

CITY SECURITIES WEALTH ADVISORS

Your Life. Your Goals. Your Advisors.

June 1, 2009

Welcome to June and the start of another summer! Before thoughts of this past school-year get too far behind us, let's spend a few minutes revisiting 529 education savings plans – they offer some of the best tax benefits available to investors but are often misunderstood. If you, your children, your grandchildren or any relative will ever incur college expenses, these plans could benefit you and your family.

A 529 plan is simply a type of account (like a joint account or an IRA) designed to accumulate money for college expenses and receive the tax benefits described in Section 529 of the U.S. tax code, plus any state-specific tax benefits. The plans are sponsored by each state, so you may have an Indiana 529 plan, a Virginia 529 plan, or some other state plan. But this does not restrict the plan or the use of the money in any way – an often misunderstood aspect of these plans. It is perfectly fine for someone to live in California, own a Virginia 529 plan, and end up with a child going to college in Indiana. The important thing is simply to invest in the state plan that provides you with the best combination of tax benefits and plan features – which is usually the plan sponsored by the state you live in.

Many states provide a state tax incentive for residents to save using their home state's 529 plan. In Indiana, for example, residents receive a 20% tax credit of up to \$1,000 for 529 savings. So a \$5,000 contribution to an Indiana 529 account only costs an Indiana resident \$4,000 after taxes – an immediate 25% return on your savings! If your state has benefits like this, you will want to use the 529 plan offered by your state.

In addition to any state benefits, all 529 plans receive federal tax incentives provided by Section 529 of the tax code. First, your savings grow tax-deferred. This means that any interest, dividends, or gains on your savings and investments in the plan are not taxed as they are received. Second, and most important, when you withdraw money from the account to pay for college expenses, the money comes out tax-free. Finally, and usually of interest to grandparents, is that 529 plans have several distinct gift tax advantages for estate planning, including the ability to make 5 years worth of gifts within the annual gift tax exclusion limit (currently \$13,000 per year) in one year. So a married couple could save up to \$130,000 per beneficiary in one year without incurring a gift tax. However, unlike most gifts, you actually retain the right to take the money back for yourself if you ever needed it (minus a 10% penalty).

One of the best features of 529 plans is their flexibility when asking the question "What if my child or other beneficiary never goes to college?" The details of the answer can be a little different from one state to the next, but in general you retain the right to change the beneficiary at any time to another person in your extended family, including yourself, and to continue changing it until the funds are used up by someone going to college. Also, you always have the option to take out the money without qualified education expenses, and pay ordinary income taxes on the earnings in the account plus a 10% penalty. After a generous state tax incentive and years of tax-deferred growth, you may still be money ahead even with this penalty. If a beneficiary receives a scholarship, then a taxable withdrawal can be made in the amount of the scholarship without incurring the 10% penalty.

Finally, another misunderstood aspect of 529 plans is how the money is invested once you save money into the account. Keep in mind that a 529 plan is just a type of account, and contributions to the account can be invested in a wide range of risk levels selected by you. After the recent stock market crash, I occasionally hear people speak of 529 plans as being a bad investment. But there is nothing inherently wrong with the plan – it is just a type of account eligible for tax benefits. However, the investments chosen within the account may or may not have been appropriate. If the beneficiary is nearing college, the plan should be invested in a conservative mix appropriate for the time-frame remaining until college expenses begin. For younger beneficiaries, the account may be invested with a higher percentage in stocks based on the time-frame and desired risk/return characteristics. The discipline of making monthly contributions while the markets are down will far outweigh any recent losses over the next 15+ years. Most 529 plans have an optional feature which automatically changes the investment mix to reduce risk as the child ages, making these investment decisions very easy.

Having so many different state-sponsored 529 plans available, combined with a relatively complex set of federal rules, can make 529 plans seem daunting. Relative to other personal finance and tax issues, 529 plans are actually pretty simple, and they provide some of the best tax benefits available. The fact that they are newer to our vocabulary and can be confusing simply means you need a good resource to answer questions and evaluate your options. Savingforcollege.com is one of the most comprehensive resources available and can help you better understand education funding; or you can just call or email my office.

Have a great week!

A handwritten signature in black ink, appearing to read "Kenneth R. Klabunde". The signature is fluid and cursive, written in a professional style.

Kenneth R. Klabunde, MS, CFP®
Vice President