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Private Wealth Advisors

PRIVATE WEALTH ADVISORS COMMENTARY

The Value of 529 Plans

A 529 plan allows individuals to save for and fund the cost of post-secondary education at any **Eligible Educational Institution** on a tax-favored basis. An Eligible Educational Institution means any college, university, vocational school, or other educational institution beyond high school that can participate in a student aid program run by the United States government.

The "Account Owner" of a 529 plan controls the account, including the ability to change the beneficiary and investment strategies. The "Designated Beneficiary" is the individual whose eligible education costs can be funded from the 529 account.

"Funds within the 529 plan grow income tax free and distributions for qualified educational expenses are exempt from income tax."

Types of 529 plans

529 plans take one of two forms:

1. **Prepaid Plans** – Prepaid plans enable contributors to prepay tuition, thereby locking in the tuition cost at current rates. Typically, prepaid plans address tuition at in-state public schools, although some programs also allow the funds to apply toward private and out-of-state schools.
2. **Savings Plans** – Savings plans allow for cash contributions that can be applied to tuition and covered expenses at the time those expenses are incurred. Qualified distributions can be made to any Eligible Educational Institution and, therefore, provide more flexibility than prepaid plans. Individuals can utilize any state's plan, allowing them to select the best investment vehicle.[1]

Primary Benefit of 529 Plans: Income Tax Savings

Individuals typically utilize 529 plans as a college savings tool because of the tax-free growth of the plan assets. Additionally, 529 plans can be used to cover a certain amount of tuition for private elementary and secondary education as well.

1. **Income Tax Free Growth** – Assets in the 529 plan grow income tax free. In other words, all investment earnings within the 529 account avoid income tax while the funds remain in the account.

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[1]Texas does not have a state income tax. However, for individuals who reside in a state with a state income tax, they might be eligible for a state income tax deduction for contributions to that particular state's 529 plan.

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2. **Income Tax Free Distributions for Higher Education –** Distributions for Qualified Higher Education Expenses, as defined below, are tax exempt:
   - Tuition, fees, books, supplies, and equipment required for a Designated Beneficiary to enroll in or attend the Eligible Educational Institution,
   - Expenses for special needs services in the case of a special needs beneficiary which are incurred in connection with such enrollment or attendance, and
   - Reasonable costs for room and board for a Designated Beneficiary who is carrying at least half of the course load required for a full time student (such costs cannot exceed the cost for housing owned or operated by the Eligible Educational Institution).
3. **Limited Tax Free Distributions for Elementary and Secondary School Tuition –** As part of the Tax Cuts and Jobs Act passed at the end of 2017, income tax free distributions also can be made for tuition of a designated beneficiary at a public, private or religious school for elementary or secondary education. However, total distributions from all 529 plans for an individual for these purposes cannot exceed $10,000 per year.

Distributions other than those outlined above incur income tax on the earnings portion of the distribution plus a 10% penalty, although the penalty can be avoided in certain cases (e.g., such as non-qualified withdrawals because the student receives a scholarship).

Changing the Designated Beneficiary

The Account Owner generally may change the Designated Beneficiary, without tax consequences, to a new Designated Beneficiary who is a "member of the family" of the old Designated Beneficiary. Member of the family means the Designated Beneficiary's: spouse, child (or a descendant of a child), sibling (or step-sibling), parent (or ancestor of a parent), step-parent, niece or nephew, aunt or uncle, and son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

An Account Owner who desires to change the beneficiary to a new beneficiary in a lower generation than the current beneficiary (e.g., child to grandchild) should consult with tax advisors before making such change as the change in beneficiary may have generation-skipping transfer tax consequences.

Contributions to 529 Plans

Donors may only contribute cash to a 529 plan. The cash can be subsequently invested in one or more investment vehicles.

Each 529 plan limits how much may be contributed to the account. Those limitations must prevent contributions on behalf of a Designated Beneficiary in excess of those necessary to fund his or her Qualified Higher Education Expenses.

Investment of Funds

Contributions to a 529 Plan may be invested in one or more investment vehicles (such as stocks, bonds, mutual funds, etc.). The Account Owner may have flexibility to change the investments, but may do so no more than twice per year.

Gift and Estate Tax Consequences

A brief word about federal estate and gift taxes. The federal gift tax is a tax on certain lifetime transfers of property. The federal estate tax is a tax on certain transfers of property at death.

Every taxpayer has an exemption from estate and gift taxes (the "Applicable Exclusion Amount"). For 2018, the Applicable Exclusion Amount is approximately $11,180,000 per taxpayer (reduced by exclusion amount used for gifts in prior years) and will increase annually for inflation.[2] Any Applicable Exclusion Amount remaining at a taxpayer's death is available to reduce federal estate taxes, if any, that apply because of the taxpayer's death.

For 2018, each taxpayer can give up to $15,000 per year to any beneficiary without gift tax consequences (the "Annual

[2] *Under current law, this increased exemption is scheduled to revert back to $5,600,000 per taxpayer in 2026, indexed for inflation.*

As with other investments, there are generally fees and expenses associated with participation in a 529 plan. Investing is subject to high degree of investment risk, including the possible loss of the entire amount of investment. There is also a risk that these plans may not perform well enough to cover costs as anticipated. Most states offer their own 529 programs, which may provide advantages and benefits exclusively for their residents. Investors should consider, before investing, whether the investor's or the designated beneficiary's home state offers any tax or other benefits that are only available for investment in such state's 529 savings plan. Such benefits may include financial aid, scholarship funds, and protection from creditors. The tax implications can vary significantly from state to state.

Exclusion"). Gifts in excess of the Annual Exclusion will reduce the taxpayer's Applicable Exclusion Amount. Once the taxpayer has consumed his or her Applicable Exclusion Amount, gifts in excess of the Annual Exclusion incur a gift tax equal to 40% of the amount of such gift. The Annual Exclusion may increase in future years.

Contributions to a 529 plan count against the donor's Annual Exclusion for gifts to the Designated Beneficiary and reduce the availability of that Annual Exclusion for other purposes.

Gifts to a 529 plan that exceed the Annual Exclusion may, at the election of the donor, be treated as if the donor made the gift in five equal increments over five years. Such election must be made by the donor on a federal gift (and generation-skipping transfer) tax return, Form 709, for the year of the gift. Such installment treatment only applies for contributions no greater than five times the Annual Exclusion at the time of the contribution.

Clients should consult with their tax advisors on the appropriateness of using Annual Exclusion gifting to fund 529 accounts, particularly those clients who anticipate significant estate taxes at their deaths. A taxpayer can pay unlimited amounts of tuition, without gift tax consequences, if the taxpayer pays the tuition directly to the educational institution. Such clients may achieve greater overall tax savings (income tax and future estate tax) by paying tuition directly as it comes due and utilizing his or her Annual Exclusion gift in other ways.

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