Transcript

Better conversations. Better outcomes.

Episode 77 – Funding education with a 529 plan

Mark Kantrowitz - Currently, only 18% of children under age 18 have 529 plans, and there's a lot of research that shows that a family that has a 529 plan, even a low income family and even a small amount, even as little as $250, it makes a difference in whether that child enrolls in college and graduates from college. It makes a really big difference. So, low income families are less likely to have 529 plans, but the benefit to them is tremendous. So if we can find a way to get more families to invest in 529 plans, it's going to make a difference in their lives and the lives of their children.

Ben Jones - Welcome to *Better Conversations. Better Outcomes.* presented by BMO Global Asset Management. I'm Ben Jones.

Emily Larsen - And I'm Emily Larson. On this show, we explore the world of wealth advising from every angle, providing actionable ideas designed to improve outcomes for a advisors and their clients.

Disclosure - The views expressed here are those of the participants and not those of BMO Global Asset Management, its affiliates or subsidiaries.

Emily Larsen - The cost of higher education has been climbing for years. Maybe more importantly, paying for college in the U.S. is getting more and more difficult for families of all kinds. That's why one of the most common questions that an advisor is asked is how can I help my children pay for college? Or for those just starting a family, what should we do now to make college a possibility in the future?

Ben Jones - Enter the 529 plan, a tax advantaged, educational savings plan that you're probably familiar with. In this episode, we're going to dive into the complexities of these plans, the advantages and disadvantages, and how to be the best advocate for your clients when it comes to saving for the education of their children or other family members.

Emily Larsen - Our guest is...

Mark Kantrowitz - My name is Mark Kantrowitz. I am publisher and vice president of research for SavingForCollege.com. SavingForCollege.com is the most popular guide to saving for college and 529 college savings plans.

Emily Larsen - I sat down with Mark at a BMO office in Illinois. He had some great advice about getting your clients started by opening and managing a 529 plan.

Mark Kantrowitz - They can help the family, first of all, evaluate their risk tolerance. Is the family comfortable with investing in an aged-based asset allocation, which is going to start off very aggressive? On the other hand, are they comfortable if they have low risk tolerance with the low returns that accompany that? Then they can help them make the process more efficient by setting up an automatic investment plan. If you have to think to save every month, you're going to miss some months, whereas if you set it up automatically, it's going to happen regardless of whether you remember to write a check or not. You can start off low. With a lot of these 529 plans, you can start off with a contribution as low as $15 or $25 a month. Once you get started, it's easier to increase the amount you save. The child no longer needs diapers. That's a couple thousand dollars a year. Redirect that money into the 529 plan. The child no longer needs daycare. That's substantial. Redirect it into the 529 plan.

Emily Larsen - And then helping the client make those choices as those life events occur.

Mark Kantrowitz - Right. And also helping them choose the selection of investments within the 529 plan to make sure it's appropriate to the family's investment horizon and their goals, make sure that they are saving the right amount. Should you be aiming to save the full amount of college costs or just a third? I recommend a third, because like any major life cycle event, it's going to be spread out over time. A third will come from past income, which is savings, a third from current income and tax benefits, and a third from future income, in terms of loans. Well, how much debt is reasonable debt? Well, your total debt at graduation should be less than your annual starting salary. The interesting thing is college costs go up by a factor of three over any 17-year period. If you're saving a third -- well, three times a third is one, that's suggesting your college savings goal should be the cost of the college education the year the child was born. You may not be able to predict the exact college that your child is going to go to, even though some parents get them little baby booties that have their alma mater on them. But you can probably predict the type of college. Is it going to be an in-state public college, and out of state public college, or a private, non-profit college? For a child born this year, you should be saving $250 a month if they're going to an in-state public college over that 17-year period, $450 a month for an out of state public college, and $550 a month for a private, non-profit college. Now how do you tell if you're on track? Let's say your child was born several years ago. There's a trick, which is you multiply the amount -- the age of the child by $3,000 for an in-state public college, $5,000 for an out of state public college, and $7,000 for a private, non-profit college. That tells you where you should be, benchmarking how much you should have saved. If the amount that you saved is less, then you start doing catch-up and you increase the amount you save. That puts you on track to save about a third of the future college costs.

Ben Jones - As you can tell, Mark has spent a lot of time thinking about this topic. He has some really great rules of thumb that may be helpful in conversations with your clients to start sketching out an overall savings plan, as well as checking in on that plan over time. But let's go back to the basics. What exactly is a 529 plan?

Mark Kantrowitz - A 529 college savings plan is a tax and financial aid advantaged way of saving for college. Essentially, it's a specialized college savings account, where you contribute after-tax money, and earnings accumulate on a tax deferred basis, and if you use the money to pay for qualified higher education expenses like tuition and fees, room and board, books, supplies, and equipment, the distributions are entirely tax free. In addition, there are 34 states and the District of Columbia that offer a state income tax deduction or a tax credit based on your contributions to the state's 529 plan -- there's actually six states where it's to any 529 plan. The 529 plan is named after Section 529 of the Internal Revenue Code of 1986. That's the piece of federal legislation that enabled the tax free status of these plans.

Emily Larsen - 529 plans have no annual contribution limit, but you have to be aware of gift tax considerations. Interestingly, you can open a 529 plan before a child is born by opening it with yourself as a named beneficiary, then changing to the child's name once they're born. Mark even went on to explain why 529 plans are smart decisions for people beyond new parents.

Mark Kantrowitz - Anybody can open a 529 plan. The financial aid treatment, though, depends on who the account owner is. It may, in some cases, be better to contribute money to a parent-owned 529 plan than for a grandparent to open up their own 529 plan, because if the 529 plan is owned by the parent, or in some cases, the student, a custodial 529 plan, it's reported as an asset on the free application for federal student aid, which has a small impact, because it is reported as a parent asset and distributions are ignored. But if anybody else is the account owner, grandparent, an aunt, an uncle, then it's not reported as an asset, but distributions count as untaxed income to the beneficiary. Untaxed income to the beneficiary combined with taxable income to yield total income, and that's what financial aid is based on. Part of the student's income is going to be sheltered. There's something called an income protection allowance, which currently is $6,660, but amounts above that, half of that amount reduces eligibility for need-based aid. As much as half of that distribution is going to reduce aid eligibility, which is a very harsh impact. It's often better for the money to be in a parent owned 529 plan than a grandparent owned 529 plan. There are some workarounds if you have a grandparent owned 529 plan. You could change the account owner from the grandparent to the parent, if that's allowed by the state, or you could wait until after January 1st of the sophomore year in college to take the distribution, assuming that the child is going to graduate in four years, because the FAFSA, the free application for federal student aid, is based on a prior prior year basis. So the income is two year old income. By January 1st of the sophomore year in college, you look ahead two years, there's no subsequent year FAFSA to be affected by that distribution from that point onward if the student is graduating in four years. If they're graduating in five years, you need to wait until they are after January 1st of the junior year in college. That's a way of working around it. Another option is to roll over a year's worth of funds from the grandparent owned 529 plan to the parent owned 529 plan, and then it's treated as though it's a parent asset. Now, timing matters. If you do the rollover after the FAFSA has been filed, it's not going to be reported as a parent asset on that year's FAFSA, and then if you spend down the money before the next year's FAFSA, then it has no impact on aid eligibility. It's kind of a way of having your cake and eating it, too.

Emily Larsen - Sure, but it's critically important for financial advisors to understand these timing issues.

Mark Kantrowitz - Absolutely.

Emily Larsen - And also potentially including more family members other than just your client, in terms of designing how contributions are going to be made and who is the owner of the account.

Mark Kantrowitz - 529 plans can be a great way for a financial advisor to get clients. Grandparents may want to leave a legacy for their grandchildren to help them pay for college, to make a difference in what they do. They may approach a financial advisor about how do we go about doing this? Because they're at a point in their lives where maybe they have more than enough assets to cover their retirement and then some, and so they want to have an impact on the second generation. The 529 plans have several estate planning benefits, because it's a way of transferring money to your grandchildren without having the gift taxes.

Emily Larsen - What happens when an account is overfunded? Plans change or education didn't cost as much as anticipated and the dollars weren't used.

Mark Kantrowitz - And the child doesn't go to college.

Emily Larsen - Or, right, they don't go to school. So what can be done with the overages in the 529 plan?

Mark Kantrowitz - If there's leftover money in the 529 plan, maybe the child didn't go to college, doesn't want to go, or maybe you saved too much money, which is pretty rare, there are several options. One is to just leave the money in the 529 plan. Maybe that child or grandchild will change their mind about going to college, or maybe they went to college but they'll go to grad school at some point. You can use 529 plans to pay for graduate school or medical school, or you could leave it for the next generation. There's no age limit or obligation to spend down the money in the 529 plan. Unlike a Coverdell Education Savings Account, where you have to spend the money by age 30. Another option is to take a non-qualified distribution. The earnings portion of a non-qualified distribution is going to be subject to income taxes at the beneficiary's rate plus a 10% tax penalty, plus a possibility of recapture of state income tax benefits attributable to that distribution. But oftentimes, this is really a negligible impact on it. You might be talking a few percent of the money that's in that distribution. That does allow you to use it for other purposes. There is another possibility, which is to change the beneficiary of the 529 plan. The beneficiary needs to be related to the current beneficiary, but you can change it to be a sibling of the beneficiary, or if the parent wants to go back to school themselves, they could change it to be themselves and use it for their own education.

Emily Larsen - When we're talking about a sibling in that scenario, did I read correctly that it doesn't necessarily need to just be higher education, but that in the last few years, acceptable expenditures from 529 plans does also include K through 12 expenses?

Mark Kantrowitz - The Tax Cuts and Job Act of 2017 allowed K to 12 tuition as a qualified expense. It could be a younger sibling who is not yet in college or in paying for that sibling's college education.

Ben Jones - So what are the tax benefits of 529 plans and how are earnings generated over time?

Mark Kantrowitz - There are a couple of key tax benefits of the 529 plan. One is that they are -- more than 2/3 of the states, 34 states and the District of Columbia, have state income tax deductions or tax credits, one state is actually both, based on your contributions to the 529 plan. In a way, that's like getting a discount on tuition. Even if your child is already in college, you give money to the 529 plan and then you take a distribution to pay the tuition bill. You're getting effectively a discount in your marginal tax rate in the state. There are four states that have provisions to try to prevent that. The other states don't really mind. They are aware of the loophole, but it isn't really abused. The earnings in the 529 plan accumulate on a tax deferred basis. If you take a non-qualified distribution, the taxes are at the beneficiary's rate, not the parent or grandparent's rate. It can be a significant savings. If you use them for qualified higher education expenses, or K to 12 tuition, it's entirely tax free. In a way, except for the added benefit of the state income tax deductions, it's very similar to a Roth IRA, because you're using after-tax money and it’s tax free if you use it for qualified expenses.

Emily Larsen - How are the earnings generated?

Mark Kantrowitz - Money in the 529 plan is going to be invested in one of a limited number of portfolios or a set of portfolios. Most 529 plans have both static and dynamic investment options. Over any 17 year period, from birth, to college, matriculation, you're going to have at least three corrections, which are drops of at least 10% in the stock market, and at least one bear market, which is a drop of 20% in the stock market. You can't avoid all risk, but what you can do is you can manage it. An age-based asset allocation is a good way of adjusting for it. When the child is a newborn, you don't have as much money saved, and you have 17 years to recover from any losses. When college is just around the corner, you have a lot more money in that 529 plan and you don't have as much time to recover from losses. So you're locking your gains and shifting it to a more conservative mix, a lower percentage of equities, higher percentage of short-term income, like bonds, as well as money market accounts and bank CDs. Another thing that the financial advisors can help the family with, which is how to spend the money in the 529 plan. If it's in a parent owned 529 plan, it's going to be reported as a parent asset on the FAFSA, which is going to reduce aid eligibility by up to 5.64% of the asset value. It's a bracketed system. Top bracket is 5.64%. If the money stays in the 529 plan all four years, then it's going to be hurting you each successive year. So one strategy is to spend it all down as quickly as possible. However, there's the American Opportunity Tax Credit, which gives you a partially refundable tax credit worth up to $2,500 based on up to $4,000 that you spend on tuition and textbooks. That is worth more for qualified expense than a tax free distribution from a 529 plan. The IRS doesn't let you double dip, so you can’t use the same dollar of textbook expenses to justify both a tax free distribution from a 529 plan as well as the American Opportunity Tax Credit. So what you probably want to do is carve out $4,000 of tuition and text book expenses that will be paid for not using 529 plan money. Depending on how much money the family has saved, they may also want to consider the student loans. The Federal Stafford Loan or Federal Direct Loan is a low cost loan that is a reasonable way for the child to have skin in the game. There are annual limits, and if you don't use the -- you don't borrow the loans one year, you can't come back the next year and borrow the previous year's loan limits. It's one year at a time. If you know that the child is going to need to borrow to pay the cost, that you don't have enough money between the 529 plan and the American Opportunity Tax Credit to cover all costs, you may want to plan for how much you're going to borrow each year. So that may be -- rather than carve out $4,000 for the American Opportunity Tax Credit, and then fill in the rest with the 529 plan. You may need to also carve out like $5,500 for the Stafford Loan as a freshman, and the amounts increase each year. So 5,500 freshman, 6,500 sophomore, 7,500 junior, and 7,500 senior. So you may want to carve out up to that amount to be borrowed in loans. Then you use the 529 to fill in the rest. There's some complexity here in planning how you're going to use the money, and that's another area that the financial advisor can help. A lot of financial advisors, they focus on the tax impact and the return on investment, and financial aid is completely foreign to them. Sometimes, there's a trade-off between what you do for the tax perspective versus what you do from the financial aid perspective. Some things that you do from a tax optimization point of view may actually hurt aid eligibility.

Ben Jones - This is an important point, and one worth emphasizing. As an advisor, you need to make sure that you know the desired payment strategy of your clients. This will help you to optimize their planning so that you can weigh the trade-offs from savings, aid, and taxes.

Emily Larsen - The state that you reside in can affect the tax benefits of a 529 plan, but the beneficiary does not have to enroll in a school in the state where the 529 plan was opened. Additionally, you can move to a new state, and keep your 529 plan in the previous state. There are lots of options here for advisors and their clients to work through.

Ben Jones - As with many planning and investing instruments, Mark talks about the central role of the advisor in helping the clients navigate the complexity of the rules, and assuring them through market downturns.

Mark Kantrowitz - The financial advisors need to look out for the best interests of their clients. So that means, what is the balance between the state income tax deduction and the fees that are going to be charged by investing in that state's plan, versus a different state's plan. There's also a lot of complexity in the details, and each state's plan has different rules. And I think the most important benefit of having a financial advisor is to help the family not panic. Because, consider that December of this past year, 2018, the stock market went down 10%. Some families might react to that by panicking and pulling their money out of the 529 plans, locking in their losses. Whereas the financial advisor can tell them stay the course, don't panic, what goes down goes up, just like elevators. If you stay in you're going to be better off, because you won't miss out on the recovery.

Emily Larsen - Are 529 plans the only tax advantaged way to save for education?

Mark Kantrowitz - 529 plans are in a category called qualified tuition plans, and there are two others besides 529 college savings plans. There are prepaid tuition plans, and Coverdell Education Savings Accounts. So, a prepaid tuition plan has you buy a share of college costs, and so that share is always going to be worth that percentage of college costs indefinitely. The idea is that you're buying future college tuition at today's prices. The problem with the prepaid tuition plans -- and you can think of a prepaid tuition plan as being kind of a defined benefit plan, and a 529 college savings plan as a defined contribution plan. So, it's like the difference between a pension and a 401(k). The challenge with the prepaid tuition plans is what happens -- who's guaranteeing that you're going to get that return? Is it backed by the full faith and credit of the state? Or, is it a legislative guarantee? And what does that really mean? Does it mean that the state's going to make up for the shortfalls if there are -- and most of them have actuarial shortfalls. That's one problem. Another is that you're not really buying tuition at today's prices. You're buying tuition at today's prices, plus a premium to make up the difference between the increase in college costs and the return on investment. And, in fact, prepaid tuition plans, they tend to work very well when the stock market is going up. But when the stock market is going down, as occurs during an economic downturn, you have two problems that they face. One is that they're losing money, and so they don't have as much money to meet their future obligations. The other problem is, during an economic downturn, you tend to have above average tuition inflation at public colleges. And they're being squeezed from two directions. That's why very few of them have enough money to meet their future obligations. Very good investment if you had invested in them decades ago, but today, they're running into problems. I don't recommend prepaid tuition plans. Now, the Coverdell Education Savings Accounts have a lot more restrictions on them that make them less useful in most cases. Now, the one advantage a Coverdell has is that you can choose individual stocks in any particular investment. But, your contributions from all sources are limited to $2,000 a year. You can only contribute through the -- when the child reaches age 18, and you have to use the money by the time the child reaches age 30. An advantage of the Coverdells is that you can use them not just for college costs; you can also use them for K to 12 expenses, and not just tuition, but any K to12 expense. So, some people like the Coverdell as a vehicle for saving for elementary and secondary school at private K to12.

Emily Larsen - And so if someone was using a Coverdell, could they also utilize a 529?

Mark Kantrowitz - They could also use a 529. However, keep in mind that the gift tax issue -- I mean, you can't give more than $15,000 per contributor per beneficiary across all the 529 plans, prepaid tuition plans, and Coverdell. So you would be splitting that as opposed to concentrating it in the 529 plans. And also, keep in mind that if you want to give other gifts to that child, I mean, if you've given the full annual gift tax exclusion, you don't have any more money that you can give to the child without incurring gift taxes, or using up the lifetime gift tax exclusion.

Emily Larsen - 529 plans are a great planning tool for funding education costs. But you can explore the topic even further using the links listed on our show notes page. Or use this episode as a resource to re-listen to when preparing for client conversations. Mark's concluding thoughts include a couple more rules of thumb to keep in mind.

Mark Kantrowitz - It's cheaper to save than to borrow, so start saving as soon as possible, as your greatest asset is time. And if you start saving from birth, about 1/3 of your college savings goal will come from the earnings. If you wait until the child enters high school to start saving, less than 10% will come from the earnings, and you'd have to save six times as much to meet the same college savings goal. At savingforcollege.com, we not only have over 1,000 articles about saving for college and all the different vehicles, 529 plans, Coverdells, Roth IRAs, prepaid tuition plans, we're also adding a lot of content about student loans. Part of the reason is that there's kind of a balance between savings and loans. The more you save, the less you'll need to borrow. And we like to encourage people to save more. But, if you haven't saved enough, you're going to have to borrow, and we're going to teach you how to do it more intelligently. Like, what is a reasonable amount of debt? For the student, their total debt at graduation should ideally be less than their annual starting salary. Total debt is less than annual income; they can afford to repay the student loans in 10 years or less. A similar rule of thumb applies to the parents. Parents should borrow no more for all their children than their annual income. Now, if retirement is less than 10 years away, let's say it's only five years away; you should borrow half as much.

Ben Jones - And we're going to leave you with one last tip from Mark, a gift idea.

Emily Larsen - Contributions to a 529 plan can be a great baby shower gift. Instead of giving the child a trinket, a toy, or something tangible for their birthday or the holidays, give them the gift of college.

Ben Jones - Thank you for listening to *Better Conversations. Better Outcomes.* This podcast is presented by BMO Global Asset Management. To access the resources discussed in today's show, please visit us at www.bmogam.com/betterconversations.

Emily Larsen - We love feedback, and would love to hear what you thought about today's episode. You can send an e-mail to betterconversations@bmo.com.

Ben Jones - And we really respond.

Emily Larsen - We do.

Ben Jones - If you thought of someone during today's episode, we would be flattered if you'd take a moment and share this podcast with them. You can listen and subscribe to our show on Apple Podcasts, or whatever your favorite podcast provider is. And, of course, we would very greatly appreciate if you'd take a moment to rate or review us on that app. This show and resources are supported by a very talented team of dedicated professionals at BMO, including Pat Bordak, Gayle Gipson, Matt Perry, Derek

Devereaux. The show is edited and produced by Jonah Geil-Neufeld and Annie Fassler of Puddle Creative. And these are the real people that make this show happen, so thank you. Until next time, I'm Ben Jones.

Emily Larsen - And I'm Emily Larson. From all of us at BMO Global Asset Management hoping you have a productive and wonderful week.