PORTFOLIO - COLLEGE SAVINGS PLANS

Paying it Forward: Funding 529 Plans for Grandchildren

BY: DONALD JAY KORN

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Brendan Kelly's clients were a married couple in their sixties. Both were still working. Financially, they were ready for retirement, says Kelly, president of Somerset Capital Advisors in Berwyn, Pa. At Kelly's recommendation, the couple opened 529 accounts for each of their four grandchildren.

"Besides the tax benefits, they're enjoying a nice, warm feeling because they're able to help out," Kelly says.

Grandparent-owned 529 accounts offer distinct advantages. Clients concerned about estate taxes can move large sums from their estate, tax-free. They can help trim college costs for their progeny. And there's security knowing that money in 529 plans can be redeemed, if necessary, often with a modest tax bill.

"We always propose 529 plans to clients who are grandparents," says Paul Dixon, senior vice president at Sovereign Investment Group in Houston. "Almost half of those clients have 529 plans. They like the idea of making the gift of education, rather than buying their grandchildren computers or some other electronic item."

FIVE IN ONE

For grandparents as well as parents, contributions to 529 plans are treated as gifts. They're subject to the annual gift-tax exclusion, which means that a client can give up to $13,000 to each beneficiary this year with no gift-tax consequences. Kelly says his clients with the four grandchildren plan to donate $13,000 a year to each one. The exclusion will rise to $14,000 in 2013. (Exemption from state taxes varies.)

That means they'll remove $52,000 from their taxable estate in 2012, free of gift tax, with four 529 contributions. If both spouses contribute that same amount, they can give $104,000.

That's not even the maximum couples can give. Each person can contribute up to five years' worth of gift-tax exclusion to a 529 plan, Dixon says. "It can be a huge tool for estate-tax planning, and it will become more useful if the estate-tax exemption is reduced, as now scheduled," he says.

In a unique tax break for 529 plans, anyone can donate up to $65,000 for each 529 beneficiary in 2013, while married couples can bestow up to $130,000. Form 709, a gift-tax return, must be filed, Dixon says, because large gifts effectively use five years' worth of gift-tax exclusions.

Reducing taxable estates might not be a prime concern now, with a $5.12Ã¢â‚¬â€°million federal estate-tax exemption. More clients, though, will likely pay attention if the exemption reverts to $1 million unless Congress acts on this issue.

Even with this year's estate-tax exemption, some clients are using the accelerated exemption. The Hartford reports a significant number of large 529 contributions - those ranging from $65,000 to $130,000 - which the company attributes to people attempting to maximize the five-year allowance for these plans. John Diehl, senior vice president of strategic markets at the Hartford, says it's likely that many of these five-year contributions come from grandparents because they're most likely to have accumulated enough wealth and to be concerned with estate-tax planning.

Taking five years of gift-tax exclusion up front won't automatically remove $65,000 from a client's taxable estate. "If someone dies within five years," says Kelly, "a pro rata portion of the gift will be returned to his or her taxable estate. However, the growth of those assets won't be returned, so it can make sense to make a larger gift at one time."

FREE OF THE FORMULA

Even if grandparents are wealthy enough to have estate-tax concerns, there's certainly no guarantee that their children - the parents of the students - have immense income or net worth. Financial aid may be needed to help make college affordable for grandchildren, and a grandparent-owned 529 plan can bolster that assistance.

Consider a family in which the father accumulates $100,000 in a 529 account for his daughter. When the student fills out her Free Application for Federal Student Aid form, up to 5.64% of her parents' assets will be included in her family's expected contribution. Holding the 529 plan in her father's name can increase the family's expected outlay by $5,640 and thus reduce financial aid by that much.

If the student's grandmother is the person who owns that $100,000 529 plan, those assets aren't included in the FAFSA calculation. The girl could qualify for $5,640 more in financial aid.

"Advisors should be cautious about discussing the role of a grandparent-owned 529 account in financial aid planning," Diehl says. "Some people say that such accounts have no ramifications for financial aid. That's true for the asset itself - it's not on the FAFSA. However, when distributions come out of the 529 plan to pay for college, they become income for the student."

If the student's grandmother uses $20,000 from her 529 account this year to pay for the grandchild's education, the distribution from that grandparent-owned 529 plan will be considered the girl's income. (The same is true for a distribution from any 529 plan owned by a third party and not reported as an asset on the FAFSA form.) It will be reported on the next year's FAFSA form as student income, which reduces financial aid eligibility by nearly 50%, or $10,000 in this case.

"There's a workaround for those situations," says Mike Piershale, president of Piershale Financial Group in Crystal Lake, Ill. "The advisor can tell the grandparent to delay distributions from the 529 plan until no earlier than January of the student's junior year, if it's possible to wait that long. By then, the student will be done with filling out the FAFSA, so the income won't matter."

Suppose that the hypothetical students starts college in August 2013 and graduates in May 2017. Her last FAFSA form (assuming she won't attend graduate school and apply for financial aid again) would cover the 2016-17 academic year. That FAFSA form will be filed early in 2016, based on financial data from 2015. Thus, distributions from the grandmother's 529 plan to the student in 2016 and subsequent years may not affect financial aid.

FAMILY VALUES

Regardless of whether grandparents have estate-tax concerns or hopes of helping to obtain financial aid, putting money into a grandchild's 529 account may be an appealing option. "Unemployment is high and a college background can have a substantial impact on future earnings,'' Diehl says. "If grandparents want to help grandchildren with college funding, then a 529 plan is the best vehicle," he says.

Many grandparents think about college costs, Kelly says. "If a client's retirement strategy is clear, we ask about secondary objectives," he says. "Grandchildren's education is usually not first on the list, but it's generally in the top five."

As with any 529 plan, the account owner can withdraw the money. Income tax and a 10% penalty will be due, but only on the earnings portion of the withdrawal. So grandparents can provide generous support to their grandchildren's future while knowing they can reclaim their own money if the school of hard knocks deals them some unexpected tough lessons.

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529 Plans: Untapped Potential of College Savings Plans

BY: ANN MARSH

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In this age of stratospherically high tuition costs, planner Mike Mayernick is preparing for an immense financial challenge: sending all seven of his young children to college at an estimated cost of close to $1 million. That's enough to make even the savviest planner blanch.

"I don't even like thinking about it," says Mayernick, an advisor with Northwestern Mutual in Nashville, Tenn. "But it's a big priority for us."

Mayernick and his wife Suzanne are counting on seven 529 plans to help them do it - one for each of their children, who range from 4 to 16 years. (The couple have four biological children, two adopted in the U.S. and one adopted from Uganda.) Mayernick has used the tax-deferred college savings plans for his clients since they became available in 1996. He estimates that, without them, he might have to save an extra $200,000 for his family. "They do play a critical role," he says.

His reliance on 529s, though, puts him in the minority of American savers. Many parents and planners, who often make little to no commission from 529s, have avoided using them to their fullest extent. Of the roughly $611 billion Americans saved to pay for college as of the fourth quarter of 2011, just 27%, or $164 billion, was growing in 529 plans, according to estimates from Financial Research Corp.

"I think these plans are basically, if not in their infancy, then in their toddlerhood," says Joan Marshall, executive director of the College Savings Plan of Maryland, one of Morningstar's six top-rated 529 plans in the country.

States and educational institutions offer the plans as part of a broad, 16-year-old public policy initiative to encourage more saving for college. Yet, even Morningstar, which began tracking the funds in 2004, just started to rate them in 2010. "Over half of Americans do not know what a 529 plan is," says Kris Spazafumo, senior manager of 529 plans at Capital Group Cos. in Los Angeles. The company runs the advisor-sold plan known as CollegeAmerica sponsored by the state of Virginia. With $33 billion in AUM, it's the nation's single largest plan. "Clearly we have an issue when it comes to college savings," Spazafumo says. "That is where advisors play such an active role."

Blame the volatile markets over the last decade for much of the plans' poor use. Meager long-term returns - as well as short-term losses - killed off one of their key selling points: tax-deferred growth. "If you don't have a great market run, then so what?" asks planner Susan Stiles, of Stiles Financial Services in Edina, Minn. As with many advisors, Stiles has used fewer 529s in the last 10 years.

But as the markets have rebounded, so have the plans. In 2011, Morningstar found that money directed into 529s climbed 12%, versus just 1% for the U.S. equity market and 5% for bonds.

A host of advantages are driving this growth, which vary dramatically among states and plans. Investors can withdraw money from 529s tax-free to cover any higher educational expense - from tuition and books to campus housing costs and equipment such as computers - associated with attending an accredited school. In many states, 529 deposits can be deducted from state income taxes up to certain amounts. In a bankruptcy, creditors generally can't touch the contents of 529s, making them safe harbors for protecting the next generation's future.

The accounts also can be transferred without penalty from one child in a family to another, depending on who ultimately attends college. They also can be transferred from child to grandparent, from child to a child's spouse, to first cousins and even back to any parent or grandparent who decides to go back to school.

"They are one of the true investing no-brainers," says planner Douglas Ciocca, chief executive of Kavar Capital Partners in Leawood, Kan., who uses them for his clients as well as his three children.

Many financial experts think it's time that investors depend more heavily on 529s, given that student debt crested $1 trillion this year and tuition costs continue to grow at double the rate of inflation.

"The colleges are posting a sticker price [for tuition]," says Deborah Fox, an expert in college financing and the founder of Fox College Funding in San Diego. "The families that have taken the time to be informed about how the system works are the ones that tend to pay significantly less than the families that don't."

Many families don't use 529s because of the high learning curve. Understanding 529s has become a planning subspecialty in its own right. Of the 83 plans available nationwide, half are "direct sold,'' meaning investors must be smart do-it-yourselfers and set them up themselves. Even with advisor-sold 529s, planners often find it too cumbersome to navigate their intricacies, especially if they carry low commissions. As the number of fee-only and fee-based planners grows with the expected adoption of a fiduciary standard industrywide, there are more reasons for planners to employ this savings tactic.

When used effectively for clients, "it builds tremendous goodwill," says planner Carina Diamond, managing director of SS&G Wealth Management in Akron, Ohio.

Here are 15 advantages of 529 plans, along with 13 notes of caution to keep in mind when investing:

THE ADVANTAGES

Deduct state taxes. Many states offer a state income tax deduction for in-state residents. This advantage isn't applicable, of course, in states without an income tax, such as Washington and Florida. Other states with income taxes, including California and Massachusetts, don't offer them. But Missouri, for example, offers an annual state income tax deduction of $16,000 per couple. Even some states with seemingly low deductions, such as Ohio at $2,000 a year, may offer other benefits that enhance the deduction's appeal. Clients who, for example, invest $40,000 in an Ohio-run 529 plan will get a carryforward, which permits them to deduct $2,000 a year from their state income taxes for the next 20 years.

Roll over a plan to save. When state tax benefits are this good, it can make sense to roll over a plan to an in-state provider from an out-of-state one. To get that benefit, Diamond recently persuaded a married couple to roll $50,000 to their local Ohio plan from their Virginia-based CollegeAmerica Plan. "The investment options were essentially equivalent," Diamond says.

Split a plan to save. In some states, investors also can split a plan to increase their tax benefits right away. Split that $40,000 Ohio plan into two beneficiaries - $20,000 for a child and $20,000, say, for a physician or lawyer who wants to save for required continuing education courses - and the investor has a $4,000 tax deduction ($2,000 per beneficiary) across both state plans for 10 years.

Use any state plan. Many people buy the plans in their own state. But investors can join any state's plan (although the tax break, if there is one, typically applies only in their home state). "There's no plan that's truly for one state's residents only," says Morningstar mutual fund analyst Josh Charlson.

That's how Virginia's CollegeAmerica plan, run by Capital Group Cos.' American Funds, managed to grow in a decade to the country's largest, with $33 billion in assets. Due to its array of investment options, the performance of those investments, its low cost, the strength of its managers and its stewardship practices, Morningstar rates it as one of the nation's six top plans. Other states with top nationally available plans include Alaska, Maryland, Nevada, Ohio and Utah. (To review the Morningstar ratings on the largest 59 plans, see the chart on page 54).

Prefund a plan to save. The benefits of paying into a 529 ahead-of-time can be manifold. A couple can fund a 529 up to five years in advance, tax-free, using the $13,000 annual federal gift-tax exclusion. That comes to $65,000 per individual or $130,000 per couple.

Reduce estate taxes. Any amount invested in a 529 plan does not count as part of a client's taxable estate.

Shelter against a storm. Once any money is socked into a 529 plan, it's generally protected against bankruptcy or creditors. This can be a real advantage to clients in high-risk entrepreneurial professions. "One of my clients got involved in a lawsuit and his 529 plans were indeed protected from his creditors," Mayernick says. "They were off the table."

Prepay tuition, if possible. Thirteen states offer families the chance to prepay years of college tuition with 529s. In some states, saving can start at a child's birth. Families might also seek colleges and universities that offer incoming freshmen the chance to prepay four years of tuition. Any funds, including regular 529s, can be used for this purpose.

Two of Fox's clients are sending their eldest child to the University of Pennsylvania this fall using the $127,000 in their 529 to pay the entire four-year tuition bill up front. "We just liquidated the whole thing," Fox says. "They are locking in four years of tuition." The family is protected against any large, unexpected jumps in tuition costs. Fox says she often recommends that families shift their investments to cash or short-term bonds in the year or two before a child will tap a fund. If the fund is going to be earning essentially nothing, it's better to protect it.

Retain control. Many clients, especially baby boomers, love retaining control over the money they save for a child, grandchild or godchild's education. If an investor changes her mind about giving away the money, she can take it back for herself by paying income tax on the gains, plus a 10% penalty. While that's not ideal, it's often better than the accounts opened under the Uniform Transfers to Minors and the Uniform Gifts to Minors Acts, adopted by most states. When those account beneficiaries turn 18 or 21, depending on the state, the money is theirs, end of story.

One of Diamond's clients panicked recently when her nephew developed a substance abuse problem in high school. He's now in treatment. His aunt still hopes he can use the money she saved for him to get a degree. "Meanwhile," Diamond says of her client, "it was so nice for her to know that, 'I don't have to give money to him for drugs.'"

Apply prepaid tuition anywhere. Amounts saved in many prepaid tuition 529s that aren't used for in-state universities can be applied to private tuition at colleges anywhere in the country.

Create peace of mind. Many planners say they urge their clients to save enough to at least cover in-state college tuition. "We knew we had bought four years of tuition benefits in the prepaid plans," Marshall says of the Maryland college savings plan. She and her husband funded prepaid tuition 529s to send their two children to college.

"Peace of mind is a big part of the equation." Ultimately, the kids chose more expensive schools. The couple covered costs beyond the 529 savings with non-qualified savings. There was a psychological benefit, she says, in knowing they had covered the basics well ahead of time.

Combine with other strategies. Often, grandparents like to open modest accounts under the Uniform Transfers to Minors or the Uniform Gift to Minors Acts, Stiles says. "They say, 'I don't know if I will be alive when my grandchild turns 18 and I don't care how they turn out. I want them to have this and I want them to know it came from me,'" she says.

Although there is no limit to the amount of money that can be put into either of these accounts, Stiles recommends their use for modest sums, of $2,000 to $5,000. Other planners use them to pay for private grade school and high school tuition before the family draws on the 529s to cover college. "We believe there should be at least two college funding options utilized for that very reason," Fox says. Transfer or gift accounts, she says, allow self-directed investments like direct stock ownership.

Pay a lot, or very little. As states expanded their 529 choices, they welcomed as many investors as possible. Some plans have minimum contributions as low as $25 and others have no minimum at all. Studies have shown that children from families who have saved any amount of money are more likely to go to college than those whose parents saved nothing, says Lynne Ward, executive director of the Utah Educational Savings Plan, another top-rated plan. "It sends a message to the child that our family is saving for your future," Ward says. Even $25 a month can grow to $7,700 in 15 years, she calculates, "and that's not counting the tax benefits along the way."

Open one for yourself, too. Money in a 529 can allow an investor to return to college and pay for certain qualifying educational expenses such as executive programs.

It can be a legacy tool. If an investor's children fail to use all the 529 assets, the plans can be reassigned to the next generation. "It's like a poor man's trust," Diamond says. "There's no paperwork, but it's a legacy tool."

THE CAUTIONS

Rebalance. Use an age-based or college target-date fund to rebalance the assets as a child gets older. Alternatively, rebalance a static mix of funds to a more conservative allocation. "As the student gets closer to college enrollment, the portfolio allocation needs to become more preservation-minded over time," Spazafumo says. Fail to do this and you may regret it. Some families whose children planned to start college in 2009, on the heels of the economic downturn, and who had not rebalanced their investments, were out of luck. "The states were reamed for that in 2008 and 2009," Fox says. "Families found their funds were halved, or worse."

And rebalance again. Even if an advisor started a 529 plan, most advisors do not regularly review their clients' accounts, many experts say. It may not be adequate to rebalance infrequently. Currently, clients can rebalance their plans just once a year. That restriction helped no one in an exceptionally bad year like 2008. That year, some of Diamond's clients lost all their gains in their 529 accounts. Since the gains are taxed only if they are withdrawn, Diamond could withdraw all the money without a tax penalty and then close the plans. By opening new 529 plans with the same assets in different investments, she maneuvered around the rebalancing prohibition. "It's a very foolish government rule," she says. Morningstar's Charlson and other experts say the rule stems from the government's desire to discourage rapid trading in any account.

Hit the finish line in cash and bonds. Some conservative planners, like Fox, take age-based funds a step further. She often puts plan assets into cash, CDs or short-term bonds within one to two years of a child's first year in college. "If we go into a cyclical correction that lasts only a year or two, they won't have any time to recover," she says.

Open a plan in each child's name. Yes, a plan can be reassigned between siblings and even first cousins, as needed. "But God forbid that a [parent] dies and there's nothing in one of the kid's names," Diamond cautions. "The point here is not to put all the money in the eldest kid's name." Every plan should name a successor owner as well, Fox says.

Remember that all 529s are not created equal. "You have to dig and be sure that you are getting the right plan," says planner Maura Griffin, founder of Blue Spark Financial in New York. "The most important thing is the quality of the underlying funds and the expenses." Of the 59 plans Morningstar rates, only six qualify for a top rank. For her 16-year-old son Calvin, Griffin invests in a New York State 529 plan up to the annual level of the state tax deduction. For contributions above that amount, she uses Virginia-based CollegeAmerica.

They are restrictive. Each plan offers a set menu of investment options. Planners like Stiles prefer to craft portfolios out of individualized stocks, but there's no way to do this in a 529. States want to protect investors against missteps, but that can frustrate planners who like to do things their own way.

Don't blow a child's financial aid package. If a child will need student aid, it's important in some states to reassign ownership of 529s maintained by grandparents, relatives and family friends before a child's first year **in college, Fox says.**

Federal financial aid formulas are complex. Families usually must tell colleges about all the 529 plans held in the name of a parent or an incoming student when seeking aid. The money in a parent's 529 is counted at 5.64 cents against the dollar of any potential student aid package.

There's no need to declare accounts held by grandparents, relatives or friends when an incoming freshman applies for financial aid. However, if money from those 529s pays for tuition that first year, then the college will take note of that for the second year. Then, money withdrawn from these non-parental accounts will count 50 cents against the financial aid dollar. That can shrink a financial aid package for the sophomore year. In some cases, the deduction will wipe out financial aid assistance for that year, Fox says. By reassigning 529s to parents two years before the accounts are tapped, clients can avoid this shock.

Worry less about financial aid during the senior year. The risk to a financial aid package drops senior year, Fox says. After colleges offers financial aid assistance for that year, the aid will be locked in. Any 529 funds in non-parental accounts can be tapped freely to cover the last year's tuition, Fox says.

Discuss college and retirement in the same breath. Advisors should talk to clients about funding 529 plans for college at the same time they discuss retirement plans. "They are not really separate topics in our view," says Michael Conrath, executive director of J.P. Morgan's new 529 plan with New York State. "College savings needs to be on the table at the same time as retirement."

Beware godchildren. Investors can fund 529 plans for a godchild or a family friend. However, if that child doesn't use those funds, then the plans can't be assigned to other godchildren or family friends outside of the first godchild's family. The money must stay in the same family.

Respect the limits. Investors cannot invest an unlimited amount in a 529 account. Most have thresholds established to prevent them from being abused as tax havens, experts say.

"Each state sets its own maximum," says John Heywood, a principal overseeing 529 plans at Vanguard, the largest plan manager in the country with $40 billion in AUM across more than 30 plans nationwide. Whenever the plan balances within a state rise to somewhere between $235,000 and $395,000 for one beneficiary, Heywood says additional contributions will be forbidden for that person in that state's plans.

Don't overfund. Unless an investor wants to create a surplus to be used by grandchildren or other family members later, most planners advise using 529s in moderation. If not, a client can end up paying a substantial amount in taxes and penalties to recover any surplus for his personal use.

"It's very difficult to plan to have the 529s zeroed out. I'm not a big fan of drastically overfunding them," Mayernick says. "When children are young, for the most part people don't know where they will go and how smart they will be. When you run these analyses, things looks really different when you plan for Harvard versus the state school down the street. I think it's a good approach to take an average tuition number and make an estimate."

Look for FDIC protection. The vast majority of 529 assets are in mutual funds that, like regular mutual fund investments, are not guaranteed by the FDIC, Heywood says. However, savers using 529s offered in eight states can stash the contents in cash bank accounts and CDs that are FDIC-insured, Fox says. She recommends families use accounts with FDIC protection in the years immediately before a child attends college. If an insured account is not offered through one plan, roll the funds into one of the eight state plans that do offer that protection.

Finally, consider the freedom that a 529 gave Alexa Williams of Alexandria, Va. Her advisor, Shawn McLaughlin, chief executive of McLaughlin Ryder Investments in Alexandria, selected the 529 plan. He is, after all, chairman of the Virginia College Savings Plan's board. Williams' parents and grandmother made contributions, as did Williams.

Having the plan didn't make the difference between her attending college or not. But it did enable Williams to consider options beyond the financial reach of many of her friends.

This fall, she returns as a junior to Wellesley College. The 529, she says, "gave me the freedom to look anywhere. I had that option of not even considering [cost] when I was applying."

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