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Wealth Insights

529 PLANS

SUMMARY

Section 529 plans are the most popular vehicles to fund college tuition for individuals with higher incomes and net worth. And thanks to the 2017 tax reform bill, grades K-12 at private schools are included as well. That is due primarily to the tax advantages that contributions and distributions receive, the amounts that may be placed into the plans on a yearly basis, and the control that the contributor of the money may have in the plan.

Generally, a 529 plan is funded by gifts made to the children into the plan. These gifts typically qualify for the annual gift-tax exclusion. This exclusion amount is the amount that each person can gift to another, free of gift taxes. The amount is currently **$15,000**, per beneficiary, per year, indexed for inflation. Couples can gift **$30,000** to any beneficiary each year.

Gifts made in excess of the annual gift-tax exclusion may, at the election of the donor, be taken into account ratably over a five-year period. For example, you can gift up to **$75,000** (**$150,000** for couples) in one year and have that gift treated as if it were made over five years at $15,000 ($30,000) per year, and free of gift taxes.

As such, you could each maximize your contributions by contributing $75,000 into each child's plan. No further contributions should be made until after five years have passed, unless you're willing to pay gift taxes, or the annual gift-tax exclusion amount has increased.

Pros of 529

A. Income tax

- To the extent used for college or K-12 qualified expenses, earnings are not subject to federal income tax.
- To the extent not used for qualified expenses, federal income tax on the earnings is deferred until distribution.
- Many states offer a state income tax deduction for contributions to those states' 529 plans, incentivizing those states' residents to choose their plan over those offered by other states. Some states even offer tax deductions on contributions to other plans.

B. Flexibility

- Unlike any other gifts, an individual can retain control over his/her gift with no "bad" estate tax consequences. The individual can change the beneficiary to certain family members with no tax consequences, or take the funds back (subject to a 10% additional tax on earnings).
- Parents are not the only ones who can set up 529 plans for their children. Grandparents, siblings or even friends can contribute to a 529 plan even if they are not the account owner.
- You can contribute to a 529 plan in any state, not just the one you live in. For example, if you live in Pennsylvania and Utah's plan will be more beneficial than Pennsylvania's, you're permitted to form a Utah 529 even though you don't live there.

C. Gift tax

- The individual can elect to treat a contribution using the annual exclusion for five years (front-loading).
  Example: Father contributes $75,000 to a 529 account for daughter in 2003. Father elects to treat the contribution as made using his $15,000 annual exclusions for 2003, 2004, 2005, 2006, and 2007. The advantage of front-loading is that earnings can begin to build tax-free faster than if separate contributions were made each year.

Cons of 529

A. 10% additional income tax

- If not used for college expenses, there is a 10% additional tax on earnings.

B. Ordinary income

- If not used for qualified expenses, all earnings are taxed as ordinary income (even if the "actual" earnings were capital gains).

C. Higher costs

- The management fees for a 529 account are higher than the fees for comparable mutual funds.

D. Less flexibility in investments

- The investment vehicle can be changed only once per year, and the choices are limited to certain managers.

E. No discount on gifts

- If an individual is choosing between a gift of an asset that can be discounted (such as partial interest in real estate) and a gift to a 529 plan, he/she can transfer "more" through gifts of real estate (which can be discounted).

F. Decreases ability to reduce estate

- If an individual makes annual gifts to a child (rather than to 529 account), he/she can pay college expenses out of his/her own pocket, and thereby, reducing their estate. Note: In this case, the individual's estate is reduced by annual gifts and by college expenses.
- If the individual makes annual gifts to a 529 account for a child and pays college expenses from the 529 account (rather than out of the individual's own pocket), the individual's estate is reduced by annual gifts, but not by college expenses.

Characteristics of a 529 funder

A. Size of estate

- Moderately wealthy ideally not making annual exclusion gifts. For this person, the estate disadvantage does not exist and he/she gets the income tax benefit (assuming funds are used for College Expenses), as well as a possible estate tax benefit (because the estate is reduced by the annual gifts to the 529 account). (If the individual is considered "moderate means," they may be more focused on saving for retirement, as opposed to their child's education. Therefore, a 529 plan may not be ideal for them. In addition, a 529 plan may impact the child's ability to qualify for financial aid (federal, state or the educational institution itself).

B. Age of children

- The younger the child the better (more time for tax-free buildup).

C. Equalization

- Equalization among beneficiaries is possible, if used with caution.
  Example: Grandpa has given $500,000 to his 10-year-old grandson and has used his entire unified credit on this and other gifts. Another grandson is born and Grandpa would like to try to equalize for him. If Grandpa uses his annual exclusions to contribute $15,000 to 529 accounts for each of the 10-year old and the newborn, there is nothing to prevent Grandpa from directing the entire distribution to the newborn down the road.

Selecting a 529 Savings Plan: Relevant factors

A. Residence

- The first place to look is the individual's home state. Some states offer special tax benefits to their residents (like a state income tax deduction for contributions to the 529 plan of that state) and/or lower fees for residents.

B. Fees[1] can have a major impact on the performance of a 529 account. Some plans to note with low fees are:

- Utah (0.150% - 0.196% for accounts over $5,000; Vanguard funds)
- New York (0.13%; Vanguard funds)
- Iowa (0.20%; Vanguard funds)
- Michigan (0.24%; TIAA-CREF)
- Nevada Upromise (0.28% - 0.89%; USAA)

C. Choice of funds

- While fees are important, different 529 plans have different kinds of funds available. These choices and track record of the funds must be examined.

D. Creditor protection

- If creditor protection is a major issue, this aspect of each plan should be reviewed. Alaska and New York (and, perhaps, other states) have special provisions for creditor protection, subject to certain restrictions.

E. Contribution restrictions

- States have contribution limits ($300,000 and up in most states) and others raise their limits each year to keep up with rising college costs. Some plans also may have a contribution limit, both initially and each year.

529 plan analysis[1,2]

Below is a simple comparison of two plans: Washington (the individual's home state) and Utah, which is one of the most popular plans available.

Plan Specifics	**Washington State** (DreamAhead College Investment Plan)	Utah	Favorable Plan
Program manager	Fidelity Investments; Schwab; Vanguard; J.P. Morgan	Utah Higher Education Assistance Authority	N/A
State tax benefits and other enhancements	No state tax deduction for contributions (no state income tax)	State benefits only to state residents	Even
Outside backing or guarantees	None	None	Even
Maximum contributions	$500,000	$485,000	Washington
Minimum contributions	$25 initial contribution per portfolio and $5 thereafter	None	Utah
Enrollment/application fee	No	No	Even
Account maintenance fee	$35 annually	None	Utah
Annual asset-based program fee	0.12% manager fee and 0.10% administrative fee to the state	0.150% - 0.196% Program management fee: 0.11% to 0.19%	Utah
Expenses of underlying investments	Ranges from 0.064% to 0.135% (portfolio weighted average) in the enrollment based portfolios; 0.056% to 0.18% in the static portfolios	From approx. .017% - .051% None for treasurer's investment fund	Utah
Investment options	3 age-based options based on risk levels (conservative, moderate or growth) containing 10 portfolios of underlying mutual funds. Or 7 static investment options.	4 age-based or years-to-enrollment options; 8 static investment options include 1 money market fund, 2 single-fund portfolios (Equity index fund and bond index fund), and 5 blended fund portfolios	Utah
Underlying funds and investments	Fidelity; Schwab; Vanguard; J.P. Morgan	Vanguard index funds and Utah State Treasurer's Investment Fund	Washington

Although one should normally first look to in-state plans, the Washington state plan seems pricier compared to Utah. Further, the Washington state plan is new for 2018 and could need time unfold. Accordingly, we would recommend the Utah 529 Plan because of its flexibility, ease of use and, most importantly, cost. Its investment performance also compares favorably to any other plan that may be available. Because it invests in index funds, you know exactly what you are getting. One note, if you have a Washington GET plan, there may be an opportunity to roll this into a 529 Plan and receive a value increase on the conversion.

As evidenced by the example above, many factors should be considered before determining whether a 529 Plan is right to finance your children's education and which plan is right for you. It is important to discuss these matters with your financial advisor to structure a plan that best fits your needs.

Visit **seic.com/privatewealth** or call our private wealth management team at **888-551-7872** to learn more.

[1]Fee range is approximate as they change periodically.

[2]my529.org (Utah Educational Savings Plan). Accessed on January 9, 2019 at savingforcollege.com/529-plans/utah/my529.

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