Are 529 Plans Right for You?

A 529 plan is a tax-advantaged savings and investment account designed to pay for expenses related to education. Known as "qualified tuition plans" and sponsored by states, these plans may provide a way to cover educational expenses while providing tax benefits.

One of the primary benefits of 529 plans is the tax-free growth of your contributions. Earnings accumulate on a tax-deferred basis and withdrawals are not taxed by the federal and most state governments when used for "qualified higher education expenses" such as tuition, fees, books, certain computer-related expenses and certain room and board. In addition, up to $10,000 during the taxable year may be withdrawn from your 529 savings plan account for tuition expenses in connection with enrollment or attendance at an elementary or secondary public (K-12), private or religious school subject to certain conditions. The person who opens the 529 account is the account holder and the account beneficiary is the person for whom you are saving. The account holder has full control of the account to change the beneficiary, request distributions, and direct investment changes. Anyone can contribute to any beneficiary's 529 plan. You do not have to be a parent or relative of the beneficiary to make contributions.

Benefits of a 529

Income Tax Savings

- The Tax Cuts and Jobs Act of 2017 allow 529 savings plans to be used to pay for K-12 tuition, up to$10,000 per taxable year per designated beneficiary for all 529 savings plans.
- For college or K-12 qualified expenses, earnings are not subject to federal income tax.
- If 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.
- Retirement Enhancement (SECURE) Act (2019) allows for tax-free withdrawals of up to $10,000 from a 529 plan to repay qualified student loans. The $10,000 cap is a lifetime—not annual—limit. Student loans repaid with tax-free 529 plan funds are not eligible for the student loan interest deduction under the Internal Revenue Code.
- The tax rules that apply to 529 investing options are complicated. Before investing, you may want to check with your tax advisor about the tax consequences of investing in 529 savings plans or read Internal Revenue Service Publication 970, Tax Benefits for Education.

continued

Benefits of a 529

Flexibility

- The Account Holder can limit the beneficiary to certain family members with no tax consequences.
- 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 in any state, not just the one in which you live. If a plan will be more beneficial in a state outside the one where you reside, you're permitted to form a 529 in any other state.
- You can avoid the penalty if you get a college scholarship.
- You can take the funds back, but subject to a 10% additional tax on earnings. There are a few special exceptions to the 10% penalty rule, including when the beneficiary becomes incapacitated, attends a U.S. Military Academy or gets a scholarship. In the case of a scholarship, non-qualified withdrawals up to the amount of the tax-free scholarship can be taken out penalty-free, but you'll have to pay income tax on the earnings.

Gift Tax

- The individual can elect to treat a contribution using the annual exclusion for five years (front-loading). The advantage of front-loading is that earnings can begin to build tax-free faster than if separate contributions were made each year.

Note: The tax rules that apply to 529 investing options are complicated. Before investing, you may want to check with your tax advisor about the tax consequences of investing in 529 savings plans or read Internal Revenue Service Publication 970, Tax Benefits for Education.

How should I choose a 529 Plan?

Each education savings plan typically has a range of investment portfolio options, which generally include various underlying mutual funds and exchange-traded funds (ETFs) and a principal-protected bank product. These portfolios also may include static fund portfolios and age-based portfolios (sometimes called target-date portfolios). Typically, age-based portfolios automatically shift over time to include more conservative investments as your student gets closer to college age. You can allocate your money among several investment options or just one. When considering your options, you should think about the fees of each investment option and the level of risk and potential investment

continued >

return you want (both of which may depend on how long until your student will use the money). If you plan to withdraw money from a 529 plan account within a short period of time after it is contributed (to pay for elementary or secondary school tuition, for example), you should be diligent about picking an investment option that meets your needs.

Keep in mind that if not used for college expenses, there is a 10% additional tax on earnings (even if the "actual" earnings were capital gains). There are certain exceptions, including circumstances where the beneficiary becomes incapacitated, attends a U.S. Military Academy, or gets a scholarship. If they receive a scholarship, non-qualified withdrawals up to the amount of the tax-free scholarship can be taken out penalty-free, but you'll have to pay income tax on the earnings (including capital gains).

You should consider how often you want to review the investments and allocations, and potentially reallocate or change your options as your student gets older. Do you want to be in control of those changes, or do you want it to happen automatically? Current federal tax law allows you to change investment options up to twice a year or when you change the plan's beneficiary. But if you want the change to happen automatically, you may want to consider an age-based portfolio. If you are using your 529 account to pay for elementary or secondary school tuition, you may have a shorter time horizon for your investment to grow. You may consider different investment options depending on when you plan to use the money that is invested.

You should also be cautious when reviewing 529 Plan Ratings. Several websites and publications "rate" 529 plans and some states tout their plan's rating in promotional materials. Make sure you understand the basis for these ratings. Some third-party ratings systems appear to give little weight to state tax benefits or low expenses.

Additional Considerations

No discount on gifts

If choosing between a gift of an asset that can be discounted and a gift to a 529 plan, "more" can be transferred through gifts (which can be discounted).

Less flexibility in investments

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

How are 529 Plans Funded?

A 529 plan is usually 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 more than the annual gift-tax exclusion may, at the election of the donor, be considered 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. 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 are willing to pay gift taxes, or the annual gift-tax exclusion amount has increased.

continued >

What type of 529 Plan options are available?

There are two types of 529 plans: prepaid tuition plans and education savings plans. All fifty states and the District of Columbia sponsor at least one type of 529 plan. In addition, a group of private colleges and universities sponsor a prepaid tuition plan.

Education savings plans

(most common and flexible type of plan)

- Do not have residency requirements.
- Offer different types of investment options.
- Can generally be used at any college or university for tuition, mandatory fees and room and board, as well as for tuition at elementary and secondary schools.
- May expose your saved money to investment risk, including loss of principal

Prepaid tuition plans

(lock-in and prepay in-state public tuition)

- Usually have residency requirements
- Restrict where you can redeem the credits (usually public, in-state colleges and universities)
- Dictate what the credits can cover (often tuition and mandatory fees only)
- Do not allow you to prepay for tuition at elementary and secondary schools.
- If the student does not attend a participating college or university, the prepaid tuition plan may pay less than if the beneficiary attended a participating college or university.
- May only pay a small return on the original investment

You can invest in almost any state's 529 education savings plan, or even in multiple plans regardless of where you live. You should compare plans to determine which are right for your family, but a good place to start your research is your state's plan. Many offer tax incentives or other benefits for residents. These benefits can vary depending on the state and plan.

All 529 savings plans have fees and expenses. These costs not only vary among 529 savings plans but also can vary within a single 529 savings plan. Fees may include enrollment charges, annual maintenance fees, sales loads, deferred sales charges paid when you withdraw your money, administration, and management fees (often called the expense ratio), and underlying fund expenses. It is important to review the offering document for the 529 savings plan carefully regarding fees.

Get the guidance you need. There are many factors to examine before determining whether a 529 Plan is right to finance your family member's education and which plan is right for you. It is important to discuss these matters with your financial advisor and tax professional to structure a plan that best fits your needs. Bahl & Gaynor is here to help answer any questions you have. Our goal is always to work hand in hand with clients on customized plans to meet your needs and expectations. Please contact your portfolio manager with any questions or if you would like to discuss education funding strategies.