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**ACCUMULATE WEALTH AND REDUCE TAXES**

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Roth IRA Advisor Newsletter Edition 11:  
**Saving for College with a Qualified  
State Tuition Program (QSTP)**

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*This month we have a special guest author, Joseph F. Hurley, CPA. In addition to the enclosed article, Joseph also wrote an excellent book **The Best Way to Save for College** available at [www.savingforcollege.com](http://www.savingforcollege.com). Joe, as I am, is a strong proponent of the qualified state tuition programs, sometimes referred to as Section 529 Saving Plans.*

I will interject comments with the following notation: *Jim's comment...*

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“Listen up,” suggests financial columnist Jane Bryant Quinn. “Section 529 savings plans are a great way for parents or grandparents to build a college fund.” Andrew Tobias says, “Almost anybody saving for college would be crazy not to at least to consider them.” And mutual fund columnist Charles Jaffe of the *Boston Globe* calls 529 plans “the next big thing.”

A 529 plan, more formally known as a Qualified State Tuition Program or QSTP, is a state-sponsored investment program that qualifies for special tax treatment under Section 529 of the Internal Revenue Code. They were designed to provide families with an easy and effective means to save for future college costs—but in fact 529 plans have investment, tax, retirement, and estate planning implications that extend far beyond their basic purpose. They are truly unique: a 529 plan provides a combination of benefits unavailable from any other IRS-approved investment.

Don't immediately assume that you are not in position to take advantage of them. Unlike most other tax incentives in the law, 529 plans are open to everyone, no matter what your income level or how old your children and grandchildren are. In fact, you don't even need to have children or grandchildren—you can establish an account for yourself! And in some states you can keep the account open for as long as you want.

Forty-six states have passed legislation authorizing a 529 plan, and 38 states have them up and operating. Of the 46 states, 23 have plans without any residency requirements. This is important, because it means you can shop among the states for the best 529 plan.

Although states have significant latitude in crafting a 529 plan, and program features vary considerably, they all fall into one of two general categories: prepaid tuition plans and savings plans. States may choose to offer one type of plan or the other, and some states are now offering both.

- **Prepaid tuition plans** are state-operated trusts offering residents a hedge against college tuition inflation. The state offers contracts guaranteed to pay future tuition costs, at in-state public institutions, at prices pegged to current tuition levels. Some states discount the contract price to reflect the projected investment gains of the program trust fund in excess of expected tuition increases.

*Jim's comment...*

*Unfortunately, Pennsylvania does not currently offer a 529 savings plan. It only offers a prepaid tuition plan. A state sponsored prepaid tuition plan restricts where the beneficiary may attend school i.e. accredited institutions within the state. In addition, the prepaid tuition plan does not have all the income and estate tax benefits of a savings plan. Under most circumstances, I consider the Pennsylvania prepaid tuition plan to be practically useless. For most PA residents, I recommend investing in a 529 Savings Plan outside of Pennsylvania.*

- **Savings plans** on the other hand, are essentially tax-favored state-sponsored investments. The basic idea is that the account owner's contribution into the 529 plan will grow in value over time to keep up with, or preferably to surpass, the increasing price of a college education. Like any investment, their returns will vary widely depending on their asset allocations between stocks and fixed income securities. Withdrawals are taken as needed, in the future, to pay for college expenses of the designated beneficiary. Most of the newer 529 plans are savings plans and they are generally viewed as more flexible and powerful than prepaid tuition plans.

For each prepaid tuition contract or savings account there is an "owner" (generally the donor) and a "beneficiary." You name a beneficiary when you set up an account and the individual you name does not have to be related to you. Many states allow the account owner and the beneficiary to be the same person.

The funds from a 529 plan can be used to pay for the beneficiary's "qualified higher education expenses" at an accredited post-secondary school eligible for Department of Education student aid programs under Title IV of the Higher Education Act. Qualifying higher education expenses include:

- tuition,
- fees,
- books,
- equipment, and
- supplies required for enrollment or attendance at an eligible education institution.

In addition, room and board expenses can qualify (subject to limits) if the student is attending college on at least a half-time basis.

*Jim's comment...*

**There are significant advantages to the 529 plans even for university employees who already have a tuition benefit package. Using a 529 plan can still make sense for university employees**

*who are offered a tuition benefit, where depending on the contract, the university pays for some or all of the employees' child's tuition costs. The 529-plan account can be used to pay for items that are not covered by the tuition benefit plan such as room and board, books, equipment and supplies. Alternatively, funds in the 529-plan account could be retained for graduate school, or rolled over to a different beneficiary under the rollover rules.*

### **Income Tax Advantages**

The income tax benefits associated with a 529 plan are attractive. Although there is no federal deduction for contributions to the account, it grows tax-deferred until withdrawn. A withdrawal consists of two pieces:

- A nontaxable return of principal
- A taxable earnings portion. The earnings portion represents a pro rata apportionment of the increase in the value of the account. It is computed by the program and reported to the recipient as ordinary income on Form 1099-G.

### There are three types of withdrawals.

1. Qualified withdrawals. A withdrawal is taken to pay for a qualified expense and the beneficiary is deemed to be the recipient. Most students are in a low tax bracket and so the shifting of income, combined with the tax-deferred benefit, can provide significant tax savings.
2. Withdrawals following the beneficiary's death or disability or receipt of a scholarship. In the event of death or disability, the program will not charge a penalty, but the earnings will be taxed to the owner, not to the account beneficiary. However, the owner will have had the benefit of a tax-deferred investment. In the event that your beneficiary receives a scholarship, or if you are eligible for a tuition benefit from your employer (in the case of some university employees), you can withdraw, without penalty, an amount that does not exceed the scholarship. Anything over and above that amount would be considered a non-qualified withdrawal and incur a 10% penalty on the earnings portion. You will still have to report the earnings portion on your tax return. *(Keep in mind however, that in the case of a scholarship, the 529 funds could be used to pay for other qualified expenses, in which case the earnings portion would be taxed at the beneficiary's lower rate.)*
3. Non-qualified withdrawals. There is no requirement that the withdrawal be used for education expenses. The account owner may simply decide to use it for other purposes. When the account owner takes a non-qualified withdrawal, the earnings will be taxed to the owner, not to the account beneficiary. In addition, a program-imposed penalty must be assessed. In most 529 savings plans, the penalty is 10% of the earnings portion of the withdrawal.

### ***Jim's comment...***

*While you are alive, you have complete control of the distributions from the 529 plan. For long term planning purposes, I recommend putting a clause in your will to delegate the power to control the 529 distributions.*

The mechanics of QSTP are illustrated by this simple example.

John contributes \$8,000 to a 529-plan account, with an interest rate of approximately 8%, for his 8-year old grandchild. The value of the account increases to \$20,000 over a ten-year period until the child is ready to attend college. John decides to use one-half of the account or \$10,000 to pay for the child's first semester of college. The earnings ratio is 60%--the \$12,000 growth in the account divided by the \$20,000 account value--and so \$6,000 (\$10,000 times 60%) is reported to the child as taxable ordinary income. John also decides to remove the remaining \$10,000 for himself, intending to go on safari in Africa. Assuming the program-imposed penalty is equal to 10% of earnings, a \$600 penalty would be withheld by the 529 plan and John would pay tax on the net earnings of \$5,400.

As you can see from this example, even if you decide to use the account for a purpose other than college or graduate school, you receive 100% of your original contribution and 90% of the earnings. And you will have enjoyed the tax deferral benefit. This is not a bad deal.

If you find that funds in the account are not needed for the beneficiary's college expenses, and you do not want to pay tax and penalty due on a non-qualified withdrawal, you will have the ability in most 529 plans to change the beneficiary or "roll it over" to someone who qualifies as a "member of the family" of the original beneficiary and keep the account intact. Rollovers can also be used to transfer money from one state's 529 plan to another, as long as the beneficiary is changed to another family member in the process. You might choose to rollover your account if you decide that another state's 529 plan is better than the one you currently hold. Alternatively, should one of your children receive a full scholarship, you could rollover the account to another child.

#### *Jim's comment...*

*The definition of "family member" includes a beneficiary's sibling but does not include a beneficiary's cousin. Thus a grandparent can initiate a rollover from one beneficiary to the beneficiary's sibling, but not to another grandchild who is not the beneficiary's sibling.*

#### **Estate Planning Advantages**

Many people, especially grandparents with sizable estates, will find the estate tax treatment of 529 plans to be their most outstanding feature. Contributions to the plan are removed from the donor's estate, yet the account owner (usually the donor) retains the power to control withdrawals from the account. The account owner has the right:

- to change the beneficiary,
- to determine the amount and timing of withdrawals, and even
- to reclaim the assets.

There is no other way under the Internal Revenue Code for a donor to remove a completely revocable gift from his or her estate. Anyone who has been unwilling to make estate-reducing gifts to family members because they were reluctant to give up control of the assets may have the perfect answer in 529 plans.

A contribution to a 529 plan qualifies for the \$10,000 (\$20,000 for married couples) annual gift tax and generation-skipping transfer tax exclusion. Furthermore, you can elect to use five years' worth of annual exclusions to shelter an immediate contribution of up to \$50,000 (\$100,000 for a married couple) into a 529 plan for one beneficiary. If the donor makes the five-year election and dies during the five calendar year period, a part of that contribution will be thrown back into the donor's estate.

The following example demonstrates how powerful this opportunity can be.

Grandparents have a combined \$5 million estate including \$1 million in bonds and cash. They are interested in reducing their estate tax exposure and would like to devote funds to the future college education of their seven grandchildren. However, they are concerned about the loss of control associated with gifts into a Uniform Transfers to Minors Act account (especially the risk that the child will reach the age where he/she will be able to direct the use of the funds for other purposes). Also, they do not want to devote the time and expense required establishing and maintaining irrevocable education trusts. Each grandparent is entitled to give each grandchild \$10,000, which amounts to a gift of \$20,000 per child, without eating into each of their once in a lifetime exclusion. They decide to contribute \$100,000 (it must be cash) to a 529-plan account for each of the seven grandchildren. They make the five-year election to shelter the entire amount from gift tax and so do not use up any of their lifetime exemptions. The result is that they have removed \$700,000 from their taxable estates in one day, without gift tax, without cost (many 529-plan accounts have no set-up cost), and without losing control of the funds. Further, the contributions are invested in a professionally managed investment account that will grow without the burden of annual income taxes. That's effective estate planning!

If the grandparents have already started a family-gifting program that uses the \$10,000 annual exclusion, they would need to decide if 529 plans are more beneficial than their current approach. Consider the fact that once the grandchildren are in college the grandparents may make unlimited gifts under the exclusion for direct payments of tuition (Section 2503(e)). Remember, however, that this exclusion *applies only to tuition* while 529 plans cover room and board and certain other expenses. In many cases it may be wise to fund a 529-plan account now and still plan to use the 2503(e) exclusion later on.

***Jim's comment...***

*One of the problems with traditional gifting, through the Uniform Gift to Minor Act Trust (the most common method of making a gift to a minor), is that the minor will have unlimited access to the funds at either 18 or 21 years of age depending on the minor's residency. I don't think Grandpa wants to finance a wild spending spree. Advisors often recommend a more restrictive education trust, such as a Crummey trust, that will restrict the grandchild's use of the money even after the grandchild turns 21. However, there are costs involved in setting up and maintaining the Crummey trusts. In addition, the QSTP has significant income tax advantages not available to the Crummey trusts.*

**Investment Issues**

Now let's talk about the investment aspects of a 529 savings plan. Each state is free to design an investment approach that it feels will best accomplish the goal of saving for college. One condition imposed by Code section 529 is that the participant in the 529 plan not have the ability to direct the investment of the contribution. Although this overly paternalistic provision is seen by some people as a reason not to use 529 plans, the fact of the matter is that among the many states offering 529 plans there are a variety of investment approaches. Many states will out-source the investment and program management to large financial service companies that provide professional investment management to plan participants.

TIAA-CREF manages more 529 plans than any other company (including plans in NY, CA, KY, VT, MO, and CT). Anyone familiar with TIAA-CREF knows it as a very large and well-respected pension and investment management company that keeps its costs low. For its 529 plans, TIAA-CREF has designed age-based portfolios combining stocks, bonds, and money market instruments. Younger beneficiaries are invested in portfolios that are weighted heavily to stocks and as they approach college age the portfolios are shifted into a more conservative allocation with bonds and money markets.

The program managers for several other states also offer an age-based portfolio approach using their mutual funds as the underlying investments. These include Merrill Lynch (Maine), Fidelity (New Hampshire), Salomon Smith Barney (Colorado), and Bank One (Indiana). Iowa and Utah manage their own investments and offer age-based programs that are invested in Vanguard mutual funds.

In their efforts to be as competitive as possible, some 529 plans are now offering participants the option to select an investment with a fixed asset allocation rather than one that shifts with the age of the beneficiary. The menu of choices may range from a 100% equities fund to a 100% fixed income fund. The states offering this option include Maine, Utah, Indiana, and Arizona.

You can find my ranking of all the available 529 plans at [www.savingforcollege.com](http://www.savingforcollege.com).

As more states open up new 529 plans, and states with existing plans make improvements in their effort to remain as competitive as possible, you will find an increasing number of investments available to you. Before deciding where to open an account, however, careful attention needs to be paid to the details of the 529 plan. They may differ in any number of areas:

- maximum and minimum contribution levels,
- permissible beneficiary and account owner changes,
- fees and expenses,
- creditor protection, etc.

You should always take a look at the 529 savings plan in your own state (not currently available in PA) because states will typically offer additional benefits to state residents (state tax benefits, grants, and financial aid preference). Although it may take some effort to understand how 529 plans work and to compare the details of competing plans, the effort may be well worth it if you

are looking for a tax-advantaged way to save for future college expenses. Your research should start at [www.savingforcollege.com](http://www.savingforcollege.com), a web site designed to provide information and links for those interested in 529 plans.

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***Jim's comment...***

*There is one other aspect of a QSTP that appeals to me for planning purposes. It provides a safe avenue for clients to earmark funds for their child's or grandchild's education. I have never heard a client say that the goal of his gifts and bequests was to make his grandchildren so stinking rich they would never have to work a day in their life. I do, however, frequently hear that, after providing for their surviving spouse, my clients want to ensure that their children and grandchildren have sufficient resources to attend a good college. What prevents some people from taking the steps to provide for their offspring's education is the fear that the money they are willing to contribute to pay for an education will be squandered. Furthermore, there is a growing concern that unconditional outright gifts of large sums of money can be detrimental to young beneficiaries, among other things it can stifle their aspirations to succeed independently. Unfortunately, retirement and estate planners often view maximizing wealth and saving taxes as primary goals and fulfilling clients' desires as secondary. Though I try to avoid that natural inclination, it is part of my fabric to try to reduce my client's income and estate taxes. The QSTP is not only advantageous from an income and estate tax planning perspective, it also fulfills what clients want—to provide funds for education while retaining control and providing some assurance that the assets will not be squandered by the beneficiary for purposes other than their education.*

*I know of no better source of objective information on 529 plans than Joe Hurley's book **The Best Way to Save for College** available at [www.savingforcollege.com](http://www.savingforcollege.com).*

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**Contact Information**

CPA/Attorney Jim Lange concentrates his practice in retirement and estate planning for individuals with significant IRAs and other retirement assets. Jim is the sole owner of a law firm and a CPA firm located in Pittsburgh on the corner of Murray and Phillips Avenues in Squirrel Hill, one block from Poli's restaurant. Jim has a staff of eleven employees. Jim has done more than 450 retirement and estate plans. If you should have any questions, Jim can be reached at 412-521-2732.