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Insight

It's Time to Go to School with 529s

-Manchester Capital Management Strategy Group

"Parents, friends, faculty, honored guests, and fellow graduates . . ." Yes, graduation season is here. While students and families celebrate and look forward to a final summer together, tuition bills for first-year or returning college students will arrive in mailboxes shortly. As any parent, grandparent, or student who has pondered the exorbitant and rising cost of college tuition knows, planning ahead is a necessity. In many cases, parents and grandparents have been planning and saving since the student's birth.

A popular tool used by families to accumulate savings for college is a 529 plan, officially labeled "qualified state tuition programs." With 529 plans, while starting early and saving often is key, almost as important is developing a strategy to use the accumulated savings. While one would think simply tapping those savings to pay expenses would be straightforward, not doing some advance planning can lead to costly mistakes. To give you an idea of what can happen, we'll touch on three potential pitfalls.

Originally created in 1996, 529 plans are tax-free educational savings plans. Designed as alternatives to Uniform Transfer or Uniform Gift to Minors Accounts (UGMAs and UTMAs), 529s offer several advantages. Assets placed in 529s grow tax free, and as long as they are used for secondary (originally) education purposes, that growth is never taxed. The owner of a 529 plan retains ownership of the assets and can recover them at any time, subject to a 10% penalty and tax on asset growth.

In addition to an owner, a 529 plan has a plan beneficiary—the student whose educational expenses are to be paid. At any time, the owner can change the beneficiary to another blood relative. This allows unused funds to be directed to pay someone else's educational expenses as long as that someone else is a blood relative such as a sibling, child, or grandchild.

For most families, financing a college education will involve some combination of scholarships, grants, borrowed funds, and savings (the student's or someone else's). Applications for several of those elements look at both the student's and the parents' assets. Because of this, it matters who owns a 529 plan benefitting the student. When applying for financial aid, 529 plan assets above a threshold, and owned by the student or parents, reduce needs-based aid; however, plan assets owned by grandparents are invisible to the initial financial aid application.

While it would seem ideal, therefore, to have grandparents own all 529 plans, once the plan makes a distribution to a school on behalf of a student, the following year's financial aid application will consider that distribution untaxed income to the student, and, depending on individual circumstances, can reduce need-based financial aid by up to 50% of the amount distributed. This type of negative effect can be avoided by using grandparent 529 assets for later tuition years or by having grandparents transfer plan ownership to the parents before the first payment is made.

Another pitfall can occur if 529 plan assets are used to pay all college expenses, with no out-of-pocket contribution by the family. The ability to claim some tax credits, such as the American Opportunity Tax Credit, requires that a portion of college expenses be paid out-of-pocket.

Finally, the Tax Cuts and Jobs Act of 2017 loosened the restrictions on 529 plans to enable them to cover not just college costs, but qualified K-12 private school expenses. While this is a change at the Federal level, many states have not yet adopted the same rules. This means it is possible to have IRS-approved withdrawals for K-12 expenses wind up subject to state taxes and penalties.

529 plans represent a fantastic vehicle for college savings and their tax-free nature and the ability to change beneficiaries give them some interesting estate planning possibilities. However, when it comes to using those savings, whether for K-12 expenses or college expenses, we strongly suggest meeting with a knowledgeable accountant or advisor to develop a plan for how to use the assets. With income limits and differing assessments, a strategy is required to allow parents and students to maximize all advantages available to them. As any student knows, doing your homework upfront can result in a much better outcome.