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Paying for College (Qualified Tuition Program)

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Let's try to keep things simple. Section 529 Plans offer wealthy taxpayers a great college savings plan. They also provide taxpayers of moderate means with enormous opportunities.

Within limits Section 529 Plans:

- Provide income tax-free growth.
- Give you the freedom to change beneficiaries within the family (first cousins included).
- Offer substantial control over asset allocation.
- Allow you to divert the fund from the beneficiary back to the contributor and use the proceeds for non-qualifying purposes (subject to a 10% penalty).
- Are excluded from the estate of the contributor.

These five factors make the decision to invest in a 529 Plan compelling, particularly for wealthy grandparents.

(Readers unfamiliar with Section 529 Plans could link to http://www.savingforcollege.com for a discussion of 529 Plan basics.)

Unfortunately, many clients (and even professionals) either get so wrapped up in trying to decide among good options that they don't contribute to any plan, or their contributions are too conservative. In my opinion, there are a lot of good plans. In most cases, you would be doing your family a service to open an account.

Summary of Recent Changes to 529 Plans

In the past year, 529 Plans have seen two major enhancements:

1. All qualified 529 withdrawals are now tax-free, i.e., when the student withdraws funds, there are no income taxes. Under the old law even though no taxes were levied during the accumulating years, there was a tax on the gain for the beneficiary.

2. Greater flexibility in choosing beneficiaries. For grandparents who want to make sure that all their grandchildren have access to tax-free education funds but who are not sure which grandchild will need how much money and when, the new law allows funds to shift between first cousins.

Things I Encourage my Clients to Do

I like to see grandparents contribute to their grandchildren's 529 plans. I often suggest this, and many clients have responded positively. Many grandparents want to provide for their grandchildren's education, but also want the ability to take the money back (just in case they need it). I find this concern is amplified in divorce settings and other unstable marriage situations where they feel giving money to their children will end up in the hands of the spouse or ex-spouse.

I have encouraged clients with Crummy and Educational Trusts to terminate the trust and put the money in a 529 Plan. I make the same recommendations for many clients whose children have UGMA accounts. In that situation, the child will still be able to have access to the money when they reach majority, but at least you can enjoy all the tax benefits of the 529 Plan.

I am less enthusiastic about transferring UGMA money to a 529 Plan if the investment has a low basis that would trigger a large capital gain for the child. However, that is partly psychological. Similarly to Roth IRA conversions, paying some tax up front for the opportunity of tax-free growth is usually a good thing and gets better with a longer investment horizon.

If the client is old enough to avoid the 10% premature distribution penalty at withdrawal and doesn't have an estate tax problem, I often say contribute the maximum to your Roth IRA before the 529 Plan.

When drafting trusts for children, clients should have the option of specifically allowing a trustee to terminate or allow a significant withdrawal from a minor's trust to a 529 Plan.

For young clients who want to provide for their children's college education, after discussing the risks, I tell them the numbers work out better if they contribute to a 529 Plan only after contributing whatever an employer will match to their own retirement plan. As always, I recommend that you visit Joe Hurley's web site, http://www.savingforcollege.com. His site has a wealth of indispensable information on 529 Plans.

General Advice

Most plans offer four investment variations: one in which the asset allocations change as the student gets closer to college (age weighted), and three options with aggressive, moderate, and conservative allocations. Some plans will let you build your own portfolio from a choice of mutual funds.

Choosing is a Daunting Task

The following issues merit consideration:

1. Who is the money manager?
2. What is the expense ratio?
3. Are there other costs?
4. Is it flexible (particularly for overfunding "schemes")?
5. Is there a maximum age for joining the plan?
6. Is there a maximum age for using the money?

What about performance? Performance is difficult to assess. Most plans are no more than a few years old. That's why it's important to have confidence in the plan's manager and to keep expenses low.

Pennsylvania's Upcoming 529 Plan

- I cannot recommend the existing Pennsylvania TAP (Tuition Account Guaranteed Saving Program). It is not the type of 529 Plan I recommend. The TAP is a guaranteed savings plan similar to the old prepaid tuition plan. It is like a future contract -- you buy units of future tuition benefits at today's price. School choice is limited.
- PA's Qualified Tuition Plan (a 529 Plan) though not yet operational, should be ready for business soon, and it should offer more flexibility than the TAP.
    - Delaware Investments will be the primary investment manager.
    - Calvert Group will offer a socially responsible mutual fund (e.g., no tobacco, alcohol or weapon companies in portfolio).
        - CSIBX - Calvert Social Investment Fund Bond Portfolio
        - CSIEX - Calvert Social Investment Fund Equity Portfolio

Though it is hard to get a straight answer from anyone in Harrisburg, it is unlikely that PA will offer an income tax break either on contributions or withdrawals. Assuming you don't get a state income tax break, particularly on the contribution side, I don't see any compelling reason to choose the PA plan unless you particularly like Delaware Investments or the social choice investments.

Fees

Fees provide one objective criteria for choosing among different plans. They can have a significant effect on the ultimate value of the investment. Hefty fees can crimp your college savings. For example, **Regent Atlantic Capital LLC** compares the effect of the fees (expenses) on the growth of $10,000 at 7% interest over 18 years:

- New York's plan with 0.65% annual expenses grows to $30,286.
- Wisconsin's plan with 2.27% annual expenses grows to $22,976.

Even though people can buy 529 Plans directly from the state, 2/3 of the dollars that went into 529 plans last year went through brokers (estimated by Joseph Hurley, founder of http://www.savingforcollege.com), so people paid even higher fees.

Many advisors who share in commissions and fees have the following legitimate arguments for charging a fee or a commission:

- It is often the advisor who brings the 529 Plan to the attention of the contributor.
- The advisor made a study of the best plan and saved the client the time and "agony of choice."
- The advisor makes recommendations based on the client's particular situation, including considerations of what the client's non-529 investments include.
- The advisor often picks an appropriate amount of money for the client to invest.
- The advisor "makes it happen" whereas, if left on their own, the client may fail to make a contribution.
- The advisor monitors the account and suggests changes in either the state program or asset allocation choices within the particular state plan.

My personal view is that the 529 Plan is for my client's children's education, not my child's college education. In my practice, I do not charge any fee or commission for making 529 Plan recommendations.

The Ratings Game

Joe Hurley's site, http://www.savingforcollege.com, is the best source of information on saving for college via 529 Plans. His star rating serves as an excellent starting point. Most of the better plans receive four stars out of five. However just as the star rating for movies can be misleading, I would urge you to look closely before making a decision.

Some advisors say if you live in one of the 20 states that offer a deductible contribution, there's probably no need to look further. Your savings on taxes likely will overcome any shortcomings your state's 529 Plan might have.

Personally I believe that the key to state tax savings is whether you get a deduction for the contribution, not whether the funds will be included or excluded on withdrawal. (Both are possible state tax benefits). However, most states have a relatively low income tax deduction allowance. Therefore, if you are putting in more than the deductible amount, other factors may outweigh the advantages of the state tax advantages.

Which States offer the Best Plans?

I offer the following summaries with my comments in italics.

Kiplinger's says consider these top picks:

- Kansas -- Kansas' "aggressive" age-based portfolio best fits our own philosophy of saving for college: invest in stocks for young children, then gradually move to less risky investments during the junior high and high school years. This option remains at 91% in American Century stock funds until age 12; bonds and money markets don't overtake stocks until age 17. Asset-management expenses range from 0.91% to a somewhat high 1.35%.
  For my tastes, this is a little too aggressive and the fees are also high.

- Massachusetts -- This Fidelity-run plan has a series of age-based portfolios that's 88% in stocks for newborns and reaches a 25-25-50 split of stocks, money market and bonds at about age 16. You also can contribute to a 100% equity or 70% equity fund. Total expenses are about 1% per year, plus a $30 annual fee that is waived with automatic contributions or a $25,000 account balance.
  Solid choice.

- Nebraska -- In the world of 529 Plans, ten investment choices are bountiful. The four age-based portfolios and six other options use funds from Fidelity, T. Rowe Price and Vanguard and include an S&P 500 index fund. The most aggressive age-based portfolio would once again be our choice: It's 80% to 100% in stocks through age 10, 40% in stocks during the high school years, and 20% in stocks at college enrollment. Expenses are about 1%. May be excellent for developing a well allocated portfolio within the 529 Plan.
  Solid choice.

- New York -- Managed by TIAA-CREF, New York's plan now has several new investment options. An "aggressive" age-based portfolio is still just 60% in stocks at age 10, but you can funnel some contributions into a separate, high-equity fund if you want a higher allocation to stocks.
  Expenses are low: 0.65% of assets. TIAA-CREF is a high quality low cost provider and has plans in about 12 states.

A plan I like but don't read much about is Utah. Utah's plan stands out for its remarkably low expenses -- and its simplicity. The plan uses just two Vanguard index funds (one S&P 500, one Bond) to build its age-based portfolios. The more aggressive choice remains entirely in stocks until the beneficiary is age 10. You can boost or reduce your exposure to stocks with separate contributions to a 100%-stock or 100%-bond account. Asset-management expenses are super low: 0.35%. The weakness is that the fund does not allow a good asset allocation with a mix of small cap, mid cap, international, etc. However, you may want to use

Utah and another state's plan and take advantage of Utah's super low expense fees of .35%

Consider Nebraska's plan if you want diversity and don't want to mess around with more than one state. You could build a wonderfully diverse portfolio of Vanguard funds with Nebraska alone. If broad diversity is important to you and don't mind having two plans, you could combine Nebraska and Utah. Normally, I figure one of the big advantages of the 529 Plan is simplicity so Nebraska could get the nod. The downside of Nebraska is the fees are higher than Utah. Nebraska's fees and costs are between 80 and 100 basis points (.80% and 1.0%).

There are plenty of other good plans not mentioned in this article. My point is not to identify which plan readers should use but rather to identify the features that make a good plan, i.e., low expenses and plenty of investing options. Of course individuals have different needs and goals, and you should read the details of the plan before you make a decision.

My Choices

For years I have recommended New York, invested by TIAA-CREF to my clients who were familiar with TIAA-CREF retirement plans. Over the years we have enjoyed good service, low costs, and no problems. Utah is cheap. Nebraska is good. There are lots of good choices.

The key is to contribute early, contribute aggressively, and don't spend too much unproductive time choosing among good plans.

Impact on Financial Aid

In contrast to prepaid tuition plans (and Education IRAs), 529 Plan assets don't have a major impact on financial aid. As Kiplinger's Personal Finance notes, "Though Congress may eventually change the rules, prepaid plans are treated more severely than savings plans under federal financial-aid formulas. Prepaid plans are considered a 'resource' that reduces a family's aid eligibility, dollar for dollar. Savings plans are treated as a parental asset, of which only 5.6% is considered available to cover college costs each year."

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On Wednesday, June 12, 2002, from 2:30- 3:30 p.m., I will be presenting a special topic workshop on 529 Plans at the Squirrel Hill Library. The special topic workshop is offered independently or in conjunction with my general seminar on IRAs, Retirement Plans and Estate Planning. For reservations and information, call 412-521-2732 or at http://www.rothira-advisor.com/seminar.htm.

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