growth.** Earnings and distributions are tax-free provided they go toward qualified higher-education expenses of the beneficiary. But if withdrawals are used for purposes other than higher education, the earnings will be subject to a 10-percent federal tax penalty in addition to federal and, if applicable, state income tax.

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**State tax deductions.** Many states allow a tax deduction or credit for investments made to a 529 plan. And while often the benefit is available only to investors who use their home state’s plan(s), an increasing number of states allow a benefit for contributions to any state’s 529 plan.

**Estate-planning potential.** The high contribution amounts allowed by 529 plans make them an effective means of using gift-tax exemptions to move assets out of one’s estate. By combining five years’ worth of contributions into a single gift, account owners could transfer $70,000 ($140,000 for married couples) for each beneficiary out of their estate without tax consequences.

**Retained control.** Unlike any other investment vehicle, contributions to 529 plans are considered completed gifts for estate-tax purposes but leave the gift-giver in control of the assets and preserve the option to take funds back should the owner so choose.

This combination of benefits makes a strong case for using a 529 college savings plan as the centerpiece of a higher-education savings strategy.

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