Using 529 Plans to Invest for Education and Transfer Wealth

Section 529 plans are state-sponsored education savings plans that allow flexibility in choosing a school and the opportunity for late starters to make sizable investments while reaping tax breaks. These plans allow individuals to invest in a predetermined pool of stock and bond investments. Most plans will require you to divide your investment according to a given asset allocation, which may be based on your risk tolerance or determined by your child's age. In general, when asset allocation is based on age, it will be more aggressive for younger children and less aggressive for children nearing college age.

Lifetime contribution limits to Section 529 plans vary from state to state, but they typically exceed $200,000 and offer some flexibility on when you can contribute.

Any earnings on plan contributions can accumulate tax deferred, and withdrawals for qualified educational expenses are generally free of federal (and potentially state) taxes. The money you contribute to a 529 plan established for your beneficiary comes out of your taxable estate — yet you retain control of the money and can even change beneficiary designations in the future.

Keep in mind that nonqualified withdrawals may be subject to ordinary income tax and a 10% additional tax, so it is generally a good idea to speak with a tax or financial professional about the details of your unique situation before initiating any new estate planning strategy. In addition, there are often important differences between the plans offered by each state.

Section 529 plans are just one of the options you have for education savings. They offer a great deal of flexibility in exchange for a higher level of investment risk. If you're getting a late start or if your child is unsure of which college he or she wishes to attend, a Section 529 plan may be your best choice.

Paying for a child's or grandchild's education is an expensive proposition, even for many high-net-worth Americans. Today's elite institutions promise graduates a rewarding future but at a cost that more often than not extends well into six figures. Enter the 529 plan, a tax-advantaged investment vehicle generally available to families regardless of their income level. For affluent parents and grandparents, a 529 plan offers a variety of potential benefits -- including some that go beyond the scope of education planning. A 529 plan may in fact play an integral role in an estate plan.

Named for the section of the Internal Revenue Code that authorized them, 529 plans allow investment earnings to grow sheltered from federal income taxes, and withdrawals used to pay for qualified education expenses are tax free. But for parents or grandparents concerned about estate taxes, 529 plans may be even more valuable, supporting a long-term gifting strategy while still providing significant control over assets that have been removed from a taxable estate.

First and Foremost, a College Savings Tool...

Before you consider the potential role of a 529 plan in your estate plan, it's important to understand a few basics.

There are two types of 529 plans -- prepaid tuition plans, which let you lock in tomorrow's tuition at today's rates, and education savings plans, which let you choose from a menu of investments and offer more return potential, as well as risk. Both types of plans are generally sponsored by a state government (although tax law permits certain educational institutions to sponsor prepaid tuition plans) and administered by one or more investment companies.

With a 529 education savings plan, the underlying investment options are typically managed by mutual fund companies. Many plans offer age-based asset allocation portfolios that become more conservative as the beneficiary grows older. Others let account owners choose from individual investment options to create a customized portfolio.

Originally, 529 plans offered the benefit of tax deferral -- taxes on earnings weren't due until withdrawal and then only at the beneficiary's rate. But qualified withdrawals are now federally tax free.

Eligibility to contribute to a 529 plan is not limited by age or income. In addition, total plan contribution limits often exceed $200,000.

Withdrawals can be used to pay for undergraduate or graduate school expenses. And, effective in 2018, up to $10,000 per year can also be used to fund K-12 education expenses. Withdrawals for purposes not related to paying qualified education expenses are subject to ordinary income taxes and a 10% additional tax.

Finally, remember that you are not limited to participating in your home state's 529 plan -- you can participate in national plans sponsored by other states as well. Be aware that your home state's 529 plan may have state income tax consequences. Consult with a tax advisor before investing in a plan.

Pros and Cons

Flexibility in contributions and choice are the biggest advantages of Section 529 plans over other tax-deferred education savings vehicles. Even though these plans are state-sponsored, you do not need to be a resident of the state to participate, although you may lose out on state tax benefits by participating in an out-of-state plan.

Apart from tax savings, these plans offer the advantage of professional asset management. Each state contracts with a single asset management firm to oversee the plan, so by comparing various state plans, you'll be able to choose from several professional management companies. For more information on each state's plan, visit www.savingforcollege.com. This website includes graphical ratings that compare the plans and links to plans that have websites.

The primary drawback to Section 529 plans is investment risk. Unlike state-sponsored prepaid tuition plans, returns from Section 529 plans are not guaranteed. This means that your investment could lose value, perhaps just as your child is ready to use the funds. Although the firms that manage Section 529 plans use less-risky asset allocations to reduce risk as your child grows older, risk cannot be eliminated altogether.

You'll also want to have a thorough understanding of contribution and withdrawal rules before investing in a plan, since rules vary depending on the state. Pay particular attention to rules regarding transfers, early withdrawals, or withdrawals for things other than education expenses. Additional federal taxes are imposed if withdrawals are not used for qualified education expenses (generally 10% on earnings only).

Choosing the Plan That's Best for Your Family

Section 529 plans are just one of the options you have for education savings. They offer a great deal of flexibility in exchange for a higher level of investment risk. If you're getting a late start or if your child is unsure of which school he or she wishes to attend, a Section 529 plan may be your best choice.

But if you're starting early on saving for college, you might consider a prepaid tuition plan. This plan allows you to lock in today's tuition rate, which can mean a savings of thousands of dollars in college costs. Prepaid tuition plans guarantee payment of a semester's tuition for each unit that you buy, and payments may be spread out over several years. Almost all prepaid tuition plans are more restrictive when it comes to choosing a college, and they may also be more restrictive in terms of withdrawals. Applicants will typically receive a list of participating colleges that a child can attend. If the child wishes to go to a school outside the plan, the value of the investment may be reduced.

As with any financial planning decision, the choice that's best for you will depend on your unique situation, including your risk tolerance and the number of years until your child begins using the funds. Another consideration is your child's plans. Does he or she even plan on attending college? If so, has he or she chosen a school? Talk with your child about college, then make an appointment with your financial advisor to find the plan that best suits your needs.

...But With Valuable Estate Planning Potential

The IRS clearly had education planning in mind when it drafted Section 529 of the Internal Revenue Code. However, it also left the door open to use 529 plans as estate planning tools. That's because a contribution to a 529 plan is considered a completed gift from the donor to the beneficiary named on the account, even though the account owner, not the beneficiary, maintains control over the money while it's in the account. Current tax rules permit you to give $15,000 to as many individuals as you choose each year, free from federal gift taxes. Couples can give $30,000 without incurring taxes. As a result, one method of reducing a taxable estate is to make scheduled gifts up to the tax-free limits each year. You might give $15,000 to each grandchild on an annual basis, for example.

That's where 529 plans come in: The first $15,000 you contribute each year per beneficiary won't come back to bite you, as long as you haven't made any additional taxable gifts to the beneficiary in that year. You can also accelerate your gifting schedule by electing to make a lump-sum contribution of $75,000 to a 529 plan in the first year of a five-year period ($150,000 for a couple). Of course, you wouldn't be able to make additional taxable gifts to that beneficiary during the five-year period. And if you use the five-year averaging election and die before the five years are up, a prorated portion of the contribution may be considered part of your taxable estate.

But the wealth transfer potential can be substantial: An individual who has five grandchildren could immediately remove up to $375,000 from his or her taxable estate by contributing the money to five separate 529 plan accounts. Five years later, he or she could do it again.

Smart Shopping: Making the Right Decision
If you decide that a 529 plan deserves further consideration, keep in mind that there are often important differences between the plans offered by each state. For example, lifetime contribution limits can vary widely from state to state. The limits are often based on average college costs within the sponsoring state. In calculating those averages, some states assume that not just undergraduate expenses are incurred but graduate expenses as well.
Also, some plans offer relatively few investment options, while others may give you a wide range of investment choices managed by specially selected subadvisors. Evaluate the performance of the investment options offered by specific plans. Compare the fees and expenses each plan charges too. And finally, keep in mind that some states offer in-state residents a tax deduction when they make a 529 plan contribution.

You Stay in Control

It's worth emphasizing: Although the assets contributed to a 529 plan are no longer considered part of your taxable estate, you still exercise control over the money. You decide how it will be invested -- within the confines of the plan's available investment options -- and when it will be withdrawn. You also have the right to change beneficiaries, in the event that the original beneficiary decides not to attend college, for example. And doing so generally won't trigger tax consequences if you choose a beneficiary who is a member of the original beneficiary's family. (As spelled out in Section 529, qualified family members include the beneficiary's brothers or sisters, mother or father, sons or daughters, and nieces or nephews, among others.) If there isn't another suitable beneficiary, you also have the option of closing the account and taking the money back, although earnings will be subject to ordinary income taxes, as well as a 10% additional federal tax.

When choosing a 529 plan, you'll need to look beyond estate planning considerations. There are dozens of plans available and their features and rules can vary greatly. To help narrow down the choices, consider working with a qualified financial professional. And be sure to consult with an estate planning attorney or tax professional before making any decisions that could affect your tax liability.

Using Risk to Its Full Potential

In life, almost every attempt at success involves some risk -- and your investment strategy is no different. By devoting time to examining your goals, conducting some research, and working with a financial advisor, you can learn how to manage risk in your portfolio by choosing appropriate investments.

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