MONEY 101

529 Educational Savings Plan - What are they? Why are they beneficial?

Memo Includes

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Part 1 - 529 PLAN BASICS

WHAT IS A 529 PLAN?

A 529 plan is a bank or investment account accumulating funds for future educational expenses. If certain investment and withdrawal regulations are followed, the interest, dividends, and capital appreciation earned on the funds are not subject to federal and state income taxes. The term "529 Plan" is based on the IRS 529 tax code number, which established the benefits.

WHO ARE THE KEY PARTIES IN A 529 PLAN?

- The **Account Owner** is the person opening the Account and usually supplying the funds. They keep control of the Account and decide how the funds are invested. They designate a Beneficiary and can change the Beneficiary at any time.
- The **Beneficiary** is the future student who will use the funds for their education.

The Account Owner and the Beneficiary can be the same person; thus, an Account Owner can open up a 529 plan for themselves. However, it is more typical that a parent or grandparent is the Account Owner and the Beneficiary is a child or grandchild. 529 plans have no income, age, or annual contribution limits.

OTHER PARTIES

- The **Fiduciary institution** is where the institution where the Account is opened up and maintained. This can be a bank or an investment firm authorized to administer 529 Plans.

WHO IS ELIGIBLE?

Any U.S. citizen or resident alien with a valid Social Security Number or Individual Taxpayer Identification Number can be a 529 Plan Account Owner or a Beneficiary.

WHAT ARE THE FEDERAL TAX BENEFITS?

Monies deposited into the Account are NOT federally tax-deductible against other income.

However, the interest and dividends, along with any capital gains distributions and capital gains when the assets are sold, are federal-tax-free provided that when the funds are withdrawn, they are used to pay for "**qualified education expenses**" for the designated Beneficiary.

WHAT ARE THE STATE TAX BENEFITS?

Like the federal tax rules, states do not tax interest, dividends, capital gains distributions, or capital gains when the assets are sold, provided that when the funds are withdrawn, they are used for "qualified education expenses."

However, some states have Account Owner residency requirements; some states allow additional benefits for low-income Account Owners, such as deducting contributions from state tax income tax. Some states allow Account Owners to select mutual funds directly from a list and manage an account online; others require using an investment broker to purchase funds. So, an Account Owner should investigate state benefits and rules. (see below notes on NYS and N.J. rules)

WHAT HAPPENS IF THE BENEFICIARY DOES NOT WANT TO USE THE FUNDS FOR EDUCATION?
The Account Owner **c**an change the Beneficiary to another eligible family member, or the funds can stay invested if the Beneficiary changes their mind. There is no age limit on using the money.

CAN THE FUNDS BE WITHDRAWN FOR NONQUALIFIED PURPOSES?
The funds can be withdrawn for other uses. However, a 10% penalty tax on earnings (as well as federal and state income taxes) may apply if the funds are withdrawn to pay for nonqualified expenses.

DOES THE BENEFICIARY HAVE LEGAL RIGHTS TO THE FUNDS?
With few exceptions, the named Beneficiary has no legal rights to the funds in a 529 account. This differs from custodial accounts under UGMA/UTMA, where the child takes control of the assets once he or she reaches legal age.

CAN THE ACCOUNT OWNER CHANGE THE BENEFICIARY?
Yes, the Account Owner can change the Beneficiary at any time. To keep the tax benefits inherent in a 529 plan, the new Beneficiary must be a member of the previous Beneficiary's family, including children, grandchildren, siblings, spouses, nieces and nephews, aunts and uncles, cousins, and in-laws.

WHAT ARE "QUALIFIED EXPENSES"? and does it include room and board, graduate school, etc.
Qualified education expenses for 529 savings plans include:

- Full tuition at "approved institutions" – you must check that the school is on the list
- Fees
- Room and board
- Books and equipment for college and grad school
- K-12 tuition up to $10,000 per year

IS TUITION FOR GRADUATE SCHOOL COVERED?
Under current federal law, graduate school tuition at approved educational institutes is a qualified expense. In the past, this was not the case.

WILL THE ACCOUNT OWNER OR BENEFICIARY RECEIVE A 1099?
A 1099 will NOT be issued to either the Account Owner or the Beneficiary if no funds are withdrawn or transferred between accounts.

During withdrawal years, a 1099-Q will be issued to the Beneficiary if the 529 distribution was paid to:

- The 529 plan beneficiary
- The college, K-12 school, or apprenticeship program the Beneficiary attends
- A student loan provider

Form 1099-Q includes some breakdowns typically:

- Box 1 lists the total distribution
- Box 2 includes the earnings portion of the distribution
- Box 3 includes the basis, which is the contribution portion of the distribution.

WHAT IS IRS FORM 1098-T?

IRS Form 1098-T is a statement issued by a college or other eligible post-secondary education institution that lists the amount a student paid in tuition, fees required for enrollment, or course materials required for enrollment.

Form 1098-T is used to determine whether or not the student qualifies for federal education tax credits, such as the American Opportunity Tax Credit (AOTC) or the Lifetime Learning Tax Credit (LLTC).

Form 1098-T can be misleading because it does not provide a complete list of qualified expenses. For example, Form 1098-T does not include room and board costs, computers and internet access, K-12 tuition, student loan repayments, or costs of apprenticeship programs. It's up to the parents to save receipts and calculate the total amount of qualified 529 plan expenses during the tax year. (from www.savingforcollege.com)

WILL HAVING A 529 PLAN AFFECT STUDENT AID?

According to multiple websites having a 529 plan has a minimal effect on the Beneficiary's ability to obtain financial aid.

HOW MUCH CAN AN ACCOUNT OWNER CONTRIBUTE ANNUALLY WITHOUT PAYING GIFT TAX?

In 2022, the IRS will allow an individual to gift up to $16,000 to another individual without paying gift tax or using up a portion of their lifetime gift tax exemption. Married couples can thus gift $32,000 annually to an individual.

There is an additional special provision for 529 plans. An individual can gift up the $80,000 in one year and have it count as if it was made over a five-year period. This might be appropriate for grandparents who had never gifted to an individual before and wanted to make a large contribution at one time.

WHAT IS A COVERDELL EDUCATION SAVINGS ACCOUNT? AND IS IT THE SAME AS A 529 PLAN?

A Coverdell Education Savings Account (ESA) is similar to a 529 savings plan as they both help save for a Beneficiary's future education expenses, and they offer similar tax advantages provided funds are used for qualified educational expenses. However, there are some crucial differences between the two:

- Unlike a 529 savings plan account, your child will take control of the Coverdell ESA when he becomes an adult.
- The Coverdell ESA must be used for education expenses when the account owner turns 30.
- The assets in a 529 savings plan are available 30 years after high school graduation — and, even then, can be transferred to another beneficiary.

Part 2 - INVESTMENT CHOICES FOR 529 Plans

WHERE TO OPEN UP AN ACCOUNT?
All the large investment firms such as Vanguard, Schwab, T Rowe Price, Franklin Templeton, College America, Edward Jones, and Nuveen, to name a few, offer 529 plan portfolios.

Additionally, every state in the United States connects with an investment firm and sets up a 529 fund. Knowing which one to choose for someone unfamiliar with investment terms can be very confusing.

The Account Holder can often open an account with a minimal deposit of $25 and then set up automatic deposits from their checking Account on a periodic basis. This makes savings easier as it becomes part of the "routine outflow of expenses."

ONCE THE CASH IS IN THE ACCOUNT, WHAT ARE THE BEST INVESTMENT CHOICES?
With investing, no one can predict the future, so no one can guarantee results. However, when investing in a 529 plan, the Account Holder has typically a long time to recover from market fluctuations,

The key in deciding how to invest money is to determine "when will the funds be needed?"

Based on the timeline, the investor would select an appropriate stock/bond ratio – often called the "target diversification ratio."

- The longer the timeline, the higher the percentage of stocks the portfolio should hold because although stocks are riskier than bonds, they generally have a greater return.
- Similarly, the closer the investor gets to needing the money, the higher the percentage of bonds the portfolio should hold because although bonds produce, on average, a lower return than stocks, they are less risky.

Finally, when the Account Owner is less than three years from needing the funds, they should begin to sell some of the stocks and bonds and keep the proceeds in cash. By doing this, the Account Owners are assured they will have enough money to pay upcoming educational costs (tuition, room and board, etc.) regardless of market fluctuations.

WHAT STOCK/BOND/RATIO IS BEST?

A 529 Investment Advisor is an appropriate person with whom to speak to determine what is the best stock/bond ratio for the Beneficiary based on when they will need the money, but below are two charts that give suggested diversification ratio assuming the funds will be needed between the age of 18-21. (source Franklin Templeton)

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MODERATE RISK

		Stock	Stock	SUBTOTAL	Bonds		
AGE	**Est. Years to withdrawal**	**U.S.**	**Intl**	**Stocks**	**Bonds**	**Cash**	**TOTAL**
0-4	16-20	56.0%	24.0%	80%	20%	0%	100%
5-6	14-15	52.5%	22.5%	75%	25%	0%	100%
7-8	12-13	52.5%	22.5%	75%	25%	0%	100%
9-10	10-11	45.5%	19.5%	65%	35%	0%	100%
11-12	8-9	42.0%	18.0%	60%	40%	0%	100%
13-14	6-7	35.0%	15.0%	50%	45%	5%	100%
15-16	4-5	28.0%	12.0%	40%	55%	5%	100%
17	3	21.0%	9.0%	30%	55%	15%	100%
18	2	14.0%	6.0%	20%	60%	20%	100%
19	1	7.0%	3.0%	10%	65%	25%	100%

MORE AGGRESSIVE RISK

		Stock	Stock	Stocks	Bonds		
AGE	Est. Years to withdrawal	U.S.	Intl	Subtotal		Cash	TOTAL
0-4	16-20	0.7	30%	100%	0%	0%	100%
5-6	14-15	0.665	29%	95%	5%	0%	100%
7-8	12-13	59.5%	25.5%	85%	15%	0%	100%
9-10	10-11	52.5%	22.5%	75%	25%	0%	100%
11-12	8-9	45.5%	19.5%	65%	35%	0%	100%
13-14	6-7	38.5%	16.5%	55%	40%	5%	100%
15-16	4-5	31.5%	13.5%	45%	50%	5%	100%
17	3	24.5%	10.5%	35%	60%	5%	100%
18	2	17.5%	7.5%	25%	65%	10%	100%
19	1	10.5%	4.5%	15%	65%	20%	100%

WHAT IS A BALANCED FUND?
A balanced fund is designed to have a set diversification ratio between stocks and bonds that remains constant from year to year. Thus, a fund with a 50/50 stock/bond ratio would remain at 50% stocks and 50% bonds from year to year.

WHAT IS AN AGE-BASED FUND?
An Age-Based fund shifts its stock/bond diversification over time so that as the Beneficiary gets closer to needing the money, the Account becomes more conservative – thus decreasing its stock holdings and increasing bond holdings.

Age-Based portfolios are often set up based on the Beneficiary's birth year, assuming they will need the funds when they are 18-21.

Age-based portfolios are a prudent choice for non-active investors because the Account Owner does not have to "rebalance" (buy and sell assets) as the Beneficiary gets closer to their date for withdrawal. The fund manager takes care of rebalancing and making the fund more conservative.

WHAT IS MEANT BY THE NAMES "GROWTH or CONSERVATIVE FUND"
To make fund names consumer-friendly, the investment community often labels Blended Funds, whereby the stock/bond ratio remains constant, with names that indicate a risk level.

- A fund that has more stocks and is riskier might be called a "Growth Fund."
- A fund with more bonds might be called a "Conservative Fund."

Additionally, some funds have brand names, i.e., Star fund, Educational Savings Program, College Counts, and Freedom Fund – to name a few.

Regardless of the fund name, the key is to know if the fund is a

- Blended fund whereby the stock/bond ratio <u>will stay the same</u> throughout time.
- Age-based fund whereby the stock/bond ratio <u>will change over time</u>.

It is also imperative to <u>look at the fund holdings and verify the Stock/Bond</u> ratio is as stated and appropriate based on when the money will be needed.

WHAT ARE OTHER FACTORS IMPORTANT IN CHOOSING A FUND?
In evaluating funds, an Account Owner might also want to investigate what percentage is invested in United States stocks or bonds and what percentage is invested in Worldwide (aka International) stocks and bonds. Having some international exposure is considered prudent. A 2/3 US stocks 1/3 International stock ratio is common.

Another consideration is the "expense ratio" for the fund. This is the internal cost of running the fund. A lower expense ratio is better.

CAN AN ACCOUNT HOLDER CHANGE FUNDS?
529 Plans allow a change in investment options twice per calendar year.

529 plans allow for a rollover of funds into another 529 plan once in a 12-month period.

Hint: If you replace the account beneficiary with another qualifying family member at the same time, there is no federal limit on the frequency of these changes.

HOW CAN A NOVICE RESEARCH OR COMPARE FUNDS?

Morningstar.com is a good research tool to investigate fund metrics because it displays the information on all funds in a consistent manner. Morningstar can be accessed for free on a trial basis, and all that is needed is the fund ticker symbol. Information worth gathering is:

- What is in the fund, Stock/bond ratio,
- What percentage of the fund's stock holdings are in U.S. vs. International companies
- What is the fund expense ratio
- How has the fund performed compared to the "category," which, in essence, is the other funds having the same objectives?
- Is the fund higher or lower risk when compared to the category?

MORE READING ON 529 PLANS
https://www.morningstar.com/articles/83256/529-plans-making-a-good-thing-better

Part 3 - 529 PLANS - STATE RULES

NEW YORK see https://www.nysaves.org/home/why-ny-529-direct-plan/tax-benefits.html

- **529 PLAN NAME –** New York State calls its 529 Plans the "Direct Plan." An account can be opened online.

- **QUALIFIED WITHDRAWALS** - New York State requires that withdrawals be used for qualified higher education expenses at an eligible educational institution or certain apprenticeship program expenses in order to remain tax-free. Eligible institutions are NOT limited to NYS schools, and they can be out of state or abroad. The NYS website maintains a list of eligible institutions

- **NONQUALIFIED WITHDRAWALS** – In New York State, distributions for K-12 tuition and qualified education loan repayments are considered nonqualified withdrawals and will require the recapture of any New York State tax benefits that have accrued on contributions. (Thus, past dividends, interest, and capital appreciation will be taxed)

- **DEDUCTIBILITY OF ACCOUNT OWNER CONTRIBUTIONS** - New York State allows resident Account Owners to deduct up to $5,000 annually if single and $10,000 annually for married couples from New York State taxable income. New York State Non-Resident Account Owners have different rules.

- **FEES** -There are no fees to open an account in New York State's Savings Program *Direct Plan*. Once an account is open, there is a fee of $1.20 per year for every $1,000 you invest in the *Direct Plan* (0.12% total annual asset-based fee).

- **MINIMUM CONTRIBUTION** There is no minimum to open or contribute to a New York 529 account. With the automatic investment plan, the NYS minimum contribution level is **$15 per month or $45 per quarter**.

- **MAXIMUM ACCOUNT BALANCE** In 2022, the Maximum Account Balance is $520,000. If the Account reaches the Maximum Account Balance, it may continue to accrue earnings, but additional contributions will not be accepted and will be returned or rejected.

- **INVESTMENT OPTIONS** – NYS Direct offers for investment a choice of
  - Balanced portfolio – whereby the portfolio stock/bond diversification ratio remains the same from year to year.
  - Age-based portfolios - that change their stock/bond diversification mix over time. The investments become more conservative as the Beneficiary gets closer to their anticipated withdrawal date.

- **MUTUAL FUND CHOICES** – NYS uses VANGUARD mutual funds for the above portfolios.

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NEW JERSEY – see https://www.njbest.com/.

- **529 PLAN NAME –** New Jersey calls its 529 Plans the "N.J. Best." An account can be opened up online.
- **QUALIFIED WITHDRAWALS** - In New Jersey, tax-free withdrawals must be used for qualified "higher education" expenses at an eligible educational institution (or for certain apprenticeship program expenses. (Institutions can be out of state or even out of the country.). Additionally, in 2022, a qualified withdrawal can be made for up to $10,000 for tuition at eligible public, private, and religious primary and secondary educational institutions (K-12).
- **DEDUCTIBILITY OF ACCOUNT OWNER CONTRIBUTIONS** – As of 2022, New Jersey resident Account Owners with a gross income of $200,000 or less may qualify for a state income tax deduction for contributions to a New Jersey plan of up to $10,000 per taxpayer per year.
- **MATCHING GRANT** - New Jersey Resident Account Owners with a gross income of $75,000 or less can get a one-time grant of up to $750 matched dollar for dollar of the initial investment for a new beneficiary.
- **SCHOLARSHIP** – Beneficiaries of a 529 Plan who attend New Jersey colleges or universities can receive a $3,000 tax-free scholarship, but rules apply regarding how long the 529 plan was open and total contributions.
- **FEES** -There are no fees to open a New Jersey 529 Plan. Once an account is open, there is a fee of $1.00 per year per $1,000 invested. (0.10% total annual asset-based fee).
- **MINIMUM CONTRIBUTION -** There is a minimum $25 deposit to open an account.
- **MAXIMUM ACCOUNT BALANCE -** A maximum of $305,000 is allowed to be invested in the plan.
- **INVESTMENT OPTIONS** – N.J. Best offers for investment a choice of
  - Balanced portfolio – whereby the portfolio stock/bond diversification ratio remains the same from year to year.
  - Age-based portfolios that change their stock/bond diversification mix over time. The investments become more conservative (higher bond ratio) as the Beneficiary gets closer to their anticipated withdrawal date.
- **MUTUAL FUND CHOICES** - N.J. uses Vanguard mutual funds for the above portfolios.