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Schools for Thought?

When it comes to investing for higher education, we all want to get our money's worth. Even though college costs seem daunting, you don't have to win the lottery to send your children to college. Just knowing how much college costs today isn't enough – you need to determine the future cost of college and then calculate just how much you need to save regularly to reach your goal. If your calculation says you need to save much more than you are able to – don't panic - save something! Making a habit of putting away any amount systematically is half the battle. There are several options for college savings accounts so it should be easy to find one that meets your needs. For more than 10 years, people have been able to invest in 529 college savings plans (named after its section number in the IRS code), which have certain tax advantages that make them appealing for saving for college. There are two types of 529 plans to choose from:

- 1) **A prepaid tuition plan** allows participants to lock in today's tuition rates, essentially removing inflation from the equation. They are generally available to residents of the sponsoring state and usually can be used only at specified schools, typically in that state's public system.
- 2) **A college savings plan** allows participants to invest in a tax-deferred account to be used to pay for education costs at a future date. These plans are more flexible and, in most circumstances, the most favored investment vehicle.

With either choice, the idea is that the investment earnings will grow to meet the higher costs of future education. The savings plan option is typically considered the more attractive of the two options and is the focus of this Pillar.

Opportunities Abound

One of the prime benefits of this plan is that the principal of the account grows tax-deferred and distributions for a beneficiary's education costs are federally tax-free. Virtually everyone is eligible to take advantage of these plans and there are no income limitations or age restrictions. The money can be used for any college and the tax-free distributions can be used for many qualified expenses such as - tuition, fees, books, supplies, required equipment, and room and board. Any withdrawals from the plan must occur in the same tax year in which the expenses were paid. Additionally, many states (not all) provide state income tax deductions for all or part of the contributions made. One of the best advantages is that the donor maintains full control of the account – the named beneficiary has no rights to the funds and the donor can even reclaim the funds at any time. (With one caveat – the earnings portion of the “non-qualified” withdrawal is subjected to income tax and a 10% penalty). The penalty may be waived if the account beneficiary receives a scholarship, becomes disabled or dies. Moreover, the amounts that can be invested into the 529 savings plan are substantial – usually over \$300,000 per beneficiary in many state plans. Furthermore, in most states there is no age limit or time limit for when the money has to be used and you can change the beneficiary on the account at any time. Another benefit is that the 529 plan is protected from the account owner's creditors in some states, as well as being protected from the beneficiary's creditors. One final advantage is that the 529 plan can be used as an estate planning tool – used to move assets outside of one's estate while still retaining some measure of control if the money is needed for later use. These assets are not counted as part of the donor's gross estate for estate tax purposes.

Of course, with the good comes the bad. In a 529 plan, qualified distributions are only good for qualified higher education expenses. Your investments in the account can only be re-allocated once per calendar year. If you have to take the money out for other purposes besides education costs there is a 10% penalty and income taxes to be paid on the earnings portion of the non-qualified distribution, and the possibility of a recapture of any state tax deductions that were taken. Additionally, you do not control the investments in the plan – they are controlled by the investment manager of the plan you choose and they are limited to a handful of investment options provided by the plan. You can only invest cash, not



appreciated securities and even though you can contribute a substantial amount into these plans – the contributions are limited to a certain dollar amount. Further, each plan charges different fees over and above the regular expenses incurred by the mutual funds in which the money is invested (i.e. enrollment fees, annual maintenance fees, administration/management fee, sales charges, etc.).

Financial Aid Planning

The 529 savings plan is counted as an asset and may affect financial aid eligibility. Relative to some other tax-advantaged savings vehicles, 529 plans may actually be the better choice from a financial-aid standpoint because when the asset is in the name of the contributor – the financial aid officer only counts up to 5.6% of the account balance when assessing for financial aid versus counting 35% if it's in the child's name or in a custodial account. However, a 529 plan owned by a grandparent will not affect financial aid eligibility in any way. But, while making a grandparent the owner of the 529 plan may make an excellent financial aid strategy, it can backfire if Medicaid issues arise; due to the fact that it would likely be a countable asset of the grandparent for Medicaid/SSI purposes.

Special Gifting Rules

Contributions to 529 plans are considered gifts under the federal gift tax regulations. With the 529 plan, you can take advantage of a special rule called the five year carry-forward option which allows you to invest five times the annual exclusion amount ($\$13,000 \times 5 = \$65,000$ for single filers and $\$26,000 \times 5 = \$130,000$ for married filing joint filers) today without gift tax consequences. This lump sum investment along with tax deferral gives you the opportunity to earn more than an incremental investment of $\$13,000$ per year over the course of five years. If you elect this option, the lump sum contribution is treated as if having been made over a five year period for gift tax purposes and you are not able to make another contribution to that individual for five years (without using part of your lifetime gifting exclusion). Once the five years have elapsed, you can contribute for another five years if you choose. However, if you die before the end of the five year period, a pro rata amount of the gift which is allocable to the remaining years would be included in the donor's gross taxable estate. For instance, suppose John contributed $\$65,000$ into his grandson's 529 plan in 2009 and utilized the five year carry-forward option. Let's assume that John then dies in 2012 – three years after he opens the account. In this example, a total of $\$26,000$ ($\$13,000$ for years 2013 and 2014) would be considered part of John's taxable estate.

A Taxing Situation

When it comes to saving for college, your first decision should be whether to opt for a 529 plan or invest in a taxable account. Of course, stashing your child's assets into a taxable account probably appeals to you because of the flexibility it affords and you're also spared from having to deal with the limitations and rules that tax-sheltered plans might impose. Investing in a taxable account also gives many more options in the mutual fund universe to choose from. This is not so with a 529 plan, which is typically managed by a single fund company and may have limited investment options. Finally, because you don't have to earmark the savings in a taxable account specifically for college expenses, you retain the freedom to use the money for anything you want.

However, Beacon believes that the limited choice in a 529 savings plan is a reasonable price to pay once you consider the benefits you accrue. Namely, not only will your child's investment earnings grow on a tax-deferred basis – the withdrawals from the plan will be tax-free provided your child uses the money to pay for college expenses. Put another way, no matter how good the choices are in your taxable account or how skillfully you chose, you'll still be hard-pressed to match the returns that you get in a 529 plan due to benefits that tax-free compounding and withdrawal provide.

When evaluating and comparing 529 plans, you should consider all variables that are important to your specific situation including estate-tax planning and asset-protection issues because, most likely your objectives go beyond just saving for your child's college education. Typically, these 529 college savings plans can be structured to accomplish more than one objective, so be sure to plan carefully before investing.

Sincerely yours,



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