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The Sound Investor Series #80

Tackling 529 Plans

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January 3, 2007

The beginning of the year is always a good time to tackle tasks you have been putting off, and setting up a college savings plan might just be one of those tasks. We know college costs are going up; over the past five years tuition at public four-year universities has increased 35 percent.

One of the best plans is called Qualified Tuition Programs and commonly referred to as 529 Plans for the section of the IRS code that governs them.

529 Plans are accounts into which parents (or anyone else) can deposit money that will grow tax-free. If the money is used for higher-education expenses, the investment income will never be taxed. "Higher-education" expenses include tuition, room & board, mandatory fees, books and computers (if required).

The drawback of 529 Plans is that if the money is withdrawn and not used for higher-education, investment gains are taxed as ordinary income and a 10 percent penalty is imposed. For example, say $10,000 was deposited into a 529 plan and grows to $12,000. If that $12,000 were taken out and used for non-qualified purposes, the original $10,000 would not be taxed again. But, the gain of $2,000 would be taxed as ordinary income, and a penalty of 10 percent would be imposed ($200).

I wouldn't worry too much about the potential 10 percent penalty on investment earnings. When parents compare 529s to regular investment accounts invested in bonds and money markets that generate interest income, the penalty diminishes and effectively disappears over time. In a regular investment account interest income is taxed every year as ordinary income and thus retards the account's growth. On the other hand, in a 529, all interest income compounds every year without being taxed. Over a ten year period, using a 5 percent return on bonds and 28 percent tax rate, the 529 Plan's investment income will be 60 percent higher than those in a regular account. If the money is withdrawn for non-qualified purposes; and taxes are paid, your income is only 2 percent lower that a regular account even after the penalty.

Remember also that each 529 plan is set-up for one beneficiary, but that beneficiaries may always be changed at a later date. You can even name yourself as beneficiary and use the money to further your own education. Also, if the beneficiary receives a scholarship, there is no penalty for withdrawal.

529 Plans were created in the late 1990s and became somewhat, if not terribly, popular. In the early years growth was strong, but from 2003 to 2005 the amount of new money coming into these plans yearly stagnated at about $17 billion. At the end of 2005, assets in all 529 Plans totaled $68.7 billion.

Last year some significant modifications were made to 529 Plans, and although the final numbers are not in, 2006 contributions appear to be much stronger. The most important change came last summer when the Pension Protection Act of 2006 was passed and made the tax benefits of these plans permanent. Prior to its passage, the 529 tax benefits were temporary and would have expired in 2011.

A second factor in the pick-up can be attributed to changes in various state tax regimes. For instance, last summer Connecticut's tax law was amended to make 529 Plans more attractive. Contributions can now be used to reduce a taxpayer's adjusted gross income by up to $10,000 for a couple filing jointly. This deduction should be easy for taxpayers to claim as it doesn't depend on itemizing the federal return. (If the funds are withdrawn for non-qualified purposes, this tax benefit is reversed.)

A third reason for renewed interest in 529s is that states are improving their plans. In particular, investment choices are growing and fees are coming down. Here in Connecticut, annual fees were lowered from 0.70 percent to 0.65 percent. While in California fees are now capped at 0.50 percent.

Connecticut's Higher Education Trust (CHET) College Savings Program now offers five funds and investments can be allocated to one fund or any combination. The choices are the Managed Allocation Option, High Equity Option, Principal Plus Interest Option, 100% Equity Index Option and 100% Fixed-Income Option. It should be noted that investments can only be reallocated once a year.

For most investors, the Managed Allocation Option is probably the best choice. This fund invests a substantial proportion in stocks when the beneficiary, (in most cases a child), is young; but as they near college age it takes a more conservative approach, employing bonds and money markets.

Here are a few other reasons to consider 529 Plans.

- One nice feature for grandparents setting up 529 Plans is that they continue to control where the funds are invested and when and how the money is spent, but at the same time, the money is no longer part of their estate. Contributions of up to $12,000 a year from an individual and $24,000 from a couple can be made without any gift taxes. You can also "pre-fund" the 529 by contributing $60,000 ($120,000 for couples) today and spreading it over the next 5 years for gift purposes (as long as no other gifts are given).
- The Deficit Reduction Act of 2005 made substantial changes in the treatment of 529 Plans in the federal student aid eligibility formula. This is complicated, but generally 529 assets will not count as much as other money on federal forms although individual schools may/will have their own rules.

In summary, all parents and grandparents should seriously consider setting up a 529 plan. For more information on CHET visit www.aboutchet.com.

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