Fors Financial Consulting
1001 East Front Street
Port Angeles, WA 98362
360-457-6116
info@forsfinancialconsulting.com
https://www.forsfinancialconsulting.com/

529 Plans vs. Other College Savings Options

529 Plans vs. Other College Savings Options

529 plans can be a great way to save for college, but they're not the only way. When you're investing for a major goal like education, it makes sense to be familiar with all of your options.

Mutual funds

Mutual funds are an option to save for college costs. They offer unlimited investment control and flexibility as you can choose from a wide variety of funds that meet your risk tolerance, time horizon, and overall investment preferences. And there are no restrictions or penalties if you sell your shares and use the money for something other than college.

But 529 plans are generally a more powerful tool than mutual funds when it comes to saving for college because they offer federal tax benefits that mutual funds don't. First, assets in a 529 plan accumulate tax deferred, which means you don't pay incomes taxes each year on the income earned by the fund's underlying assets. With mutual funds, you'll pay income tax every year on the income earned by the fund (dividends and capital gain distributions paid by the fund), even if that income is reinvested. Second, withdrawals from a 529 plan that are used to pay the beneficiary's qualified education expenses are completely free of federal income tax (and typically state income tax). With mutual funds, you'll pay capital gains tax on any gain in the value of your fund when you sell your shares.

The main drawbacks of 529 plans is that they offer less investment control and flexibility. Regarding investment control, you're limited to the investment portfolios offered by the plan (investment portfolios typically consist of groups of mutual funds) and you can change your investment options on your existing contributions only twice per calendar year. This can make it difficult to adjust to changing market conditions. Regarding flexibility, if you use 529 plan funds for non-educational expenses, the earnings part of the withdrawal is subject to income tax and a 10% federal penalty (state income tax and a penalty may also apply).

Keep in mind that both mutual funds and 529 plans involve risk — your ultimate college fund could be worth more or less than the principal you invested.

Coverdell accounts

A Coverdell education savings account (ESA) is a tax-advantaged savings vehicle that lets you save up to $2,000 per year for a beneficiary's college or K-12 expenses. Qualified education expenses include tuition, fees, room and board, books, equipment, computers, tutoring, uniforms, and transportation. At one time, Coverdell accounts were the only tax-advantaged way to save for K-12 expenses. Now, though, 529 plan funds can be used to pay K-12 expenses, up to $10,000 per year for tuition only.

The tax treatment of Coverdell ESAs and 529 plans is generally the same. Contributions to both accounts accumulate tax-deferred and withdrawals are completely tax free at the federal level (and typically the state level) when used for the beneficiary's qualified education expenses. For withdrawals used for any other purpose, the earnings portion of the withdrawal is subject to federal income tax and a 10% federal penalty (state income tax may apply as well).

Coverdell accounts offer more investment flexibility than 529 plans because you can generally buy and sell investments in the account whenever you'd like. But Coverdell accounts are much more restrictive than 529 plans. First, the $2,000 annual contribution limit for Coverdell ESAs is much less than the lifetime maximum contribution limit for 529 plans, which is typically $350,000 and up depending on the plan. Second, in order to be eligible to contribute to a Coverdell account single filers must have a modified adjusted gross income (MAGI) under $110,000, and married filers must have a MAGI under $220,000. Another drawback is that you can't contribute to a Coverdell account for a beneficiary who is 18 or older, unless the beneficiary has special needs. By contrast, 529 plans don't restrict your ability to contribute based on your income, and most plans let you contribute after the beneficiary reaches age 18.

Custodial accounts

A custodial account is another college savings option. Assets in a custodial account are held in your child's name and must be used exclusively for your child's benefit. A custodian (who can be you or another adult) manages the account and invests the money for your child until he or she is no longer a minor (18 or 21, depending on the state). At that point, your child gains complete control of the funds. Custodial accounts are established under either the Uniform Transfers to Minors Act (UTMA) or the Uniform Gifts to Minors Act (UGMA). They are similar in most ways but an UTMA account can typically hold certain assets that an UGMA account can't (states must enact one or the other).

A custodial account is not a tax-deferred account. Earnings, interest, and capital gains generated from assets in the account are taxed every year to your child under special "kiddie tax" rules that apply when a child has unearned income. Under the kiddie tax rules, a child's unearned income over a certain threshold ($2,300 in 2022) is taxed at parent income tax rates. The kiddie tax rules generally apply to children under age 18 and full-time college students under age 24 whose earned income doesn't exceed one-half of their support.

Generally, a 529 plan gives you more control than a custodial account because as account owner, you decide when the money will be withdrawn and for what purpose; your child doesn't become the legal owner of the funds at age 18 or 21 as with a custodial account.

But a custodial account might appeal to you for some of the same reasons as mutual funds. Though money in the account must be used for your child's benefit, that requirement is broader than just college expenses. For example, it could include paying for a gap year or other enrichment activities, a car, computer, etc. Also, your investment choices are virtually unlimited (e.g., stocks, mutual funds, real estate), allowing you to be as aggressive or conservative as you wish, and you can generally buy and sell investments at any time. As mentioned, 529 plans don't offer this degree of investment flexibility.

U.S. savings bonds

U.S. savings bonds are another possible education savings option. They're very easy to purchase and backed by the full faith and credit of the federal government. You can purchase bonds in face values as low as $50 ($25 if purchased electronically). Two types of savings bonds, Series EE and Series I bonds, are available. Not only is the interest earned on them exempt from state and local tax at the time you redeem (cash in) the bonds, but you may be able to exclude the interest from federal income tax if you meet the following conditions:

- Your modified adjusted gross income (MAGI) must be below $100,800 if you're filing single and $158,650 if you're married filing jointly in 2022 (limits are indexed for inflation every year)
- The bond proceeds must be used to pay for qualified education expenses
- The bonds must have been issued in 1990 or later
- The bonds must be in the name of one or both parents, not in the child's name
- Married taxpayers must file a joint return
- The bonds must have been purchased by someone at least 24 years old
- The bonds must be redeemed in the same year that qualified education expenses are being paid

Savings bonds offer a low steady rate of return that's guaranteed. But you may not be able to keep up with college inflation, which has generally averaged between 3% and 5% per year. And despite the potential tax savings, trying to amass a large college fund with regular monthly savings bond purchases can be inconvenient. If you're interested in making monthly contributions to a college fund, 529 plans let you set up electronic funds transfer from your checking or savings account on a monthly or quarterly schedule.

Traditional and Roth IRAs

Traditional IRAs and Roth IRAs are retirement savings vehicles. However, withdrawals for qualified education expenses are exempt from the 10% premature distribution tax (also called the early withdrawal penalty) that generally applies to withdrawals made before age 59½. So some parents may decide to save for college within their IRAs. In order to be exempt from the early

withdrawal penalty, money you withdraw from your IRA must be used to pay the qualified education expenses of you or your spouse, or the children or grandchildren of you or your spouse.

However, keep in mind that even if you're exempt from the 10% penalty, money withdrawn from a traditional IRA may be subject to federal income tax and possibly state income tax (withdrawals from a Roth IRA are income tax free if certain requirements are met). And, of course, any withdrawals for college expenses will reduce your retirement nest egg, so you should think carefully before tapping your retirement funds.

Trusts

Trusts can be used to save for education expenses, but they can be expensive to establish. There are two types you may want to investigate:

Irrevocable trusts: You can set up an irrevocable trust to hold assets for your child's future education costs. This type of trust lets you exercise control over the assets through the trust agreement. However, income retained in the trust is taxed to the trust itself at a potentially higher amount. Also, transferring assets to the trust may have negative gift tax consequences.

2503 trusts: There are two types of trusts that can be established under Section 2503 of the Tax Code: the 2503 (c) "minor's trust" and the 2503 (b) "income trust." The specific features and tax consequences vary depending on the type of trust used, and the details are beyond the scope of this discussion. Suffice it to say that either type of trust is much more costly and complicated to establish and maintain than a 529 plan. In most cases, a 529 plan is a better way to save for college.

Note: *Before investing in a 529 plan, please consider the investment objectives, risks, charges, and expenses carefully. The official disclosure statements and applicable prospectuses, which contain this and other information about the investment options, underlying investments, and investment company, can be obtained by contacting your financial professional. You should read these materials carefully before investing. As with other investments, there are generally fees and expenses associated with participation in a 529 plan. There is also the risk that the investments may lose money or not perform well enough to cover college costs as anticipated. Investment earnings accumulate on a tax-deferred basis, and withdrawals are tax-free as long as they are used for qualified education expenses. For withdrawals not used for qualified education expenses, earnings may be subject to taxation as ordinary income and possibly a 10% federal income tax penalty. The tax implications of a 529 plan should be discussed with your legal and/or tax professionals because they can vary significantly from state to state. Also be aware that most states offer their own 529 plans, which may provide advantages and benefits exclusively for their residents and taxpayers. These other state benefits may include financial aid, scholarship funds, and protection from creditors.*

Content in this material is for general information only and not intended to provide specific advice or recommendations for any individual. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and may not be invested into directly.

The information provided is not intended to be a substitute for specific individualized tax planning or legal advice. We suggest that you consult with a qualified tax or legal professional.

LPL Financial Representatives offer access to Trust Services through The Private Trust Company N.A., an affiliate of LPL Financial.

Fors Financial Consulting
1001 East Front Street
Port Angeles, WA 98362
360-457-6116
info@forsfinancialconsulting.com
https://www.forsfinancialconsulting.com/

Prepared by Broadridge Investor Communication Solutions, Inc. Copyright 2022