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ADVISOR'S BULLETIN

WHAT'S IN THIS MONTH'S NEWSLETTER

SECTION 529 PLANS AND COLLEGE FUNDING REVISITED

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A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Planning for college funding is big business. According to the National Center for Educational Statistics (www.nces.ed.gov), the number of students in U.S. colleges this year is about 20 million. The same website reports the most recent average annual costs for undergraduate tuition, room, and board were estimated to be nearly $20,000 at public four-year institutions and nearly $40,000 annually at private institutions.

The high cost of college generates challenges for parents and prospective students planning to pay those costs. Some financial professionals are dedicating a substantial portion of their time to the college planning market. Training organizations, such as the National Institute of Certified College Planners (NICCP), offer advisor certifications in college planning. Even those professionals who do not focus primarily on the college planning market must be prepared to give their clients some advice about saving for higher education.

Federal and state governments have stepped into the discussion by offering tax incentives for participating in certain kinds of college savings programs. One of the most popular examples is the *Section 529 plan*. In the May 2012 issue of *Advisors Bulletin,* we wrote about planning to pay for college, especially through the use of Section 529 plans. Since then, some of the details surrounding financial aid and Section 529 plans have changed.

In this article, we will review

- the basics of Section 529 plan savings,
- the role Section 529 plans can play with regard to financial aid,
- some of the uncertainties connected with Section 529 plans,
- a court case that highlights complexities in Section 529 plan ownership, and
- alternative approaches to saving for college.

Let's get started.

Regards,

Michael W. Lagos, CFP®

SECTION 529 PLANS AND COLLEGE FUNDING REVISITED

THE COLLEGE FUNDING MARKET

Parents have two basic strategies to provide for their children's college education:

- Save enough of the parents' own resources to cover the costs.
- Maximize the child's ability to qualify for financial aid to cover the costs.

For most, the optimal approach will involve a combination of both ideas.

Saving Enough for Children's College Expenses

Planning to save enough to cover the costs of college means making several financial calculations based on assumptions regarding:

- Current costs for the target college
- Projected cost inflation
- Years until the student will need college money
- Number of years for which funding is needed
- Investment return
- Tax costs of accessing funds
- Tax benefits of savings

Free and simple college expense calculators are available online—for example, see the one at http://www.dinkytown.net/java/CollegeSavings.html. The calculators can also be sophisticated, for-fee programs available for licensing, such as the one at http://www.collegiatefundingsolutions.com/advisor.php#.

Maximizing Eligibility for Financial Aid

Decisions about eligibility for *federal* aid programs for college funding—such as Pell Grants or federal loan programs—are driven by information included on the *free application for federal student aid* (FAFSA). Parents and dependent students must typically fill out the form months in advance of the school academic year for which aid is sought. The form is available online at www.fafsa.ed.gov.

The FAFSA form seeks information about students' and parents' income and net worth. Income information is generally provided for the calendar year prior to the start of the academic year. For example, for the 2019–20 academic year, applicants provide income information for calendar year 2018.

Net worth information is based on a personal balance sheet snapshot on the day of application.

FAFSA is friendly to the life insurance business because the cash value of permanent life plans or annuities is not a countable asset under its methodology. FAFSA also does not consider equity in a home, retirement plan assets, or the value of a closely held business to be available to pay for college.

In general, the more countable income or assets a student or the student's parents have under FAFSA, the less likely they are to qualify for federal aid programs.

In addition to federal programs, colleges may also have their own scholarships, grants, or loan programs. Eligibility for such programs may be based on a methodology that differs from FAFSA. One such alternative is the College Scholarship Service Profile (CSS).

According to the website http://www.savingforcollege.com, here are some of the differences between FAFSA and CSS:

- The FAFSA ignores the net home equity of the family's principal place of residence, while the CSS Profile does not.
- The FAFSA ignores the net worth of small businesses owned and controlled by the family, while the CSS Profile does not.
- Deferred annuities are countable assets on the CSS Profile, while the cash value does not figure for FAFSA.
- The CSS generally expects the student to contribute more of her own assets for college funding than FAFSA.
- The CSS methodology assumes a student can work part-time to contribute some of that income toward college expenses.
- The value of a grandparent-owned Section 529 plan is a countable asset for CSS, while it is not for FAFSA.

Each college's financial aid department must be consulted to determine the financial aid programs available and eligibility.

OVERVIEW OF SECTION 529

To provide parents and students incentives to save for college, Congress and the president approved the Small Business Job Protection Act in 1996, which created Revenue Code Section 529.

Section 529 History

Section 529 provides certain tax benefits for *qualified state tuition programs* sponsored by individual states or their designees. The original language of Section 529 was amended in 1997, 1998, and 2001.

In 1998, the IRS issued proposed regulations governing Section 529 plan. Taxpayers have been permitted to rely on them for tax years since 1997. *The Section 529 regulations have not been updated or finalized.*

Section 529 Basics

Since Section 529 accounts are run by each individual state, each state's plan is different. A particular state's plan might concentrate on certain investment choices that are unavailable in another state's Section 529 plan. In general, taxpayers can choose to invest in any state's Section 529 plan and use the benefits to pay for college expenses in that state or any other state.

When a Section 529 account is created, the account owner is required to designate a beneficiary. This beneficiary is the person who is expected to attend college in the future.

Anyone can contribute to a Section 529 plan, regardless of income. However, contributions to a Section 529 plan are considered to be completed gifts to the plan beneficiary, so the gift tax consequences of contributions need to be considered. This fact makes Section 529 plans unique and helps explain why there are so many uncertainties in connection with how they operate. We will discuss this in more detail later.

When distributions are made from the account for the beneficiary's *qualified educational expenses*, the distributions are tax-free to the account owner and the beneficiary. Here's how Code Section 529 defines qualified educational expenses:

The term "qualified higher education expenses" means—

> *(i) tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution;*
> *(ii) expenses for special needs services in the case of a special needs beneficiary which are incurred in connection with such enrollment or attendance.*
> . . .

(B) ***Room and board included for students who are at least half-time***

> *(i) In general in the case of an individual who is an eligible . . . for any academic period, such term shall also include reasonable costs for such period (as determined under the qualified tuition program) incurred by the designated beneficiary for room and board while attending such institution.*

The account owner can change the initial designated beneficiary at any time. This flexibility is useful, especially if the named beneficiary decides not to go to college or if some account money is still available after graduation. The beneficiary can be changed to any immediate family member of the account owner, as well as descendants of the original beneficiary.

INCOME TAX ISSUES IN SECTION 529 PLANNING

While there may be estate, gift, and GST issues related to Section 529 accounts, we will focus on income tax rules.

Income Tax Principles

Contributions to a Section 529 plan are not federal income tax deductible.

Distributions for the account beneficiary's qualified higher education expenses are federal income tax free. The gain portion of *nonqualified distributions* paid to the account owner is taxable to the account owner. If a nonqualified distribution is paid to the account beneficiary directly, the beneficiary pays income tax on the taxable portion of the distribution.

A nonqualified distribution from a Section 529 plan is considered to be coming pro-rata from the account's basis and growth. The taxable portion of a nonqualified distribution is also subject to a 10 percent penalty tax.

Here's an example:

> Dave set up a Section 529 plan account with a single $10,000 deposit for his son Buster. The account is now worth $20,000. Dave decides to take a nonqualified distribution from the account of $5,000. The distribution is 50 percent a return of basis and 50 percent taxable. The taxable portion—$2,500—is also subject to a 10 percent penalty tax.

Nonqualified distributions may be exempt from the penalty tax if made on account of the death or disability of the beneficiary or if the distributions are no greater than a scholarship received by the beneficiary.

State Income Tax Deduction

According to https://www.savingforcollege.com/college-savings-201, 38 states and the District of Columbia currently grant state income tax deductions or state tax credits for contributions to a Section 529 plan. Most of the deductions are limited to contributions to the state's own plan, but some allow deductions for contributions to any state plan.

Most of the tax benefits are subject to dollar caps.

Exchange

Two kinds of exchange of a Section 529 plan account are recognized from a federal income tax perspective:

1. The naming of a new beneficiary by the account owner is considered to be an income tax free exchange, so long as the new designated beneficiary is a *member of the family* of the old beneficiary. A family member is a spouse, children (and descendants), parents, nieces or nephews, aunts or uncles, and in-laws. Step-relatives also generally qualify as family members.
2. An account may be rolled over from one state's Section 529 program to another state's program on a tax-free basis.

The rules limit tax-free rollovers to a new account for the same beneficiary to just one in any 12-month period.

While moving a Section 529 plan to another state's program may be income tax free from a federal perspective, such a move may have state income tax consequences. Some states that allow taxpayers to deduct Section 529 plan contributions will force a taxpayer to recapture the state tax benefits when a plan is moved. Also, some states that allow for tax credits or deductions for contributions will make those tax benefits available for rollover contributions.

Change in Ownership

Say that Mother is the owner of a Section 529 account for the benefit of Daughter. Assume the account has value after Daughter graduates from college, and Mother decides to transfer ownership of the account to Daughter at that time. What are the tax consequences?

Because under the Section 529 statute Mother made a completed gift of the Section 529 account to Daughter when the account was funded, there should be no additional gift tax consequences to Mother. That result doesn't seem to make logical sense based on traditional gift-tax principles, but it's probably correct.

Nothing in the rules or regulations says a change in ownership triggers an income-taxable event upon change in account ownership. However, the rules do say a *change in beneficiary* could be income taxable.

Change in Beneficiary

Only one individual may be named the beneficiary of a Section 529 account. Trust beneficiaries are not permitted.

If the owner of the account changes the account beneficiary, a change in beneficiary to a family member of the old beneficiary is not income taxable.

A change of beneficiary during the beneficiary's lifetime to a nonfamily member is probably treated as an income taxable disposition of the account. The rules don't say for sure whether the income-tax result belongs to the account owner or to the old beneficiary.

Likewise, for gift tax purposes, there's a gift tax exception to naming a new beneficiary in the same family as the old one. If the account is transferred to someone else, the transfer is gift taxable. The rules imply that the gift tax result is the old beneficiary's rather than the account owner's.

What about a change in beneficiary due to the beneficiary's death? Could there also be an income-tax event? The temporary regulations are not clear. The best guess is probably not, unless the plan value itself is distributed to the estate of the beneficiary.

PLAN OWNERSHIP

Some Section 529 plans restrict ownership to one individual owner. Others permit joint ownership between spouses, and a few also allow trust ownership of the account.

Choices

Where ownership is an individual, the best practice is to name a contingent owner in case the named owner dies prior to the account's being exhausted. What if no contingent owner is named? Normally we'd expect the ownership of the account to be sorted out through the probate process of the owner's estate. However, the Section 529 statute says that the account is considered the beneficiary's from a gift tax perspective. In the absence of contractual language in the Section 529 plan directing the plan to the account owner's estate upon the owner's death, should the beneficiary be the new legal owner automatically? We don't know for sure.

Some may want to sidestep the uncertainty about transfer of the account in the event of the death of the account owner. If the state plan permits it, parents who have revocable trusts might consider trust ownership of the Section 529 plan account.

Parents planning for their children's college education expenses sometimes plan to put money aside in various financial vehicles to fund for the liability. In many cases they consider titling the account in the name of the intended recipient using Uniform Gifts or Uniform Transfers to Minors Act (UTMA) custodianship. The downside of that strategy is that once the child reaches the age of majority—as young as 18 in some states—the custodianship terminates, and the account is considered to be a countable asset of the student.

Potential Ambiguities with Section 529 Plan Trust Ownership—a Court Case

In the case of *Alberhasky v. Alberhasky*, No. 18-0927 (Ct.App. IA May 15, 2019), the Iowa state appeals court was asked to rule on a beneficiary's claims on a Section 529 account.

Rod and Angela had two sons—Max and Grayson. In 2000, the boys' paternal grandmother, Allie, established a revocable trust as part of her estate planning. Rod and his sister JoEllen assumed their roles as co-trustees of Allie's Trust in 2009.

In 2010, Allie's Trust deposited $65,000 into an Iowa 529 Plan with Max as the named beneficiary. Allie's Trust likewise set up 529 plans with identical deposits for the benefit of her other three grandchildren.

At some point after 2010, Rod and Angela divorced. Apparently during that process, Rod and Max had a falling out. In 2013, Rod was removed as custodian of Max's UTMA accounts and also as co-trustee of Allie's trust.

Allie died in 2011. In 2012, prior to his removal as co-trustee of Allie's trust, Rod modified the 529 plan that had initially naming Max as the beneficiary to instead name Max's younger brother Grayson as beneficiary.

In December 2013, Max sued Rod, alleging, among other things, that Rod had no right to remove Max as beneficiary of the Section 529 account. His petition contended that Rod owed Max fiduciary duties in handling the 529 plan, and Rod breached those fiduciary duties. The petition sought to void the transaction transferring the beneficiary designation of the 529 account from Max to Grayson.

In dismissing Max's claim relating to the 529 plan, the state district court found Max had no right to challenge how the account was controlled by the owner. The court also found no authority to support the proposition that a 529 account is subject to the Iowa trust code.

Max appealed. The court reviewed Max's factual assertions that Allie funded college savings

plans for each of her grandchildren in equal amounts and Rod had changed the beneficiary designation while acting as a trustee of the 529 plan established for Max's benefit by Allie's Trust. The complaint alleged Rod breached his fiduciary duty to Max by transferring to Grayson the funds in Max's 529 plan—in opposition to Allie's original intention.

The appeals court decided that both Iowa trust law and Section 529 law could apply to the fact situation in this case. While there was not enough evidence to decide that Rod had definitely breached his duty to Max, the appeals court believed the district court needed to reconsider its decision in light of the fact that Iowa trust law did apply to the account. It reversed the finding in Rod's favor and sent the case back to the lower court.

CHANGES TO SECTION 529 PLANS AS A RESULT OF THE TCJA

The Tax Cut and Jobs Act (TCJA) made changes to some Section 529 plan rules. One change allows distributions from 529 plans to be used to pay up to a total of $10,000 of tuition per beneficiary (regardless of the number of contributing plans) each year for a K-12 public, private, or religious school of the beneficiary's choosing.

The second TCJA change allows funds to be rolled over tax-free from a designated beneficiary's 529 plan to a tax-favored ABLE account. ABLE accounts are intended for the disability expenses of certain people who become disabled before age 26.

ALTERNATIVE INVESTMENTS TO SECTION 529 PLANS FOR COLLEGE

Section 529 plans aren't the only way to save for college. Life insurance and financial professionals have other investment tools available for their clients' consideration.

Coverdell Education Savings Accounts

Coverdell Education Savings Accounts, sometimes also called Education IRAs, are a reasonable alternative to Section 529 plans. Here's a summary of the relative advantages.

- A Coverdell account has more investment choices than a Section 529 plan.
- Coverdells can cover more expenses on a tax-free basis than Section 529 plans, including private elementary and high school costs.

Here are the disadvantages of Coverdells.

- The annual contribution limit is *$2,000 per child,* no matter how many donors there are.
- The account beneficiary must be younger than 18 at the time any deposit is made.
- The account must be used up by the time the beneficiary is 30 or be rolled over for the beneficiary of a sibling younger than 18.
- The ability to make contributions is phased out for those with too much adjusted gross income.

Permanent Life Insurance

Cash-value life insurance is often used as an alternative for college funding. When the policy is owned by the parent, also insuring the parent's life, life insurance has the obvious advantage that it will provide a college-funding death benefit if the parent dies early.

Life insurance also has these advantages:

- If the policy is owned by the parent, there are no gift-tax worries when the premium is paid.
- The cash value of policies owned by parents is not currently a countable asset for FAFSA or CSS purposes, although the cash value may be countable under other financial aid methodologies.
- The cash value and death benefit are available for noneducation purposes without any special tax penalties.
- The investment choices in a life policy can be greater than the number offered through Section 529 plans.
- The coverage can be maintained post-college without any loss in lifetime or post-death tax benefits.

- There is no limit on the amount of money that can be saved in this way (subject to life insurance guideline limits).

Life insurance can be less effective than a Section 529 plan for the following reasons:

- Lifetime distributions can be partly taxable, even if used for college education.

- If the parent tries to put cash into the policy all at once, the life policy may become a modified endowment contract (MEC). MEC distributions made during the insured's lifetime are taxed on a gain-first basis and may also be subject to an extra 10 percent penalty tax.

Deferred Annuities

Annuities may also be considered for college funding. As with life insurance, annuities offer more investment choices and funding capabilities than Section 529 plans. Also, for FAFSA purposes, an annuity owned by the child's parent is not currently a countable asset—although annuities count under the CSS Profile.

Distributions to pay for college from an annuity contract are taxed less favorably than life insurance or a Section 529 plan.

Other Nonqualified Investments

A savings account or parent-owned mutual fund can be used to earmark funds to be used for a child's college expenses. The main advantages of using nonqualified investments are that a broad range of investments is available, and nonqualified investments have no current gift tax consequences.

On the other hand, most kinds of nonqualified investments are countable assets for the parents—and considered available to help pay for college. The nonqualified investments may also have some current income-tax result associated with them, unlike Section 529 plans which grow tax-deferred.

CONCLUSION

So, are Section 529 plans the *best* way for a parent to help a child save for college? Like so much in the financial and tax world, the answer is that it depends.

- a grandparent who wants to earmark several years' worth of annual exclusion gifts for a favored grandchild, while also keeping control of the account, or
- parents who want to save a modest amount annually for a child's college expenses but who have already maximized their ability to contribute to a Coverdell account.

Many Section 529 plan advantages are hidden, including

- possible state income tax incentives,
- ability of the account owner to change the beneficiary, and
- relatively annual high contributions limits.

Some disadvantages are also less obvious:

- The hybrid ownership rules between account owner and beneficiary make for some tax and practical ambiguities.

- The tax regulations are temporary and are more than 20 years old.

With so many moving parts associated with planning for college—taxes, cost of college, investment time available, and financial aid considerations, to name a few—it's hard to make many generalizations. However, the financial professional, properly armed with knowledge of Section 529 plans and their alternatives, can guide confused parents through the process.

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Building Protecting and Perpetuating Family Wealth

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