KayneInsights

College Savings Plans

Saving for College Starts Now

Planning for tomorrow's tuition starts today—and 529 plans can offer meaningful tax advantages while helping secure a brighter future for the next generation.

We all want our children and grandchildren to have a bright future filled with opportunity and success. College can be a key component of that success, but paying costly future tuition bills requires careful planning today. Fortunately, some Qualified Tuition Programs (QTPs), commonly referred to as 529 Plans after Internal Revenue Code (IRC) Section 529, allow those responsible for paying education expenses to realize significant tax savings while accelerating the gifting process.

Types of 529 Plans

There are two types of 529 plans; Prepaid Tuition Plans and College Savings Plans, and all fifty states sponsor at least one of the two.

Prepaid Tuition Plans

As their name implies, Prepaid Tuition Plans allow for prepayment of tuition for future enrollment at current rates. Specifically, tuition credits are purchased for a designated beneficiary to use later for either payment or waiver of higher education expenses, and future tuition costs are thereby locked in at current rates. While this cost assurance may sound appealing, we think it comes with significant risks. Namely, participating in a school's prepayment program presumes the child will ultimately apply to, be admitted to, and choose to attend that particular school. There is also a risk that the child may earn a scholarship to—or prefer the specific curriculum opportunities at—another institution.

College Savings Plans

With a College Savings Plan there is much greater flexibility. For starters, the plan is not limited to a certain school or state. Rather, distributions from a state's College Savings Plan can be used for tuition at any school, including out-of-state schools. That includes two and four-year colleges, graduate schools (including law and medical) and vocational or technical schools. Further, the owner (not the beneficiary) of the plan completely controls the account and can roll it into a different state's plan, change the strategy selection (typically once per year), change the beneficiary or revoke the account altogether. The account owner can even use the funds for his or her own higher education as well.

So how does it work? The owner of the account—usually the parent or grandparent—contributes money which will eventually be used to pay for the higher education of a designated beneficiary. These contributions grow tax-deferred, ideally realizing a higher return on investment than could be achieved outside of the plan. As long as any withdrawals are used to pay for qualified higher education expenses (defined as tuition, fees, room and board, books, supplies and any equipment required for attendance or enrollment at an eligible educational institution at least part time), they are removed from the taxable estate and are excludable from gross income. Withdrawals for qualified higher education expenses are tax-free at both the federal and (generally) state level. Withdrawals for up to $10,000 of tuition expenses at a public, private or religious elementary, middle, or high school per student, per year across all 529 plans are tax-free at the federal level. The earnings portion of any withdrawal used to pay for tuition expenses at a public, private or religious elementary, middle or high school are taxable at the state level for California taxpayers.

Beyond the flexibility described above, we believe there are numerous other advantages to using a College Savings Plan. For example, College Savings Plans generally charge comparatively low commissions and low management fees, especially those plans that invest in cost-effective index funds and ETFs (Exchange-Traded Funds). In addition, while there is no federal deduction for contributions to a College Savings Plan, many states (currently 34) provide state tax deductions for at least a portion of contributions. Further, there is no income level phase-out to restrict high-net-worth individuals from contributing and the maximum overall investment limit is higher than $300,000 in many states.

As an example, in California there are no income limitations. You can contribute as much as $529,000 per beneficiary account (as long as the total balance of all accounts for that beneficiary does not exceed

$529,000) and you get both federal and state tax-deferral on the build-up of your assets. However, there are no state income-tax deductions for contributions.

While there are no other official annual contribution limits on College Savings Plans, contributions are treated as completed gifts, meaning the annual limitation for tax-free gifts to family of $17,000 per beneficiary ($34,000 if from a married couple, filing jointly) does apply. However, College Savings Plans have a unique five-year election which allows for five years' worth of gifts to a beneficiary in a single year without triggering the federal gift tax. In other words, this unique option enables a financially secure couple to accelerate the gifting process by contributing up to $170,000 (five years of $34,000) per beneficiary every five years up to the maximum contribution limit (which is, again, higher than $300,000 in many states). While College Savings Plan contributions remove assets from the taxable estate, the gifting family member retains control of the assets.

Lastly, there are no beneficiary age limits for either contributions to—or distributions from—College Savings Plans, and there is no contributor-beneficiary relationship requirement. Importantly, the ability to rename beneficiaries can transform a College Savings Plan into a legacy tool. In other words, if one child fails to use all the College Savings Plan's assets, the parent or grandparent can reassign the plan to a sibling or another member of the family tax and penalty free. Alternatively, the child could continue to hold the plan in his or her name with the goal of funding graduate school or even passing the account along to his or her own future children. It should also be noted that if the beneficiary receives a scholarship, 529 plan assets—up to the amount of the scholarship—can be returned to the account owner with the customary 10% penalty on "non-qualified" withdrawals waived. However, any earnings will be subject to federal income tax, and possibly state and/or local income tax.

Limitations of College Savings Plans

Are there any drawbacks to College Savings Plans? One disadvantage is that the contributor does not have the right to choose the individual investments in the plan (he/she can just choose the strategy), but we believe this can be remedied by seeking out a plan with good variety in its menu of investment options. Furthermore, the existence of a College Savings Plan could affect a student's financial aid eligibility if the plan is deemed an asset of the contributor. Typically they are considered assets of the account owner (versus the beneficiary) on the FAFSA (Free Application for Federal Student Aid) and will be factored into the EFC (Expected Family Contribution) at a rate of 5.6%, just like any other parental asset if the account owner is the parent of the student. However, if someone other than a parent (grandparents, aunts, uncles, or friends) opens and contributes to a College Savings Plan account, those assets are not currently included in the calculation that determines a student's eligibility for federal financial aid. Even trusts, corporations, and non-profit organizations with valid Tax ID numbers may be account owners.

Only when a student takes a qualified distribution for college from the account must the amount be reported as student income on federal financial aid forms. For this reason, many families think that grandparent-funded College Savings Plans should be the last asset used for college expenses. In other words, students who might be eligible for financial aid should use the College Savings Plan to fund their senior year expenses because they will not be applying for aid in the following year.

Choosing a College Savings Plan

Beyond investment performance, tax advantages are often the most important considerations for investors evaluating various College Savings Plans. This is because over half of the states in the U.S. offer residents state income-tax deductions for in-state 529 contributions, and some states—including Arizona, Kansas, Maine, and Pennsylvania—even offer their residents tax deductions for contributions to any state's 529 plan, not just their own. Further, while most states have dollar limits on 529 deductions, some states—such as New Mexico, Colorado, and South Carolina—allow you to deduct the full amount of contributions to their respective 529 plans.

Along with a high rate of return, these tax deductions can have a significant positive impact on your savings plan. That is, unless administrative and management fees eat away at your investment. Accordingly, we think it is also important to consider the fees for your state's plan (including whether those fees are waived for in-state residents) and compare those fees to the fees of other states.

Further, we feel it is important to know whether the plan includes enough variety in its menu of investment options. Like with your other investments, you need the right diversification and balance among various asset classes, and you need a mix that suits your investment goals, risk tolerance, and timeline. With this in mind, some investors select a glide-path portfolio, or one that is age-based, meaning the investments start off aggressive and automatically become more conservative as their child nears college-age, in order to protect principal.

Lastly, many investors naturally value top-rated customer service along with a user-friendly website that allows them to check in frequently on the performance of their portfolios.

Alternatives to 529 Plans

Two other tuition preparation vehicles are Coverdell Education Savings Accounts (ESAs) and UTMA/UGMA accounts.

Coverdell Education Savings Accounts (ESAs)

Like College Savings Plans, Coverdell ESAs are established with cash contributions that are not tax deductible, but are allowed to grow tax-free within the account, and money withdrawn from this account is free from tax or penalty if used for qualified education expenses. There are, however, some key differences.

Coverdell ESAs allow the contributor to self-direct the specific investments, and there are no restrictions on changing investments. Typically there is no program manager fee either. Furthermore, withdrawals can be used not only for higher education, but also for elementary and secondary education. While these traits are intriguing, Coverdell ESAs are less commonly utilized by high-net-worth investors because of some key limitations.

The biggest limitation of Coverdell ESAs is the income phase-out level. The contributor who establishes the account cannot have $110,000 ($220,000 if married couple filing jointly) or more of modified family annual gross income. Further, unlike College Savings Plans which allow for larger contributions, Coverdell ESAs have an annual contribution limit of $2,000 (significantly less helpful for income tax and estate planning), and if a contributor goes over that limit, a 6% excise tax on excess contributions will be imposed on the beneficiary and assessed each year on May 31st until corrected. As with College Savings Plans, these contributions are treated as completed gifts, but there is no five-year election. Further, there is no ability to revoke Coverdell ESA because the accounts are established for the sole benefit of the child and all distributions go to the beneficiary. There are also significant age limitations requiring that no contributions be made to the account once the beneficiary turns 18. Additionally, the money needs to be used for qualified education expenses by the time the beneficiary turns 30, or else the beneficiary will be forced to take a distribution and pay taxes and a 10% penalty on the accumulated earnings, unless the account is rolled over to another beneficiary who is a family member.

UTMA/UGMA Accounts

The Uniform Gift to Minors Act (UGMA) and the more recent Uniform Transfers to Minors Act (UTMA) allow parents to put cash and securities into a custodial UGMA or UTMA account for a child. The child receives

full ownership of these assets at the age of majority (18 or 21, depending on the state). These accounts are inexpensive to set up, and there are no limitations regarding the contributor's income level or the maximum overall investment. Plus the custodian of the account may direct investments.

However, there are no state tax-deductible contributions with UGMA/UTMA accounts, and transfers are treated as completed gifts but without any accelerated gifting options. Further, UGMA/UTMA accounts are not revocable (the minor assumes control), and their assets cannot be transferred to a different beneficiary. Rather, the value is removed from the donor's gross estate as long as the donor is not also appointed custodian of the account, and the accounts are deemed an asset of the designated child. Consequently, these accounts are considered in determining a student's need-based financial aid (they are assessed in most aid formulas at 20% or 25% a year) and can significantly reduce his or her eligibility.

Most importantly, UGMA/UTMA accounts do not have the same tax benefits that College Savings Plans do. These accounts were more popular in the past when parents could move investment income out of their high tax bracket and into their child's lower bracket, but with the federal kiddie tax recently being expanded to cover students through the age of 23, that option has basically been reduced to getting a tax break on only $2,500 of interest income. In other words, while the first $1,250 of unearned income in a UGMA/UTMA account is generally tax-exempt, the next $1,250 of unearned income is generally taxed at the child's rate, and any unearned income over $2,500 is generally taxed at the parents' rate. The only exceptions occur when a student covers more than half his living costs with earned income, turns 24, or files a joint return with a spouse.

Lastly, while the two account types may sound very similar, there are a few differences between the two acts rendering UTMA more flexible. Most notably, parents may transfer real property into an UTMA account.

Conclusion

We believe it is generally recognized that College Savings Plans have distinct advantages over Prepaid Tuition Plans, Coverdell ESAs, and UGMA/UTMA accounts. In our view, these plans provide a combination of benefits not found anywhere else, including income-tax savings, accelerated gifting, and potential gift and estate tax benefits. In addition to delivering tax-free gains to pay for college, we think College Saving Plans help investors achieve broader goals, from enhancing their total portfolio's overall tax efficiency to establishing a family legacy tool. That said, a financial advisor can help you determine which alternative will best help you achieve your specific goals related to college savings.

	529 College Savings Plan	Coverdell Educational Savings Accounts (ESA)	UGMA/UTMA Accounts
Tax Advantages			
Earning grow tax-deferred	✓	✓	
Distributions are federal income tax-free	✓	✓	
Gift and estate tax benefits	✓		✓
Contribution Details			
Contribution minimum	✓	✓	✓
Contribution maximum	✓	✓	
Low impact on financial aid	✓	✓	
Qualified withdrawals limited to educational expenses	✓	✓	
Contributions not limited by the income of the account owner	✓		✓
Account Management			
Beneficiary can be changed	✓	✓	
Account owner maintains control over distribution of assets	✓	✓	
No age limit for the beneficiary (child)	✓		
Professionally managed portfolio	✓		

Source: Fidelity Investments

Kayne Anderson Rudnick is an investment firm specializing in high-quality investment and wealth management strategies. The firm has an over 40-year history serving a diverse client base that includes high-net-worth individuals, corporations, endowments, foundations, public entities, taft-hartley clients, and mutual funds. Kayne Anderson Rudnick is known for its commitment to high-quality investment strategies and business practices. For more information, please visit www.kayne.com.