Introduction to 529 Plans

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Agenda

- History of 529 Plans
- 529 Plan Basics
- Important Resources
- Questions?
What is a 529 Plan?

Named after the federal tax code by which they are governed, 529 college savings plans are tax-favored, qualified tuition programs administered by each state, for the purpose of helping families save for college nationwide and, in many cases, overseas as well.

Historical Background

- **1986**: Michigan created a prepaid tuition program (Michigan Education Trust – MET) to help with rising costs of education.
- **1988**: IRS challenged Michigan as a taxable entity.
- **1992**: IRS won their initial challenge.
- **1993**: Michigan appealed the decision, and, in 1994, won the decision which established MET as exempt extension of the state.
- **1996**: Bob Graham (Sen. D-FL) & Mitch McConnell (Sen. R-KY) co-sponsored section 529 of the IRC as a rider to the Small Business Protection Act of 1996, later signed into law by President Bill Clinton, effectively defining two types of Qualified Tuition Programs: Prepaid Tuition Plans & 529 College Savings Plans.

Source: CollegeInvest, Govtrack.us
Historical Background

IRS rulings since 1996:
- Proposed regulations were released in 1998, but after hearing comments in January of 1999, regulations were never finalized.
- Notice 2001-55: Permitted investment changes in accounts once per year per beneficiary.
- Notice 2001-88: Clarified distribution recordkeeping as the responsibility of the taxpayer.
- Notice 2009-1: For 2009 only, investment elections could be changed twice per year, per beneficiary.
- Advanced Notice of Proposed Rulemaking in January of 2008 included anti-abuse rules to be incorporated into forthcoming proposed regulations. Regulations, again, have yet to be finalized.
- A series of Private Letter Rulings and Notices have formed the basis for understanding for IRS Section 529.

Source: CollegeInvest, Govtrack.us

529 Plan Basics

- Types of Qualified Tuition Plans:
  - Prepaid Tuition Plans
  - 529 College Savings Plans

- Important 529 Plan Features:
  - Professional Money Management
  - Account Owner Control
  - Tax Advantages
  - Distributions
Prepaid Tuition Plans - Definition

Administered by individual states, allow individuals to lock in today’s tuition rates for a future student beneficiary at any of a state’s eligible public colleges or universities.

- Typically have residency requirements/restrictions.
- No choice of investment options.
- May or may not be guaranteed by the state and have variable assurance levels in case the plan is insolvent or does not keep pace with inflationary costs.
- Many states, including Colorado, no longer offer these types of plans.
- Acceptance at college is not guaranteed.

Prepaid Tuition Plans – Two Types

**Contract Plans:**

- Purchase a contract covering from 1 to 5 years of tuition (or a percentage), either on a lump-sum or installment basis. Usually offers lower prices for younger children.
- Example: Parents and grandparents contribute 2 years’ worth of 2013 tuition ($20,000 per year, $40,000 total) for 10-year-old beneficiary. When child attends college in 2022, first 2 years are prepaid, even though tuition is now ~$34,000 per year*.

**Unit Plans:**

- Buy “units” (credits) of tuition which may equate to credits or hours at 2013 price per unit.
- Regardless of price in 2022, the same number of units are prepaid.

*Assumes 6% annual tuition increases. Sources: http://www.finaid.org, http://www.nasaa.org
529 College Savings Plans - Definition

Administered by individual states and maintained by “program managers” (mutual fund companies).

- Contributions are “after-tax” money, but grow tax-deferred and are federally and state tax-free when used for qualified higher educational expenses.
- More flexibility of use than a Prepaid Plan - assets may be used at any “accredited” higher educational institution that participates in the U.S. Department of Education’s Federal Student Financial Aid (FAFSA) program, including:
  - Colleges
  - Universities
  - Vocational schools
  - Trade schools
  - Over 500 schools abroad

Important 529 Plan Features

- Professionally managed investment options made up of underlying mutual funds or other investments, including:
  - Actively managed mutual funds
  - Index funds
  - Stable value funds
  - ETF (Exchange Traded Fund) portfolios
  - FDIC-insured savings and CD accounts

- Investment option choices vary from plan to plan, such as:
  - Age–based or Years to Enrollment options
  - Static Allocation options (e.g. All Equity or All Fixed Income)
  - Individual Fund options
  - Money market options
  - Principal Protection options

- How to invest:
  - Direct Sold – individuals self enroll and self select investments.
  - Advisor Sold – enrolled through a financial advisor for a fee.
Important 529 Plan Features

- Due to current IRS regulations, investment options may only be changed once per calendar year, or at any time there is a beneficiary change.

- Maximum aggregate account balance limits vary by state, but equal or exceed $235,000 per beneficiary.
  - Colorado limits contributions to accounts after the account value reaches $350,000 per beneficiary.

- Tax-free rollovers to another 529 plan may occur once per 12 months, per beneficiary.

Who Can Participate?

- Account Owner:
  - Must be a U.S. resident & have a Social Security or federal tax ID number.
  - No age or income restrictions on owner or beneficiary.
  - Maintains full control of the account, including distributions & investment choices.
  - A Successor account owner may be named to take over ownership of the account in the event of the account owner’s death.

- Beneficiary:
  - Does not need to be living in the U.S. at time of account opening, but must have a valid Social Security or federal Tax ID number.
  - May be changed to another “member of the family” of the beneficiary at any time without penalty.
  - Accounts may be held without a beneficiary in the case of scholarship accounts or 501c(3) organizations as owners.
College Savings Plans: Introduction to 529s

Tax Advantages

- General Tax Advantages
- Estate Tax/Gifting Provisions
- Specific State Tax Benefits

Tax Advantages

- Tax-deferred growth of assets while invested the plan.
- Tax-free distributions for qualified higher educational expenses. Eligible expenses include:
  - Tuition
  - Room & Board
  - Fees
  - Books & Equipment
- Gift Tax Benefits - Contributions of $14,000 for an individual ($28,000 if a married couple) can be made for a single year without incurring gift taxes and are removed from the contributor’s taxable estate.
- 5-year Forward Gifting Provision - Contributions made in a single year in excess of annual gift tax limits (up to $70,000 for an individual / $140,000 if a married couple), are allowed to be forward gifted over 5 years on a pro rata basis.

**Forward Gifting Example**

Total Contribution Over 10 Years: $200,000

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**State Tax Benefits**

U.S. residents in all 50 states and the District of Columbia may open a 529 plan. 48 States offer 529 plans (WA & WY do not have plans).

- **States with Tax Considerations** - 27 States and the District of Columbia offer either an in-state tax deduction or tax credit on state taxable income for contributions into the state’s plan.
  - 4 of those states offer an unlimited in-state tax deduction from state taxable income (CO, NM, SC & WV).

- **Tax Parity States** - 6 additional states are considered “tax parity” states meaning contributions made to any state’s 529 plan are eligible for an in-state tax deduction (AZ, KS, MO, MT, PA & ME).

- **Tax Neutral States** - 17 states do not offer any tax deductions or credits.
Distributions & Transfers

- Withdrawals:
  - Qualified Withdrawals
  - Non-qualified Withdrawals
- Beneficiary Changes
- Rollovers

Qualified Withdrawals

- Distributions made for qualified higher educational expenses are free from federal and state taxes.
- Qualified withdrawals include:
  - Tuition
  - Room and Board
  - Books
  - Supplies
  - Required Equipment (laptops or computers are only considered qualified if they are “required” by the school)
  - Certain Fees

Non-qualified Withdrawals

- Distributions that are made for non-qualified expenses.
- Only the earnings portion is taxed (as ordinary income) upon withdrawal.
- Also subject to an additional 10% IRS tax penalty on the earnings portion of the withdrawal.
- Exceptions to the 10% IRS Tax penalty:
  - Scholarships awarded to the beneficiary
  - Death or disability of the beneficiary
  - Attendance at a military academy

Tax-Favored Transfers

- **Beneficiary changes** - Unused 529 funds may be transferred to another “member of the family” of the beneficiary without causing a taxable event.
- **Rollovers** - Tax-free rollovers to another 529 plan may occur once per 12 months, per beneficiary.
  - Liquidation of Coverdell ESA assets are tax-free, provided those proceeds are contributed to a 529 plan with the same beneficiary as the liquidated ESA beneficiary.
  - Class EE and I savings bonds may be liquidated with the proceeds going into a 529 plan as a non-taxable event, provided that the bond owner, spouse or dependent is listed as the beneficiary of the new 529 account.
Resources to Learn More

- IRS Publication 970
- IRS Tax Topics
- IRS Tax Tips
- FINRA.org “Smart Saving for College – Better Buy Degrees”
- www.savingforcollege.com
- www.collegeinvest.org
- www.nces.ed.gov
- www.fafsa.ed.gov

Questions?

Important disclosure
Introduction to 529s

Questions?

Important disclosure

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