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TAX PLANNING 529 PLANS

How to help clients chose the best 529 plan

By Kerri Anne Renzulli December 29, 2020, 11:09 a.m. EST 10 Min Read

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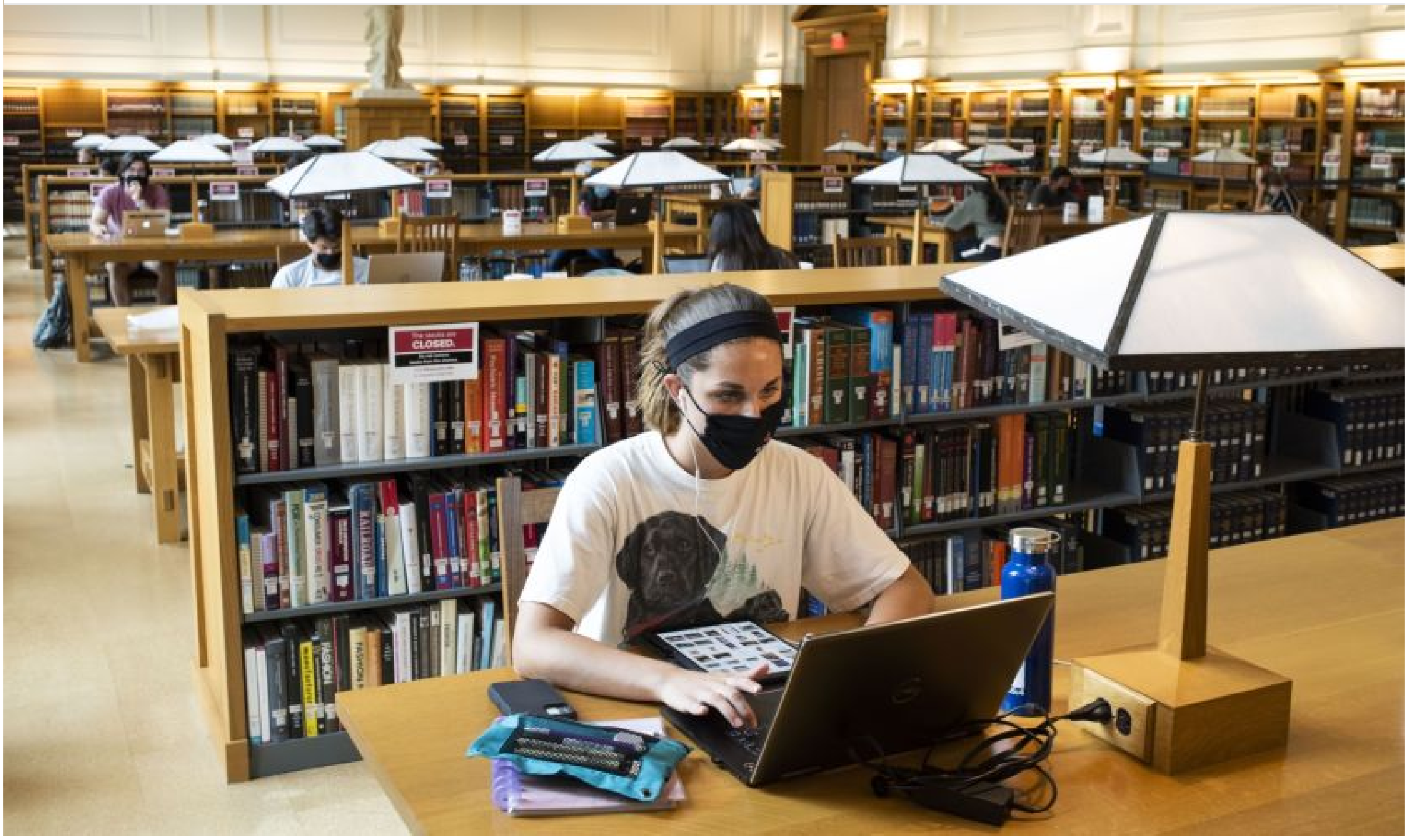

Ty Wright/Bloomberg

When it comes to saving for their children's college fund, most parents could use a little direction. Some may know about the benefits of using tax-advantaged 529 plans, but many will need help navigating the vast array of options.

More than five dozen 529 plans exist for guardians and loved ones to consider using — each offering its own blend of investment portfolios, fees, and performance history. They take two forms: prepaid tuition plans or education savings plans.

Additionally, more than 30 states across the nation offer their own state income tax breaks to 529 savers — though a majority restrict such generosity to residents who opt for their local plan over another state's.

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Below are all the critical questions, strategies and tax planning moves you'll need to know to help clients wade through the myriad options offered by all 50 states and carefully weigh whether to take a state tax break or opt for a better plan out-of-state.

Deciding to go in-state or out-of-state?

For most Americans, there is at least some slight tax advantage to going with the plan offered by their state.

In 34 states and Washington, D.C., residents receive either a tax deduction or credit for sticking with their state's option, though seven among those offer tax parity, meaning residents can claim the break no matter where they park their college savings. States that offer such parity include: Arizona, Arkansas, Kansas, Minnesota, Missouri, Montana, and Pennsylvania.

Nine states don't charge any state income tax and, so, do not offer tax breaks for saving. These include: Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming.

And finally, seven states offer no tax benefits, despite levying state income taxes. These are: California, Delaware, Hawaii, Kentucky, Maine, New Jersey and North Carolina.

If your client lives in one of the states offering tax parity or no income tax benefits, the choice to go out-of-state comes down to how well their home plan fares on factors like investment options and fees compared to other available plans.

But for those living in states where tax breaks are dependent on staying with the local 529 plan, the decision is trickier as a tax deduction doesn't always mean an in-state plan wins.

"The superior returns of an out-of-state plan may override any tax benefit received for a home state one."

Making that final determination on where a client should invest comes down to the state's marginal income tax rate, the difference in the fees between plans, and the number of years until the child enrolls in college. To help, higher education and 529 expert Mark Kantrowitz created a formula to quickly calculate whether the in-state or out-of-state plan is the right move.

In his formula, T = the marginal state income tax rate, ∆F = the difference in fees between the out-of-state plan and in-state plan, and N = the years until the child enrolls in college.

"If ∆F x N > 2T, the out-of-state plan with the lower fees will yield the greater net return on investment, otherwise the in-state plan with the tax deduction is the better option," says Kantrowitz, who is the publisher and vice president of research for SavingforCollege.com. Typically, the more years until matriculation, the greater the savings from having lower fees, he adds.

Research conducted by Morningstar earlier this year found that nine states offered tax benefits large enough to cover the cost of their direct-sold plan for 18 years. About half of the states with benefits' generosity totaled more than a decade of fees. Clients using advisor-sold plans fared worse, and typically saw tax benefits cover fewer than half the years of expenses that direct-sold plans did.

The rewards of multiple plans

In some cases, clients may be best served by using two different 529 plans, either simultaneously or at different points in the child's life.

Financial planner Jeff Farrar, executive managing director at Procyon Partners in Wilton, Connecticut, says if the 529 plan's investment options stink, he recommends clients only contribute enough to an in-state plan to get the deduction and save the rest in a better plan.

point where the benefit of a state income tax deduction exceeds the benefit of lower fees usually occurs around when the student enters high school, says Kantrowitz. But, that point may be earlier if there is a small difference in the fees or if a state has a high marginal tax rate.

For instance, Kantrowitz found that a state with a marginal tax rate of 1% that had a difference of 0.75% in fees between its plan and a better competing plan would help savers most if they only used the in-state option for the three years before their child entered higher education. But if the state had a 6% tax rate and the same fee difference, the switch to in-state should occur 14 years before starting college. Kantrowitz adds that whenever the difference in fees is 0.10% or less the state income tax break is always more valuable. (These calculations assume a 6% average annual return on investment.)

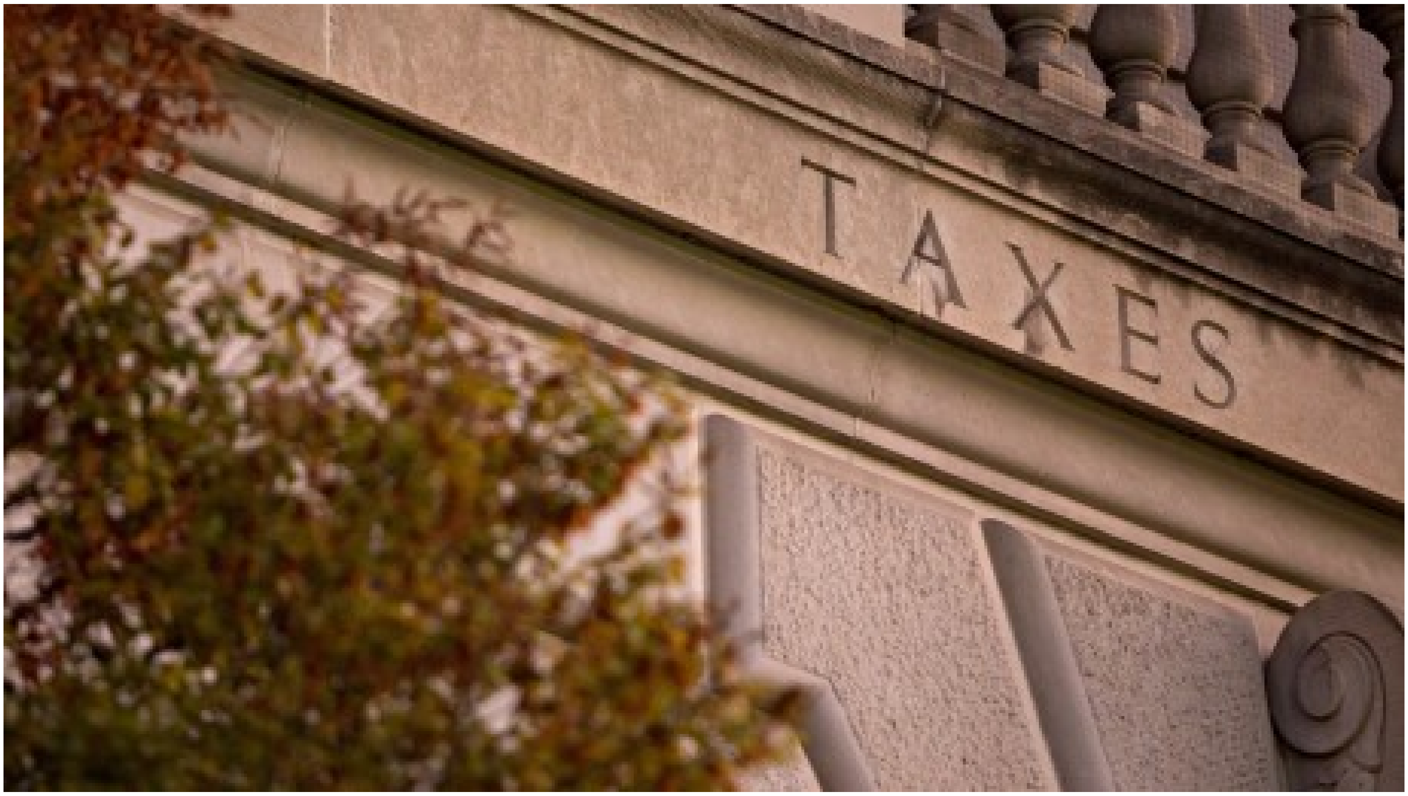
Regardless of when a client makes this in-state switch or decides to fund two plans simultaneously, if they earn a tax deduction or tax credit for participating, they should continue to contribute even after their child enrolls in college since the break acts like a discount on education costs pushed through the plan, says Kantrowitz.

Only four states have anything on the books that stop you from taking advantage of this loophole. Michigan and Minnesota prevent this by basing the tax break on annual contributions minus distributions. Though you can get around this by making contributions one year and then waiting till the following year to take a distribution to pay for college costs.

Montana and Wisconsin, however, impose time limits, recapturing the tax deduction for contributions when a withdrawal is made within three years of the account's opening or when a distribution is made within 365 days after a contribution, if the account balance is less than the distribution amount prior to the contribution, respectively.

Clients generally shouldn't be encouraged to rollover the balance of one 529 account into another as such transfers come with potential penalties and plans can already be used to finance education expenses throughout the U.S. regardless of where the 529 account is based.

attributable to the distribution, says Kantrowitz. States that do this include: Alabama, Arkansas, Colorado, Georgia, Idaho, Illinois, Indiana, Iowa, Montana, Nebraska, New Mexico, New York, Ohio, Oklahoma, Rhode Island, Utah, Virginia, Washington D.C. and Wisconsin.



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Some cash-strapped clients with high medical costs could really benefit from making this move.

By Kerri Anne Renzulli

October 16

High performance and low fee plans

After looking at where a plan is located, it's time to begin digging into the investment mix and fees that comprise each state's plan to find the best option.

Most 529 plans offer a limited menu of investment portfolio choices, typically a dozen or fewer, says Kantrowitz. Clients can use age-based portfolios, which will limit stock exposure gradually as the child approaches 18, or static portfolios, which you or the client can direct as desired.

The advisors *Financial Planning* spoke with were divided over whether they'd recommend clients stick with the pre-done age-based option or the static option, though many said it comes down to the client.

"I base the recommendation for static vs age-based on the client's level of interest to manage the investments in the account," says financial planner Ron Guay, of Rivermark Wealth Management in Sunnyvale, California. "A DIY client that is very involved can be fine with a static portfolio, while a 'hands off' client will be better served in an age-based strategy. I give a fair amount of weight to the associated fees. I'm typically advising passive index funds where the holdings are determined by the applicable index, so fees can be the deciding factor."

Fees will typically be cheapest if clients opt for direct-sold plans and stick to passively managed funds. The average fee for an age-based portfolio in a direct-sold plan was 0.35% last year vs. 0.87% in an advisor-sold plan, according to Morningstar.

Another key consideration is whether the client has additional college savings set aside in other investment vehicles.

expects to start school," says Brian Fischer, a senior financial advisor with Evensky & Katz/Foldes Financial Wealth Management in Miami, Florida. "However, sometimes folks may have additional investments set aside for expenses other than just a 529 plan. Static portfolios may make sense if they serve as a diversifying piece to a larger portfolio. For example, a 100% stock static portfolio may provide the entirety of the stock allocation to a larger portfolio."

While each state will offer both kinds of portfolio choices, not all are created equal. State 529 plans can vary greatly when it comes to past performance, fees, and the exact investment fund options offered making some clear winners and other duds to avoid.

This fall, Morningstar analyzed 61 plans, representing 97% of the more than $363 billion invested in 529s, and found that only three were worthy of it's gold medal designation, because they offered: "a well-researched asset-allocation approach, a robust process for selecting underlying investments, an appropriate set of options to meet investor needs, strong oversight from the state and investment manager, and low fees." (State tax benefits were not considered.)

The highest ranked plans? Illinois' Bright Start College Savings, Utah's my529, and Michigan's Education Savings Program, which charges 0.10% for its target-enrollment portfolios — the cheapest Morningstar rated.

California's ScholarShare College Savings Plan and Virginia's Invest529 were former gold winners, who this year received silver medal designations, but came in right behind the top three. Nine other states received a silver, including: Pennsylvania 529 Investment Plan, New York's 529 Program, Oregon College Savings Plan, and Ohio's CollegeAdvantage 529 Savings Plan. (All gold and silver plans were direct-sold options.)

Only eight plans received the failing grade of negative, but all charged high fees and should be avoided, even by in-state college savers hoping to hook a tax benefit, Morningstar concluded. Six of the negative-rated plans were advisor-sold and include: Colorado's Scholar's Choice College Savings Program, Indiana's CollegeChoice Advisor 529 Savings Plan, Maine's NextGen College Investing Plan

Jersey's NJBEST 529 College Savings Plan and Nevada's USAA College Savings Plan.

Kantrowitz's SavingforCollege.com also ranks plans based on their historical investment performance and fees. The cream of the crop according to its analysis was similar to that of Moringstar's with Ohio, West Virginia, New York, and Indiana, performing in the top 10 of plans over both a three-year and five-year horizon. The site also hosts a free comparison tool that allows you to compare 529 plans based on more than 30 different factors, including state tax benefits.

While the perfect 529 plan for your client may differ from these industry picks, the most important thing is that you steer them clear of costly ones whose fees will eat up any tax breaks or investment returns.

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