ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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Which States Reward College Savers?

The last *Adviser Fund Update* focused on the basics of 529 plans. In this edition, we'll continue examining 529s with a look at tax implications, management considerations and the implications on financial aid eligibility.

529 Tax Implications

Contributions to 529 plans are not tax deductible, though earnings made in the plans are not subject to federal taxes when used properly. Account owners can make annual gifts of up to $14,000 for single tax filers and $28,000 for those filing jointly to a beneficiary without facing a federal gift tax. Withdrawals also can have tax implications. Even if you know the exact amount of tuition you want to withdraw, make sure to subtract any grants or scholarships. As we discussed last time, taking out more money than you need for education-related expenses can lead to a paying federal income tax and a 10% penalty on the difference between qualified and non-qualified distributions.

More than 30 states currently offer a tax credit or deduction on 529 plans. If you live in one of these states, there's a strong incentive to invest at home. Arizona, Kansas, Maine, Missouri and Pennsylvania offer tax parity, meaning you can invest in *any* state's plan and get the tax benefits.

Tax Parity States

State	Maximum Annual 529 Deduction
Arizona	$750 single or head of household/$1,500 joint
Kansas	$3,000 single/$6,000 joint per beneficiary
Maine	Up to $250 per beneficiary (any state plan) for contributors with adjusted gross income of $100,000 or less if single filer or $200,000 or less if filing jointly
Missouri	$8,000 single/$16,000 joint per beneficiary
Pennsylvania	Up to $12,000 per beneficiary per taxpayer

State Tax Deductions

State	Maximum Annual 529 Deduction
Alabama	$5,000 per parent
Arkansas	$5,000 per parent
Colorado	Fully deductible up to contributor's adjusted gross income

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Connecticut	$5,000 per parent
Georgia	$2,000 per beneficiary per tax return
Idaho	$4,000 single/$8,000 joint
Illinois	$10,000 single/$20,000 joint per beneficiary (25% tax credit for employers for matching contributions up to $500 per employee)
Indiana	20% tax credit on contributions up to $5,000
Iowa	$2,685 per beneficiary (adjusted annually for inflation)
Louisiana	$2,400 single/$4,800 joint per beneficiary
Maryland	$2,500 per beneficiary per year with a 10-year carry forward of excess contributions
Michigan	$5,000 per parent
Mississippi	$10,000 single/$20,000 joint
Montana	$3,000 single/$6,000 joint
Nebraska	$5,000 per tax return ($2,500 if filing separate)
New Mexico	Full amount of contribution
New York	$5,000 per parent
North Carolina	$2,500 single/$5,000 joint
North Dakota	$5,000 per parent
Ohio	$2,000 per beneficiary
Oklahoma	Up to $10,000 per contributor per year with a 5-year carry forward of excess contributions
Oregon	Up to $2,000 for single filers/$4,000 for joint filers
Rhode Island	$500 single/$1,000 joint, unlimited carry forward of excess contributions
South Carolina	Full amount of contribution
Utah	5% tax credit on contributions up to $1,650 per beneficiary for single filers or $3,300 per beneficiary for joint filers
Vermont	10% tax credit on up to $2,500 in contributions per beneficiary
Virginia	$4,000 per account per year (no limit age 70 and older), unlimited carry forward of excess contributions
Washington, DC	$4,000 single/$8,000 joint
West Virginia	Full amount of contribution
Wisconsin	$3,000 per dependent beneficiary, self or grandchild

No State-Specific Benefits

No State Tax Deduction	No State Income Tax
California	Alaska
Delaware	Florida
Hawaii	Nevada
Kentucky	Oklahoma
Massachusetts	South Dakota
Minnesota	Texas
New Hampshire	Washington
New Jersey	Wyoming
Tennessee	

Managing Your 529 Plan

As many investors scale back their equity allocation and opt for more fixed-income investments as they approach and enter retirement, a similar strategy can make sense with college savings 529 plans. If you start early, it may make sense to weight the 529's investments more towards equities, which generally have better long-term growth potential than bonds or cash. Once college expenses come closer, you might feel that a heavier weighting to fixed-income is more appropriate to protect your earnings and make sure that you are insulated against market declines now that you actually need the money. Be aware, however, that under current law, you can only change your investment option once a year without getting a tax bill.

(Speaking of retirement, parents need to consider their own priorities if weighing the decision to only fund their own retirement portfolio or their children's 529 funds. After all, your kids can always borrow money for college. You can't borrow money for retirement.)

Most plans offer at least a handful (if not more) of individual fund options focused on stocks, bonds or money markets with which to create a customizable portfolio and may have some pre-built portfolios to choose among. College savers can also opt for age-based 529 investment tracks to avoid the legwork of reallocating on their own. Vanguard, for example, offers a questionnaire for parents to determine their risk tolerance. Once set on a conservative, moderate or aggressive course, Vanguard will automatically adjust asset allocation over time, gradually shifting from stocks to bonds as the beneficiary approaches college age. Many other plans share similar age-based tracks for hands-off investors.

Financial Aid Implications

The College Cost Reduction and Access Act of 2007 (CCRAA) enacted legislation to treat assets held in 529 prepaid tuition plans and college savings plans as parental assets (rather than as belonging to the student), and thus generally have little impact on a student's federal financial aid eligibility. Savings in 529 funds are reported on the student's Free Application for Financial Aid (FAFSA) as parental assets, which are currently assessed at 5.64%. For example, under the CCRAA, if a student's parents have $25,000 in a 529 plan, only $1,410 will be considered the student's "Expected Family Contribution."

Let's walk through an example, assuming you file the FAFSA aid application when your child is a high school senior. You have a 529 account with $100,000 in it, of which $50,000 was your initial contribution and $50,000 is earnings. In the first year, your child's eligibility for federal financial aid will decrease by no more than 5.64% of the account value, or $5,640. Assuming the account value stays the same over the course of the year and you withdraw $20,000 to pay for freshman year education expenses, when you apply for sophomore year aid, your account value is now $80,000, which is again assessed at 5.64%, or $4,512. The $20,000 withdrawal included $10,000 of excluded earnings with it, but none of the withdrawal is counted as financial aid income.

There is a widespread misunderstanding, even on the websites of many plan administrators, of the impact of a grandparent's 529 plan on a student's eligibility for need-based financial aid. True, the value of 529 plan assets owned by a grandparent (or any non-parent) is not reportable on the FAFSA application.

However, precisely because grandparent-owned 529s do not have to be reported as an asset on FAFSA applications, any distributions from those 529s are considered untaxed student income on the next year's FAFSA. Any financial support given to a student from grandparents, even 529 distributions, counts as untaxed income and is reportable on the next year's FAFSA as student income.

There are ways to circumvent this. The savvy grandparent might wait to use the 529 account to pay for senior year of college, when the student will not need to worry about applying for financial aid again. Grandparents can also transfer the account to a parent, so the 529 counts as parental assets, as seen above. Finally, grandparents can wait until the student has graduated and take a non-qualified distribution (perhaps to pay off student loans). While you'll pay income taxes and a penalty on the earnings of non-qualified distributions, those hits can be less than losing eligibility as a result of untaxed income going to the student via 529 distributions.

Next Time

In the next Adviser Fund Update, we'll conclude our series on 529s with an in-depth look under the hood of several popular plans, including the Maryland College Investment Plan, T. Rowe Price College Savings Plan, The Vanguard 529 and the Utah Educational Plan.