Is a 529 Plan the Best Way to Save for College?

Presented by LifeTime Asset Management, LLC

To parents with aspirations of sending their children to college, the costs associated with doing so can be daunting. For decades, the price of higher education has risen at a rate close to three times that of the Consumer Price Index. And though the rate of increase recently has subsided to some degree, this expense continues to be among the most significant faced by parents. Consider the following statistics:

- According to *Trends in College Pricing 2023,* produced by The College Board, a nonprofit organization serving students and schools, the average published tuition, fees, and room and board for in-state students at public four-year colleges and universities for 2023−2024 are $28,840.
- In addition, the study states that the average published tuition, fees, and room and board at private four-year colleges and universities for 2023−2024 are $60,420.

Realizing that the pursuit of higher education will come at a substantial cost, you may be searching for the most efficient way to save for that moment when your children leave home and the bills roll in. But there are many options to consider. Here, we'll explore 529 plans and compare their effectiveness with other means of saving for college.

What Is a 529 Plan?

A 529 plan is a qualified tuition program codified in section 529 of the Internal Revenue Code (IRC). There are two types of 529 plans: state savings plans and prepaid tuition plans. We will focus primarily on the state savings plan—a tax-deferred investment typically bought directly from the plan's sponsoring mutual fund company or through a financial advisor. Although governed by federal statute, the 529 plan is state sponsored and managed by a mutual fund company that provides the underlying investment choices within the plan. If the state savings plan meets the requirement of section 529 of the IRC, the plan's balance and the subsequent distributions from the plan receive favorable tax treatment.

Income Tax Benefits

A 529 plan provides a host of tax benefits, with the primary benefit found in the tax treatment of contributions, earnings, and distributions. Contributions to a 529 plan are typically invested in a mix of equities and fixed income mutual funds. Similar to an IRA, the earnings on the contributions are tax deferred; however, unlike a traditional IRA, distributions from the 529 plan are tax free, as long as they're used to pay for qualified higher education expenses.

Qualified higher-education expenses are defined as expenses incurred for the enrollment and attendance of a full- or part-time student at an eligible educational institution. Common qualifying expenses for both full- and part-time students include tuition, books, supplies, and associated fees. Expenses attributed to on- or off-campus room and board are considered qualifying expenses only for students who attend on at least a half-time basis. The purchase of computer technology or equipment may be a qualified higher education expense, but only if the computer technology or equipment is required for enrollment or attendance at an eligible institution.

Several states also allow for a limited deduction against state income taxes for contributions to a 529 plan. To determine the availability and extent of the allowable income tax deduction, visit savingforcollege.com.

The Tax Cuts and Jobs Act of 2017 expanded 529 savings plans to include K−12 tuition, as well as college expenses. 529 plans will be able to use qualified distributions of up to $10,000 per year, per student, for elementary and secondary school expenses.

As of 2019, the SECURE Act added qualified education loan repayments. Funds in 529 plans can be used to repay principal and interest of the 529 plan's beneficiary qualified student loans, up to a lifetime limit of $10,000. If the 529 plan beneficiary has siblings with qualified student loans, an additional lifetime limit of $10,000 per sibling is available to repay the sibling's qualified student loans.

The SECURE Act provides additional flexibility to access 529 plan funds if your child decides to attend a registered apprenticeship program instead of a college. Qualified fees, books, and required equipment are considered qualified higher education expenses from 529 plans for registered apprenticeship programs.

Beginning in 2024, SECURE 2.0, will allow the ability to roll unused 529 plans into a Roth IRA if eligibility rules and limits are met. With the new legislation, additional clarity and guidance will need to be provided.

- The recipient Roth IRA must be in the name of the 529 beneficiary.
- The 529 plan must have been open for more than 15 years.
- Rollover amounts cannot include any contributions to the Roth IRA (or any earnings on those contributions) within five years of the rollover.
- Rollovers are subject to a $35,000 lifetime maximum.
- Roth IRA contribution limits and rules still apply, with the exception that the modified adjusted gross income limit is not applicable. Therefore, to use the entire lifetime limit of $35,000, the owner will need to effectuate the rollovers over a period of years within Roth contribution limits. In addition, the beneficiary must also have earned income to support the Roth contribution.

Gift and Estate Tax Benefits

A 529 plan can also serve as an effective gift and estate tax−planning tool. A contribution to a 529 plan is considered a completed gift to the plan beneficiary and, therefore, removes the contribution from the donor's estate. The contribution is also considered a gift of present interest, which qualifies for the annual gift tax exclusion ($18,000 in 2024).

Typically, to qualify for the annual gift tax exclusion, the recipient must be able to enjoy the gift without restriction. A gift to a 529 plan beneficiary, however, remains under the control of the plan owner. The owner can withdraw funds from the 529 plan at any time and for any reason (including for nonqualifying educational expenses), or the owner could change the 529 plan beneficiary. Unlike an outright gift to an individual, the gift tax treatment of contributions to a 529 plan is unique, allowing for the completion of a present-interest gift that qualifies for the annual exclusion while the owner retains control over the gift.

Another gift tax benefit unique to 529 plans allows a donor to front-load five annual exclusions (i.e., $90,000) into one initial gift to the 529 plan beneficiary without incurring any gift tax liability. The beneficiary benefits from a large contribution that can begin growing in a tax-efficient manner, while the donor benefits from the immediate removal of a large sum from their gross estate. If the donor chooses the five-year contribution and passes away before the fifth calendar year, the contributions allocated to the years after the donor's death will be included in the donor's taxable estate.

The Effect on Financial Aid

A 529 plan not only provides substantial income, gift, and estate tax savings, but it also often has minimal effects on financial aid. Plans owned by parents or dependent students, as well as custodial-owned plans, are considered parental assets; this means they are assessed at a rate of 5.64 percent when determining how much a family is expected to contribute to tuition costs. 529 plans owned by independent students are considered student assets; student assets are assessed at a much higher rate of 20 percent.

Qualifying distributions from 529 plans also receive advantageous treatment when determining eligibility for the subsequent year of financial aid. The rules for plans owned by a grandparent or other third party are somewhat different. Funds in a grandparent-owned 529 plan are not considered countable assets or income (when distributions occur out of the 529 plan) on the FAFSA.

Other College Savings Vehicles: Pros and Cons
Determining whether a 529 plan is the most advantageous vehicle for college savings requires a review of other common options. What follows is an overview of various savings vehicles and the pros and cons associated with using each to accumulate funds for qualified educational expenses.

UGMA/UTMA Custodial Account
A custodial account is established at a financial institution for the benefit of a minor. Account assets are managed by the custodian, commonly the minor's parent. Assets transferred to a custodial account are an irrevocable, completed gift that may be used only for the benefit of the minor. When the child reaches a specified age, between ages 18 and 25 (determined by state law), the custodian releases the property to the child without restriction.

Benefits for education savings:

- There are no contribution limits.
- Transfers are completed gifts and qualify for the annual gift exclusion.
- No restrictions are imposed on the use of distributions, as long as the distributions are for the minor's benefit.

Trade-offs for education savings:

- A custodial account is considered a student asset when calculating financial aid eligibility.
- Custodianship terminates as early as age 18, depending upon state law.
- Income taxes may be subject to Kiddie Tax rates. In 2024, this applies to unearned income of more than $2,600 for children younger than 18 (and full-time students between ages 19 and 24 whose earned income does not exceed half of their support for the year).

Due to the SECURE Act, all net unearned income greater than $2,600 is taxed using the parents' tax brackets.

Coverdell Education Savings Account (Coverdell ESA)
A Coverdell ESA is a tax-advantaged education savings account that can be established for any child younger than 18. Nondeductible, after-tax contributions grow tax deferred, and distributions made to pay qualified education expenses are tax free at the federal level (and possibly at the state level).

Benefits for education savings:

- Qualifying distributions are not taxable at the federal and, possibly, the state level.
- Qualifying education expenses are not limited to expenses incurred for college education. A qualifying expense can include expenses incurred at elementary and secondary schools (K–12).
- Contributions to the Coverdell ESA grow tax deferred.
- Contributions to the Coverdell ESA are completed gifts that qualify for the annual gift tax exclusion.
- Assuming the parent is the owner, a Coverdell ESA is counted as a parental asset when calculating financial aid eligibility.

Trade-offs for education savings:

The ability to contribute is limited, based on the modified adjusted gross income (MAGI) of the contributor. In 2024, the Coverdell ESA MAGI phaseouts are:
  - $190,000–$220,000 for married couples filing a joint tax return
  - $95,000–$110,000 for all others

- Total contributions are limited to $2,000 annually.
- Contributions must be made before the beneficiary reaches age 18 and must be distributed from the account before the beneficiary reaches age 30.
- Distributions for nonqualifying education expenses are subject to ordinary income tax and a 10 percent penalty.

U.S. Savings Bonds
Issued by the U.S. government, Series EE and Series I savings bonds offer a tax benefit when redemptions of the bonds are used for paying qualified education expenses.

Benefits for education savings:

- When redeemed for qualifying education expenses, the proceeds are tax free at both the federal and state levels.
- The interest is backed by the full faith and credit of the U.S. government.
- Qualifying bonds must be owned by the parent and are therefore treated as a parental asset when calculating financial aid eligibility.
- Redemptions for nonqualifying expenses are included in ordinary income but do not incur a penalty.

Trade-offs for education savings:

- Purchase of the bond is not considered a completed gift to the child and is therefore included in the gross estate.
- There is a $5,000 annual purchase limitation, per owner, per bond series.
- Qualifying expenses are limited to tuition and fees only.
- The ability to make a tax-free redemption is limited by the bond owner's MAGI. This amount is indexed annually. In 2024, the MAGI interest exclusion phaseout is:
    - $145,200–$175,000 (joint filers)
    - $96,800−$111,800 (others)

Traditional IRA
The traditional IRA is most commonly used as a vehicle for retirement savings; however, the rules governing withdrawals provide an advantageous exception when applied toward the payment of qualified higher education expenses. Typically, an early withdrawal (before age 59½) is subject to ordinary income taxes, plus a 10 percent penalty. When the withdrawal is used for qualifying higher education expenses, the 10 percent penalty is waived.

Benefits for education savings:

- The 10 percent penalty imposed for early withdrawal is waived when the withdrawal is for qualifying higher education expenses.
- Contributions to a traditional IRA grow tax deferred.
- A traditional IRA is not a countable asset when calculating eligibility for financial aid.

Trade-offs for education savings:

- The ability to make a deductible contribution to an IRA is subject to MAGI limitations. In 2024, phaseouts for deductible IRA contributions are:
    - $77,000–$87,000 for single taxpayers
    - $123,000–$143,000 for married couples filing jointly
    - $223,000–$240,000 for married couples filing jointly where the spouse is an active participant in an employer plan
- Withdrawals are subject to ordinary income taxes when used for qualifying higher education expenses.
- Withdrawals for nonqualifying higher education expenses are subject to ordinary income taxes and a 10 percent penalty.
- Withdrawals are counted as income when calculating eligibility for financial aid.

Roth IRA
The Roth IRA is most commonly used as a vehicle for retirement savings; however, the rules governing withdrawals provide for an advantageous exception when a withdrawal is applied to payment of qualified higher education expenses. A withdrawal from a Roth IRA is tax free after five years and the account owner is 59½ or older. An early withdrawal subjects the earnings portion (excess above basis) to ordinary income tax and a 10 percent penalty. When the withdrawal is used for qualifying higher education expenses, the 10 percent penalty is waived.

Benefits for education savings:

- When a withdrawal is used for qualifying higher education expenses, the 10 percent penalty for early withdrawal is waived.
- Contributions to a Roth IRA grow tax deferred.
- A Roth IRA is not a countable asset when calculating eligibility for financial aid.

Trade-offs for education savings:

- The ability to contribute to a Roth IRA is subject to MAGI limitations. In 2024, the phaseouts for Roth IRA contributions are:
    - $146,000–$161,000 for single taxpayers
    - $230,000–$240,000 for married couples filing jointly
- Withdrawals in excess of basis for qualifying higher education expenses before age 59½ are subject to ordinary income taxes.
- Withdrawals are counted as income when calculating eligibility for financial aid.

Tax-Deferred Annuities
Issued by a life insurance company, a tax-deferred annuity is an investment vehicle most commonly used for producing retirement income. It can be fixed or variable. A fixed annuity offers a fixed interest rate of growth; a variable annuity provides the investor with a mix of underlying equity investment options. The portion of a withdrawal representing a gain in an annuity contract is taxed as ordinary income. Withdrawals from an annuity contract before age 59½ are subject to a 10 percent penalty—even if the withdrawal is applied toward qualified higher education expenses.

Benefits for education savings:

- Growth within a deferred annuity is not taxed until withdrawn from the contract.
- The annuity is not a countable asset when calculating eligibility for financial aid.

Trade-offs for education savings:

- A withdrawal from a tax-deferred annuity contract before age 59½ is subject to ordinary income tax and a 10 percent penalty.
- A withdrawal may also be subject to a surrender fee if it is taken within a certain period after the purchase of the contract. A common surrender fee schedule ranges from three to seven years.
- An exception to the 10 percent penalty does not apply to withdrawals for qualifying education expenses.

Cash-Value Life Insurance
Issued by a life insurance company, a cash value life insurance policy is commonly used as a mechanism for providing a death benefit to family members in the event of the insured's death. Cash-value life insurance, however, may also be an effective means of accumulating cash for retirement or education on a tax-deferred basis, which can be accessed later by the policyowner in the form of withdrawals or policy loans.

Benefits for education savings:

- Depending on the type of policy (e.g., whole life, universal life, or variable life), the cash value of the policy can grow tax deferred.
- Cash values can be withdrawn from the policy for any reason, including education expenses.
- Withdrawals up to basis are tax free.
- Cash values can be accessed in the form of a policy loan.
- Cash-value life insurance is not a countable asset when calculating eligibility for financial aid.

Trade-offs for education savings:

- The proposed insured must be underwritten to prove insurability.
- The amount of the death benefit and eligible premium contributions may be limited.
- Surrender charges may apply if the policy is canceled.
- Withdrawals in excess of basis are subject to income tax.
- The surrender of a policy subject to a loan may create reportable income for the policy owner.

A Beneficial Choice

Considering the multiple options set forth above, a 529 plan offers the most beneficial means to save for college. Tax deferral on the growth of underlying investments, tax-free withdrawals for qualifying higher education expenses, the possibility of a state income tax deduction, the low impact on eligibility for financial aid, and the gift and estate tax benefits make a 529 plan an excellent vehicle for saving toward higher education goals.

The fees, expenses, and features of 529 plans can vary from state to state. 529 plans involve investment risk, including the possible loss of funds. There is no guarantee a college-funding goal will be met. Earnings must be used to pay for qualified higher education expenses to be federally tax free. The earnings portion of a nonqualified withdrawal will be subject to ordinary income tax at the recipient's marginal rate and subject to a 10 percent penalty. By investing in a plan outside your state of residence, you may lose any state tax benefits. 529 plans are subject to enrollment, maintenance, and administration/management fees and expenses.

This material has been provided for general informational purposes only and does not constitute either tax or legal advice. Although we go to great lengths to make sure our information is accurate and useful, we recommend you consult a tax preparer, professional tax advisor, or lawyer.

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