# How to Choose a 529 College Savings Plan

By W. Ben Utley, CFP® and Lawrence B. Keller, CFP®, CLU®, ChFC®, RHU®, LUTCF

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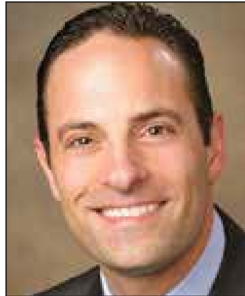
Lawrence B. Keller

Section 529 College Savings plans are tax-advantaged college savings vehicles, and one of the most popular ways to save for college today. Known officially as "qualified tuition programs," 529 college savings plans have changed the world of tuition savings, much like the way 401(k) plans changed the world of retirement savings a few decades ago. While a 529 plan may be the best vehicle to save for college, you will need to understand the basics in order to make the right choice.

## The Basics of 529 Plans

Congress created 529 plans in 1996 and named them after Section 529 of the Internal Revenue code. A 529 plan is state-operated and offers tax advantages as well as other potential incentives to ease saving for college or postsecondary training for a designated beneficiary, such as a child or grandchild. Eligible educational institutions generally include colleges, universities, vocational schools, or other postsecondary educational institutions eligible to participate in a student aid program administered by the US Department of Education.

When establishing a 529 plan, you can name anyone as a beneficiary, including a relative, a friend, or yourself. There are no income restrictions on you as the contributor, or on the beneficiary, and there is also no limit to the number of 529 plans you can establish. College savings plans are established by individual states and typically managed by an experienced financial institution that the state has designated. All 50 states and the District of Columbia sponsor at least 1 type of 529 plan.

The main advantage to these plans is that earnings are not subject to federal tax—and generally not subject to state tax—when the designated beneficiary uses the money for "qualified higher education expenses" (eg, tuition, fees, books, room and board). If you make a nonqualified withdrawal (ie, a withdrawal used for something other than the beneficiary's qualified higher education expenses), then the earnings portion of the withdrawal will be taxed at the federal level at the rate of the person who receives the distribution (usually the account owner). State taxes will likely apply in addition to a penalty; specifically, the earnings portion of the withdrawal will be subject to a 10% federal penalty.

The majority of plans are open to residents of any state. This means you can shop for the plan with the best money manager, overall performance record, investment options, fees, and customer service. Keep in mind, however, that many states limit their tax benefits to residents who participate in an in-state college savings plan.

Opening a 529 plan is simple: complete a short application, designate a beneficiary, and contribute the required minimum amount. Most plans also offer automatic deductions or electronic fund transfers to make future saving even easier. Once the account is open, you or anyone else can contribute as much money to the account as you wish, subject to the plan's specific limits. Some plans may require a minimum amount to open the account, have a minimum amount for each contribution, or restrict the total contributions allowed per year. All plans have total lifetime contribution limits; however, most states generally have limits in excess of $300,000.

You can roll over your existing college savings plan account to a new 529 plan account once every 12 months without any federal tax penalty and without having to change the beneficiary. There may be state income tax consequences (and, in some cases, state-imposed penalties) that result from such a rollover. This option lets you leave a plan with few investment choices or one that has earned poor returns for a plan with more investment flexibility or a better track record. If you are satisfied with the plan but want to change the way your existing assets are invested, this can be done twice each calendar year, or whenever the account beneficiary changes. You do have the ability to change how your future contributions are allocated at any time.

If your child receives a college scholarship, you can withdraw money without penalty as long as your withdrawals during the year don't exceed the annual scholarship amount. However, you will owe federal and state income taxes on the earnings portion of each withdrawal.

If the beneficiary doesn't use the money in the account for college, you can use the savings for graduate school or other higher education later, transfer the balance without penalty to another eligible family member (including a parent, step-sibling, half-sibling, or, in some cases, an inlaw of the original beneficiary), or simply make a nonqualified withdrawal as described earlier.

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Section 529 plans yield another valuable break: estate taxes. Contributions to the plan are considered a completed gift under estate tax code, so your contribution qualifies for the $14,000 annual gift tax exclusion amount. In fact, you can contribute up to $70,000 per child and then elect to treat the contribution as if it were made over a 5-year period. This means a physician's family with 2 children could move as much as $280,000 into the plan, and out of their estate, in a year.

Now that you understand the basics, let's look at the steps you will need to take as you do your financial planning for college.

1 **Determine whether your state offers a tax advantage for 529 plan contributions.** Colorado, Georgia, Idaho, Iowa, Kansas, Louisiana, Maryland, Michigan, Mississippi, Missouri, Montana, Nebraska, New Mexico, New York, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Utah, Virginia, West Virginia, and Wisconsin offer tax benefits for 529 contributions made by taxpayers residing in those states.

2 **Learn how your state's tax break works.** Contact your tax specialist and ask these 3 questions:

- How much money do I need to contribute to my state's 529 plan to get the maximum tax benefit?
- How much will I save in taxes when I make my contribution?
- What is the deadline for making a contribution?

Note that some states will only allow you to deduct calendar year contributions from your tax return, while others will allow you to contribute up until the time your return is filed (as is the case with IRA contributions). If you discover this article in March, this means you might still have a chance to save taxes if you forgot (or didn't know) to make a contribution last year.

3 **Research investment results and expenses for in-state and out-of-state plans.** If your state offers a tax break for 529 plan contributions, it might seem like this is the best option. But what if the performance of your state's plan is poor? The cost of lower returns may outweigh the benefit of the tax break, so do a little digging and run a quick calculation.

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4 **Calculate the performance gap: this is the difference in total return between your in-state plan and the out-of-state plan.**

5 **Think about the amount of money you will have in the plan.** If you are targeting a 4-year private university at a cost of $200,000 per student, and your family has nothing saved today, the average balance between now and then will probably be about $100,000.

6 **Calculate the opportunity cost of using the in-state plan: multiply the average amount you'll have invested by the performance gap.**

Amount Invested × Performance Gap = Opportunity Cost

7 **Let the opportunity cost help you choose your plan.** If the tax benefit outweighs the opportunity cost, consider using your state's plan. If the opportunity cost is much larger than the tax benefit, then the out-of-state plan might be a better choice. We say "might be" because there's one more thing you need to consider as you choose your plan: asset protection. Some state plans confer a measure of protection against the claims of creditors, and in some states this protection only extends to physicians who live in that state and contribute to the in-state 529 plan. The law on this issue varies from state to state, so you might want to seek legal counsel if you are at all concerned about the protections your plan may (or may not) afford.

Joseph F. Hurley, CPA, founder of www.savingforcollege.com and the nation's expert on saving for college, hails the 529 plan as the best way to save for college. Even though the tax benefits, creditor protection, and kid-friendly usability were intended for everyone's benefit, these features make 529 plans the best way for families of physicians to save for college, too. Choosing the right 529 plan is not as easy as it appears, but these steps will help you make the right choice for your family. ●

*Lawrence B. Keller, CFP®, CLU®, ChFC®, RHU®, LUTCF, is the founder of Physician Financial Services, a New York–based firm specializing in income protection and wealth accumulation strategies for physicians. He can be reached by calling 516-677-6211 or by e-mail to Lkeller@physicianfinancialservices.com.*

*W. Ben Utley, CFP®, is the lead advisor with Physician Family Financial Advisors, a fee-only financial planning firm helping doctors throughout the United States to save for college and invest for retirement. He can be reached by calling 541-463-0899 or by e-mail to ben@physicianfamily.com.*