

529 Plans  
By Lisa Marino

As a financial planner, it's inevitable that you'll one day encounter a family desperate to save money for college. On average, tuition tends to increase about 8 percent each year, meaning that the cost of college theoretically doubles every 9 years.<sup>1</sup> With such fast-climbing tuition costs, it's never too early to consider a college fund, which means you'll be assisting parents of all ages as they attempt to sort through the options. One popular option is the 529 plan. This article is meant to help you frame your initial discussion with a client about 529 plans, with the goal of educating rather than engulfing him.

### WHO IS RIGHT FOR A 529 PLAN

Before you pull out 529 pamphlets, you must identify the right candidates for 529 plans. "It is the job of a financial advisor to help the client by making specific recommendations that are in the best interests of the client," says Howard Gartenhaus, founder and President of Gartenhaus Financial Corporation, and member of the Paladin Registry which represents financial advisors ranking in the top 10 percent of their profession. Here are some ideal candidates whose best interests might include 529 plans.

- **Those unlikely to qualify for need-based financial aid:** 529 plans can have an adverse effect on financial aid, so if your client isn't expecting to qualify for need-based financial aid to begin with, a 529 plan is an excellent option.
- **Those in an above-average federal tax bracket:** With the compelling tax-deferred compounding that comes with 529 plans, families in this category will enjoy the tax benefit even more.
- **Residents of a high-tax state with significant 529 tax breaks:** Even if they're in a lower tax bracket, clients in states such as New York may enjoy generous state tax deduction on contributions to a 529 plan.
- **Grandparents who want to reduce their estate:** These individuals can move a large chunk of their estate into a 529 plan without incurring a federal gift tax.

If a parent in any of the following situations requests information on a 529 plan, it would be a better idea to help them re-evaluate their priorities and options:

- Retirement fund is quite low: A child can receive financial aid for college, but there is no such assistance for retirees.
- Family has wealthy grandparents: Allowing the grandparents to open a 529 rather than the parents means that financial aid won't be adversely affected.
- Child may not be college-bound: Consider other options – ones without the 10 percent penalty withdrawal fee of 529 plans.

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<sup>1</sup> "Tuition Inflation," FinAid.org.

## INTRODUCING THE OPTIONS

The key here is to keep the discussion general. “Financial advisors should have a broad knowledge of 529 plans,” says Gartenhaus. Don’t overwhelm your client with complications, exceptions and specifics.

“The most important pieces of information for a financial advisor to share with clients are an overview and the differences between the two types of plans,” Gartenhaus states. Explain that the Prepaid Tuition Option allows parents to lock in today’s tuition rates by purchasing units/credits at participating college and universities. So, if a parent purchases one year’s tuition at a state school right now, the shares will always be worth one year’s tuition. With the College Savings Option, the parent saves money in a tax-deferred account to be used to pay for college at the future tuition rates. Either way, the investment earnings will grow to meet the rising costs of education.

## DIFFERENCES

Comparing the options is the best way for clients to determine which 529 option is best for them. “I typically use a brochure to explain the nuances of a plan,” Gartenhaus says. Specifically, a simple chart can help explain important differences, such as the ones below.

### Pre-Paid Tuition Option

- Only covers tuition and mandatory fees
- Age and/or grade limit for beneficiary
- State plans require residency
- Plans guaranteed by state

### College Savings Option

- Covers all qualified fees, including room and board
- No age limits for beneficiary
- No residency requirement
- No state guarantee; subject to investment risk

## OVERVIEW: BENEFITS

There may be countless benefits regarding a 529 plan, but tackle the biggest ones first. Here are some important, valuable imperatives.

- **Taxes**  
The investment grows tax-deferred, so the client won’t pay taxes on the account’s earnings. Also, parents enjoy tax-free withdrawals as well. “State tax deductions may also be available,” says Gartenhaus.
- **Gifting**  
Contributions (up to \$12,000 per beneficiary) are exempt from gift taxes. Also, an accelerated gifting option allows contributions of \$60,000 per beneficiary – contributions which are averaged over a period of 5 years to avoid gift taxes.
- **Parental Control**  
The child isn’t in control of the account – the client is. Parents control when withdrawals are taken, how they are used, etc. The account owner is also free to change investment strategies.
- **Flexibility**

The account owner can choose any initial beneficiary and can change beneficiaries (a family member) at any time. Also, funds can be rolled over into a different 529 plan if desired.

- **Ease/Simplicity**

Since the ongoing investment is handled by the plan and managed by a professional, the client doesn't have to worry about constantly monitoring the plan himself. Also, no Form 1099 is needed until the client makes withdrawals.

## OVERVIEW: PITFALLS

"The advisor should just be very up-front in discussing the pros and cons of 529s versus other alternatives," says Gartenhaus. "Clients do not appreciate negative surprises!" As such, make sure that you are very clear on the potential pitfalls of 529 plans. Here are some you'll want to mention.

- **Non-Qualified Withdrawals**

Gartenhaus points out that this is a very important factor to discuss. Only qualified withdrawals are tax-free. Taking out money from a 529 for a non-qualified expense will cause the client to incur a 10 percent tax penalty on top of being taxed at the client's tax rate. So, the client will want to be sure that his child will attend college.

- **Fees**

This is another important discussion point, says Gartenhaus. Many plans charge enrollment fees, annual fees and administrative fees. There are variations in how these fees are distributed based on the specific plan, so be clear and upfront when explaining the charges.

- **Impact on Financial Aid**

A 529 plan is counted as a parent's asset, so the parent's expected contribution to a child's college fund will include part of the value of the 529, lessening the financial aid they can receive. After that first year of college, part of the 529 is considered a part of the beneficiary's assets, further reducing financial aid eligibility.

- **Sunsetting**

Some of the 529 plan provisions may end (sunset) on December 31, 2010 unless Congress acts to make the provisions permanent. For example, the earnings portion of withdrawals may revert to being taxed as ordinary income at the beneficiary's rate.

## CONCLUSION

In short, you'll want to keep this initial discussion general but informative. It's difficult, considering how many options exist within 529 plans, but clients will appreciate your extra effort in making sure they understand what's going on. "It's also important for a client to understand that they will pay more if they use an advisor as opposed to doing it themselves," Gartenhaus says. Indeed, you may run into a client who questions the value of using a financial advisor such as yourself. Gartenhaus sum it up perfectly: "An advisor will make sure everything gets done (individuals tend to procrastinate), and we can save people valuable time, select superior performing plans and give clients ongoing advice."