MAUREEN LENEGHAN, CPA, CFP®, CGMA, DIRECTOR OF FINANCIAL PLANNING

BREAK ON THROUGH – SAVING FOR COLLEGE WITH A 529 PLAN

BY MAUREEN LENEGHAN CPA, CFP®, CGMA, DIRECTOR OF FINANCIAL PLANNING

Break on Through is a short documentary film I recently saw as part of the 2018/2019 Banff World Tour Films. It chronicles then 20-year-old Boulder, Colorado rock climber, Margo Hayes in 2017, as she became the first women to climb 5.15 rated (top difficulty scale) iconic mountains in Spain and France. As I write this article on College Savings, I cannot help but think parents, students, and grandparents may feel like Margo in the picture below when tasked with funding a college education.

Source: Photo by Greg Mionske

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Their concern is justified. According to a report by College Board, "between 2008-2009 and 2018-2019, published in-state tuition and fees at public four-year institutions increased at an average rate of 3.1% per year beyond inflation, compared with average annual increase of 4.1% and 4.2% over the prior two decades. The Median Family income in the United States increased at an average rate of .8% per year between 2008 and 2017 (after adjusting for inflation)."[1]

The chart below shows the 2018-2019 Average Cost of Tuition and Fees per the College Board Annual Survey of Colleges. Now, multiply these figures by 4 to 5 years and then for each child, and that is a daunting challenge.

	Public, In-State	Public, Out-of-State	Private
Tuition & Fees	$10,230	$26,290	$35,890
Tuition & Fees and Room & Board	$21,370	$37,430	$48,510

Source: College Board, Annual Survey of Colleges: NCES, IPEDS Fall 2016 Enrollment data and IPEDS 2017 Institutional Characteristics Data

There are many ways to fund a college education: grants, scholarships, student loans, private loans, employer plans, savings, and gifts. This issue of ClearPoint will focus on the popular Qualified Tuition Plans (also known as 529 Plans) and address some of the most common questions we receive on 529 Plans.

WHAT IS A QUALIFIED TUITION PLAN?

Qualified Tuition Plans, better known as 529 Plans, are authorized under Internal Revenue Code Section 529 and are tax advantaged savings plans designed to encourage saving for future education costs. There are two types of these plans: Prepaid Tuition Plans and Education Savings Plans.

Prepaid Tuition Plans: These plans allow the account holder to purchase units or credits at participating colleges and universities (usually public, in-state) for future tuition and mandatory fees at current prices. There are two types of prepaid plans: state-sponsored and the Private College 529 Plan. There are 11 states that have open state-sponsored plans, 9 of which have residency requirements and may be backed by the full faith and credit of the state. The Private College 529 Plan has 300 member colleges and they are backed by the colleges and universities in the plan.[2] The advantages of Prepaid Tuition Plans are locking-in tuition rates at today's cost, with no investment decisions or limit on the amount you can save, and the ability to choose a different school and receive the average in-state tuition payment to be used at another school. However, prepaid plans have several disadvantages, including limited college options for the child, potentially paying current costs if a child chooses a school outside the plan, only covering tuition and fees, less flexibility in funding since you sign a contract, limitations on transferring the account to another person, and, if not used for college tuition, only receiving the original investment with minimal or no return.

Education Savings Plans: These are the more popular 529 Plans that allow the account owner to open an investment account to save for a beneficiary's tuition, mandatory fees, room and board, and some computer equipment and services (internet). Withdrawals from Education Savings Plans can generally be used at any U.S. college and university and some non-U.S. universities. Additionally, with the Tax Cuts and Job Act of 2017, Education Savings Plans can now be used to pay up to $10,000 per year per beneficiary for tuition at a public, private, or religious elementary or secondary school. Unlike Prepaid Tuition Plans, investors can invest in other state plans without residency requirements or the student attending that states' universities.

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CHOOSING A 529 EDUCATION SAVINGS PLAN

Nearly all 50 states, the District of Columbia, and investment companies like Fidelity or Schwab offer 529 Plans. With over 90 plans available and a choice between Direct Plans and Broker Advised Plans, investors must research plans and choose the best option for them based on investment options, investment expense ratios, account and maintenance fees, and state tax incentives. Direct Plans are offered by most of the states and investment companies, and these plans usually have lower account and maintenance expenses, index fund investments with lower expense ratios, and possible special incentives if you are a resident of that state with an income tax deduction, matching contribution, scholarship or financial aid boost, or creditor protection. According to SavingforCollege.com, "broker sold plans generally have higher annual costs and may include sales charges from 1 to 5.75 percent."[3] With Broker Advised Plans you receive advice from a financial professional, whereas with a Direct Plan you will have to do some research to find the best plan. SavingforCollege.com and FINRA are excellent resources for evaluating plans. We would recommend you consider a Direct Plan.

WHAT MAKES THE EDUCATION SAVING PLANS SO APPEALING?

Tax-Free Growth: Contributions to a 529 Plan are made with after-tax dollars, but the earnings growth will be tax-fee if the withdrawals are used for qualified education expenses. If withdrawals are made for non-qualified expenses, then the earnings portion will be subject to tax and a 10% penalty. The contribution amount is never subject to tax or penalty, only the earnings. However, there are some exceptions to the 10% penalty. The most frequently asked question is if a beneficiary receives a scholarship, can the owner or student withdraw the amount of the scholarship? In this situation, the portion of the withdrawal attributed to earnings will be taxable, but the 10% penalty will not apply. Qualified expenses and exceptions to the 10% penalty are:

Qualified Expenses

Tuition, fees, books, computers and related equipment, supplies, special needs, room and board* at eligible institutions, if at least a ½ time student, internet, and $10,000 for K-12 tuition expense at private, public, or religious schools.

**Room and Board - If living in campus-owned dormitories, the amount you can include is the amount the school charges for its room and board. If your student is living off-campus or at home, ask the financial aid department for the room and board allowance for students living at home with parents or living elsewhere on campus.*

Exceptions to the 10% Penalty

- Beneficiary passes away or becomes disabled
- The beneficiary received a scholarship
- Beneficiary attends a U.S. Military Academy
- Other – beneficiary received Veteran's educational assistance, education assistance through qualified employer program ($5,250 excluded from penalty), or any nontaxable (tax-free) payments (other than gift or inheritance) received as educational assistance; amounts included in income only because the qualified education expenses were taken into account in determining the American Opportunity or Lifetime Learning credit.

Ease of Use: Many plans offer low initial investments, low systematic contributions, and low or no enrollment and maintenance fees.

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Ownership: The donor can stay in control of the account even though the funds are out of their estate. This is unlike other gifts where the donor must give up control of the funds. The donor can also change the beneficiary to a beneficiary's family member, which has a very broad definition:

> *Beneficiary family member: Son, daughter, stepchild, foster child, adopted child, or descendant of any of them; brother, sister, step-brother, step-sister; father or mother or ancestor of either; stepfather or stepmother; son or daughter of brother or sister; brother or sister of father and mother, son, daughter, father, mother, brother, sister -in laws; the spouse of any individual listed, and first cousin.*

The two most common questions under Ownership are what is the financial aid impact on the Federal Student Financial Aid (FAFSA) and how do you change the account owner?

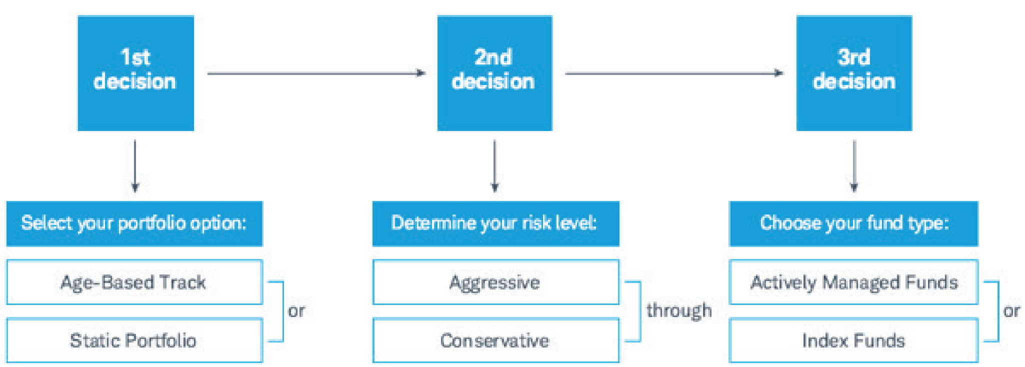
FAFSA – Federal Student Financial Aid

- If the account owner is parent or dependent student: assets are considered owned by the parent. A maximum of 5.64% of parental assets are used in the Expected Family Contribution calculation (EFC).
- If the account owner is the grandparent or anyone else: when the grandparent or another person withdraws funds for the student's education, the withdrawal will be counted as the student's income on the FAFSA. Student income is assessed at 50%, and the higher the EFC means less financial aid. The FAFSA looks at income two years prior, so one strategy is to avoid withdrawing assets until the student's second semester of college if graduating in four years.

Change Account Owner

When changing the account owner, it is important to be mindful that the new owner has total control over the account and could withdraw the funds for their own use and/or change the beneficiary and that changing the owner may also trigger gift and generation skipping tax.

Investment Options: Plans offer a variety of investment options from cash equivalents, certificate of deposits, to investment portfolios. Many plans have ready-made investment portfolios, or allow you to build your own portfolio. The chart below shows a typical decision tree to assist account owners in selecting a portfolio based on their investment acumen, time horizon, risk profile, and how often they want to re-evaluate their investment selection. With an age-based plan, the investment allocation will automatically move to more conservative investment as the child ages, whereas a static portfolio will require the account owner to make the changes. One caveat of 529 Plans, is that you can only change the investments twice every calendar year or when there is change in the designated beneficiary. You can only roll-over the account once per 12-month period. Do your research before rolling funds out of a state plan to determine if there are any tax consequences, as many states will recapture any tax benefit you have received.



Source: https://www.schwab.com/public/schwab/investing/accounts_products/accounts/college_savings/529_plan

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Gifting: Contributions to 529 Plans are treated as gifts to the named beneficiary for gift and generation-skipping transfer tax purposes. Individuals may gift up to $15,000 to each individual ($30,000 if married) without incurring a gift tax. 529 Plans have a special provision allowing 5 years of annual exclusion gifting in the first year. This means an individual could give each beneficiary $75,000 ($150,000 if married) in the first year and elect to treat the gift as made over a 5-calendar-year period on their gift tax return. If the donor dies during the 5-year period, a portion of the gift will be added back to the donor's estate.

Time Restrictions: There are no time restrictions unless imposed by plan. Funds can stay in the plan for as long as the plan allows, and you may be able to transfer unused funds to grandchildren or hold for graduation or other life-time learning education.

State Tax Benefits: Many states offer tax credits, income offset for contributions, or matching on 529 contributions. Each state has different rules, so you need to check with your state. To get the state tax benefits, you usually must participate in the state-sponsored plan. It is important to weigh the tax benefits against the program rating for investment options and fees to make sure the credit is worthy of consideration.

If you have a chance to catch the documentary, *Break on Through*, you'll see Margo with marked paper taped to the wall, diligently studying, preparing, and reviewing each hand and foot step to successfully ascend to the top. Funding college expenses will be less daunting if you choose the proper funding vehicle and investments, select a plan and investments with low expenses and fees, and are steadfast in investing early and reviewing your investments and allocation throughout the years. Please contact your Clearstead private client advisor to discuss the right plan for your family.

Sources:

(1) https://trends.collegeboard.org/college-pricing

(2) https://www.privatecollege529.com/OFI529/theme/pc529/learn-more/plan-details.jsp

(3) https://www.savingforcollege.com/article/where-to-start-when-choosing-a-529-plan

MARKET BENCHMARK RETURNS

April 30, 2019		1M	3M	12M	YTD
US Large Cap	S&P 500	4.0%	9.5%	13.5%	18.2%
US Small Cap	Russell 2000	3.4%	6.5%	4.6%	18.5%
Developed Intl	MSCI EAFE	2.8%	6.1%	-3.2%	13.1%
Emerging Intl	MSCI Em Mkt	2.1%	3.2%	-5.0%	12.2%
Real Estate	NAREIT	-0.1%	4.7%	18.8%	16.6%
Core Fixed	BarCap Agg	0.0%	1.9%	5.3%	3.0%
Short Fixed	BarCap 1-3Yr	0.2%	1.0%	3.4%	1.4%
Long Fixed	BarCap LT G/C	-0.4%	3.7%	6.9%	6.0%
Corp Debt	BarCap Corp	0.5%	3.2%	6.4%	5.4%

Source: Bloomberg

The performance data shown represent past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.