ADVISER INVESTMENTS

SPECIAL REPORT

Smart Ways to Save (and Pay) for Education

THE BENEFITS OF 529 PLANS

You have heard the horror stories. Today's average annual cost of tuition, room and board at a four-year private college is a whopping $53,217. While it seems a bargain by comparison, even the average cost of a four-year state school is a steep $25,487 for residents (and a hefty $43,161 for out-of-state enrollees). And the price continues to climb—jumping some 50% for private schools from the 2011–2012 academic year to the 2020-2021 one.

At Adviser Investments, we've been helping clients plan for the cost of education since our 1994 founding. And while there are a number of ways to save, 529 plans are an attractive option for a wide range of people because of their high contribution limits, federal tax benefits, potential home-state tax incentives, flexibility in choosing and changing beneficiaries, and the ease with which they can be established and funded. And as of 2018, you can use them for private elementary and secondary school tuition as well. Here's what you need to know.

529 Plans

529 plans are designed specifically for investors helping a child, relative, friend or even themselves save for tuition and expenses related to private K–12 and higher education. Plans are sponsored by states, generally in partnership with a mutual fund company or institute of learning. 529 plans offer a number of savings and investment options to choose from or a means of locking in today's tuition rates for use in the future.

Anyone can open a 529 plan account for a designated beneficiary. All withdrawals that go toward "qualified educational expenses," which, depending on the plan type, can include tuition, room and board, books, a computer and peripherals, and even internet access, are exempt from federal and (usually) state taxes.

There are no income restrictions and no limit to the number of plans you can contribute to, though withdrawals above and beyond the costs of qualified education expenses (called "nonqualified withdrawals") are subject to federal and state income tax, as well as a 10% penalty.

Two Types of 529s, Both Tax-Exempt

There are two types of 529 plans: Savings plans and prepaid tuition plans. States have their own unique plans and are allowed to offer both if they wish. Many states offer additional tax benefits for residents, but you are not restricted to the plan in your home state. For certain investors it is worthwhile to explore plans in other states to find the best fit. Take a look at the table on page 3 to see a list of characteristics for each.

TYPE ONE: SAVINGS PLANS

A good comparison for 529 savings plans is the Roth IRA. Like a Roth IRA, 529 savings plan contributions cannot be deducted from federal taxes and approved withdrawals (education expenses instead of retirement income) are tax-free.

Your 529 savings plan will be invested in mutual funds, so your return depends on the performance of the holdings in your portfolio. You'll have the opportunity to invest in a selection of individual stock, bond and money market funds, and many plans feature diversified portfolios, including age-based options that automatically reallocate funds from stock holdings to lower-risk bond and money market funds as the plan's beneficiary gets closer to needing them.

Investors can pick from two types of 529 savings plans. In direct-sold plans, you pay no sales charges and are responsible for choosing your investment options. This type of plan is good for the cost-conscious do-it-yourselfer who doesn't mind taking the time to research which state's plan is the best fit and is comfortable choosing among the available investment options.

If you do not wish to pick your own investments, you can go through a broker to invest your money for you, but this comes at a price. Broker-sold programs can be subject to costs such as sales charges and/or annual distribution fees, all of which can cut deeply into your potential gains. Many broker-sold plans use a different set of investment options from those available from low-cost firms like Vanguard and Fidelity, typically with much higher annual costs.

Whether you buy direct or through a broker, many states offer tax incentives for residents who contribute to 529 plans, although not all states give deductions (the tables on the next pages indicate whether your state offers a deduction).

TYPE TWO: PREPAID TUITION PLANS

Prepaid tuition plans enable college savers to buy credits at participating schools to lock in current tuition prices. (As of May 2022, it does not appear that any private K–12 schools offer these plans.) Most prepaid tuition plans are sponsored by state governments for residents and cover tuition and fees only (books and room and board are excluded). They are typically guaranteed by the state backing them.

With prepaid tuition plans, you are not investing in mutual funds—instead, you are making a bet on rising tuition prices. Depending on the state or plan, there may be some flexibility as to where you can apply your credits, but these types of plans are often optimized for in-state school tuition. For out-of-state or private schools, you may find yourself having to make up the difference between the plan's assigned value and tuition costs out of pocket (some private schools do participate in prepaid tuition plans, however).

Note that these plans *do not* guarantee admission to participating schools. If your beneficiary chooses not to attend college or is not accepted, most states have refund options, or the plan can be transferred to another family member. Prepaid plans can be a good fit for some, but they have more strings attached than savings plans and offer less of an opportunity to grow your investment beyond the cost of in-state college tuition.

Tax Implications and Wealth-Transfer Benefits

Contributions to 529 plans are not deductible from federal taxes, though earnings made in the plans are not taxed when used for allowed education expenses. Account owners can make annual gifts of up to $16,000 per beneficiary for single tax filers ($32,000 for those filing jointly) without exceeding the annual federal gift tax limit.

529s can work well as wealth-transfer and estate-planning vehicles. You can make a one-time contribution of up to $80,000 ($160,000 if married, filing jointly) for as many beneficiaries as you like. In this case, for gift-tax purposes, the deposits are treated as if they were made over a five-year period. The benefit to those who can afford to do so is two-fold: It moves a big chunk of money out of your estate in one fell swoop and it front-loads the 529 plan with a large sum that can immediately begin compounding upon itself as its investments grow.

The Two Types of 529 Plans

College Savings Plan	Prepaid Tuition Plan
No lock on education costs.	Locks in tuition prices at eligible public and private colleges and universities.
Covers all qualified higher education expenses: Tuition, room and board, fees, books, computers, internet access. $10,000 in withdrawals a year permitted tax-free per beneficiary for K–12 tuition.	Plans typically cover tuition and mandatory fees only.
Many plans have contribution limits in excess of $300,000 per beneficiary.	Most plans set lump sum and installment payments prior to purchase based on age of beneficiary and number of years of tuition purchased.
Investment options are subject to market risk. Your investment could decline in value.	Many plans are backed or guaranteed by the sponsoring state.
No age limit. Open to adults and children.	Most plans have age/grade limit for beneficiary.
No residency requirement. Nonresidents may only be able to purchase some plans through financial advisers or brokers.	Most state plans require owner or beneficiary to be a resident.
Account owner can change beneficiary to another family member.	Refunds or transfer options vary state by state.
Enrollment open all year.	Most plans have limited enrollment period.

Sources: *Smart Saving for College*, NASD.

States That Offer Tax Deductions or Credits (for contributions to in-state plans)

State	Maximum Annual 529 Deduction
Alabama	$5,000 single/$10,000 joint per beneficiary
Arkansas	$5,000 single/$10,000 joint per beneficiary ($3,000/$6,000 for out-of-state plans)
Colorado	Full contribution amount up to contributor's adjusted gross income
Connecticut	$5,000 single/$10,000 joint per beneficiary, five-year carryforward of excess contributions
District of Columbia	$4,000 single/$8,000 joint per beneficiary, five-year carryforward of excess contributions
Georgia	$4,000 single/$8,000 joint per beneficiary
Idaho	$6,000 single/$12,000 joint per beneficiary
Illinois	$10,000 single/$20,000 joint per beneficiary
Indiana	20% tax credit on contributions up to $5,000 ($1,000 maximum credit)
Iowa	$3,522/$7,044 joint per beneficiary
Louisiana	$2,400 single/$4,800 joint per beneficiary, unlimited carryforward of excess contributions
Maryland	$2,500 single/$5,000 joint per beneficiary, 10-year carryforward of excess contributions
Massachusetts	$1,000 single/$2,000 joint per beneficiary
Michigan	$5,000 single/$10,000 joint per beneficiary
Mississippi	$10,000 single/$20,000 joint per beneficiary
Nebraska	$10,000 per tax return; $5,000 if married filing separately
New Mexico	Full amount of contribution
New York	$5,000 single/$10,000 joint per beneficiary
North Dakota	$5,000 single/$10,000 joint per beneficiary
Ohio	$4,000 per beneficiary, unlimited carryforward of excess contributions
Oklahoma	$10,000 single/$20,000 joint per beneficiary, five-year carryforward of excess contributions
Oregon	$150 single/$300 joint per beneficiary up to $30,000 adjusted gross income (higher income lowers deduction percentage)
Rhode Island	$500 single/$1,000 joint per beneficiary, unlimited carryforward of excess contributions
South Carolina	Full amount of contribution, including rollover contributions
Utah	5% tax credit on contributions up to $2,130 per beneficiary for single filers or $4,260 per beneficiary for joint filers, with maximum credit of $105.44/$210.87
Vermont	10% tax credit on up to $2,500 in contributions single/$5,000 joint (maximum credit $250/$500 per beneficiary)
Virginia	$4,000 per beneficiary per year (fully deductible age 70 and older), unlimited carryforward of excess contributions
West Virginia	Full amount of contribution
Wisconsin	$3,560 per beneficiary; $1,780 if married filing separately

Note: Information as of May 1, 2022. Sources: Savingforcollege.com, finaid.org.

It goes without saying that parents need to consider their own priorities if weighing the choice between funding their own retirement portfolio versus a child's 529 account. After all, your child can always borrow money for college. You can't borrow money for retirement.

When the time comes, withdrawals from 529 plans can have tax implications. Even if you know the exact amount of tuition you want to withdraw, it's imperative that you make sure to subtract any grants or scholarships earned by the beneficiary. Why? Because taking out more money than is needed for education-related expenses can lead to federal taxes and a 10% penalty on the difference between qualified and nonqualified distributions.

Currently, 29 states and the District of Columbia offer account owners a tax credit or deduction for contributions to their state's 529 plans. If you live in one of these states, there could be a strong incentive to invest at home. Arizona, Arkansas, Kansas, Minnesota, Missouri, Montana and Pennsylvania offer tax parity, meaning residents can invest in any state's plan and get their state's tax benefits (see table on page 4).

Though the tax bill signed into law in December 2017 permits 529 account owners to use up to $10,000 annually per beneficiary for private K–12 school tuition, not every state has reconciled their 529 rules with the new federal code. Consult a tax professional before assuming these state deductions will apply to K–12 tuition.

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Tax Parity States

State	Maximum Annual 529 Deduction
Arizona	$2,000 single/$4,000 joint per beneficiary
Arkansas	$3,000 single/$6,000 joint per beneficiary ($5,000/$10,000 for in-state plan)
Kansas	$3,000 single/$6,000 joint per beneficiary
Minnesota	$1,500 single/$3,000 joint per beneficiary (Or a credit of 50% of contributions—minus any withdrawals—up to $500, subject to a phaseout schedule starting at a $75,000 income threshold)
Missouri	$8,000 single/$16,000 joint per beneficiary
Montana	$3,000 single/$6,000 joint per beneficiary
Pennsylvania	$15,000 single/$30,000 joint per beneficiary

Note: These states offer deductions for contributions to *any* state's 529 plan. Information as of March 1, 2021. Source: Savingforcollege.com, finaid.org.

Managing Your 529 Plan

If you fund a 529 plan when your beneficiary is an infant, with an 18-year time horizon, it may make sense to allocate the plan's investments heavily toward stocks, which generally have better long-term growth potential than bonds or cash. As the student gets closer to heading off to college, you might feel that bonds or cash are more appropriate to protect your earnings and to insulate against market declines when you actually need to spend the money. Under current tax law, you can reallocate your account twice a year, and you can change how future contributions are allocated as often as you like.

Age-based 529 plan portfolios manage allocation decisions for you, though they tend to be conservative in their approach. 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 the portfolio over time, gradually shifting from stocks to bonds as college age approaches. Fidelity's 529 plans, among many others, share similar risk- or age-based tracks for more hands-off investors.

Financial Aid Implications

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

Special Rules for Grandparents

There are a few wrinkles when it comes to withdrawals and a student's eligibility for need-based financial aid: The value of 529 plan assets owned by any non-guardian is not reportable on the FAFSA application.

However, because non-guardian 529s do not have to be reported, any distributions from them, or any other financial support, is considered untaxed student income on a future year's FAFSA. And as of the 2017–2018 academic year, 529 plan distributions are reported as student income two years after those funds were used for qualified expenses.

The savvy grandparent might wait to use the 529 account to help pay for junior and senior years of college, when the student will not need to worry about applying for financial aid again (unless they will seek aid for graduate school within the next two years). 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 nonqualified distribution (perhaps to pay off student loans). While you'll pay income taxes and a penalty on the earnings of nonqualified withdrawals, those costs could be less onerous than losing financial aid eligibility as a result of untaxed income going to the student via 529 distributions.

Next Steps

As you can see, there are many considerations in finding the right education-saving investment plan for you. We recommend working with a trusted financial adviser, not a broker, to determine the best way for you to help the future scholars in your life. Our wealth managers at Adviser Investments are happy to consult with clients regarding education savings as well as any other accounts, investments or financial planning topics they may have questions about.