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What You Need to Know About 529 College Savings Plans

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The Key Wealth Institute is a team of highly experienced professionals from across wealth management, dedicated to delivering commentary and financial advice. From strategies to manage your wealth to the latest political and industry news, the Key Wealth Institute provides proactive insights to help grow your wealth.

Saving for your child's education may have taken a back seat to coping with rising inflation, elevated market volatility, and the ongoing implications from the COVID pandemic. But that could be a mistake. Eventually, those hardships will be in the rearview mirror. Yet the average cost of college in the 21st century already has more than doubled, according to the Education Data Initiative, with in-state students at public colleges spending an average of $25,707 for one academic year, and private school students spending an average of $54,501.[1] If we rely on history, we can expect that those costs will continue to rise.

The good news is that today, 529 College Savings Plans are more accessible and offer more tax advantages than when states created them more than 25 years ago. Much like the way 401(k) plans changed the world of retirement savings decades ago, 529 savings plans are changing the world of education savings. In addition to college and post-secondary school expenses, many of these plans also can be used for K-12 tuition, student loan repayment and some apprenticeship programs. Anyone can contribute – parents, grandparents, friends of the family – and at any time. For the tax year 2022, the maximum contribution eligible for federal gift-tax exclusion increases to $16,000 per child. And savers can make a one-time lump sum gift of $80,000 for a single taxpayer or $160,000 if electing to split gifts with a spouse that could be considered spread over five years for federal gift tax exclusion purposes. As a result, this would not be counted as a taxable gift.

We answer frequently asked questions on 529 plans below:

Exactly what is a 529 plan?

There are two types of 529 savings plans, which also are known as qualified tuition plans. The education savings plan is the most popular and flexible, but some states also offer prepaid tuition plans. Both types are authorized by Section 529 of the Internal Revenue Code but are implemented by the 50 states and the District of Columbia. They also allow the investments to grow free of federal and state income tax. Some states also allow you a deduction on your state income tax return for contributions up to a certain limit, and each state has its own 529 deduction rule.

What is the difference between the two plans?

Prepaid tuition plans allow you to prepay tuition and fees at participating colleges at today's prices to be used in the future by the beneficiary. They are typically limited to in-state colleges and universities and can't be used to prepay tuition for elementary and secondary schools. Prepaid plans are not guaranteed by the federal government. Some state governments do guarantee the money paid into the prepaid tuition plans that they sponsor, but some do not, according to the US Securities and Exchange Commission.[2]

Education savings plans usually don't have residency requirements and can be used to pay tuition, fees, and room and board and other directly related expenses. These plans also can be used to pay up to $10,000 per year per beneficiary at any public, private or religious elementary or secondary school.

Are all education savings plans the same?

No. Each state has its own rules and restrictions and they can change at any time. The National Association of State Treasurers created the College Savings Plan Network (collegesavings.org), which provides links to information about most 529 plans. You will want to compare the tax benefits, investment options, fees and expenses, reputation of the financial institutions managing the plans, and the website's user experience. You should look for a plan with a wide variety of investment options, ranging from conservative to growth-oriented. Most plans also offer some sort of age-based portfolio to take the guesswork out of picking investments appropriate to the beneficiary's age.

You mentioned fees and other expenses. What should we look out for?

Fees and expenses will vary on a state-by-state basis. Both prepaid tuition and education savings plans may charge an enrollment/application fee and ongoing administrative fees. Education savings plans may also charge asset management fees depending on the investment option you choose. The fees can affect the return on your investment, but some states may waive fees if you maintain a large enough balance. And a warning: If 529 withdrawals are not used to pay qualified education expenses, they are subject to federal and state taxes as well as a 10% federal tax penalty. The same goes if the student who receives the distribution is not listed as the beneficiary.

How does a 529 plan impact federal financial aid?

Your 529 savings will generally affect a student's ability to receive need-based financial aid, but that varies depending on who owns the account, according to Tina Myers, Director of Financial Planning, Key Private Bank. If it is owned by a dependent student or the student's parents, it is reported as a parental asset on the Free Application for Federal Student Aid (FAFSA) and can reduce eligibility for aid by as much as 5.64%. If it is owned by an independent student, it is reported as a student asset on the FAFSA and can reduce eligibility for aid by as much as 20%. In both cases, though, distributions are ignored as student income. If grandparents or anyone else own the account, it will not be counted as an asset on the FAFSA; but, when funds are withdrawn, they count as student income and can reduce eligibility for aid by as much as 50% of the distribution. However, beginning in the 2024-2025 academic year, students will not be required to report distributions from a grandparent-owned 529 or any other type of cash support.

Can we prevent our 529 savings from limiting financial aid eligibility?

Yes. A few suggestions:

- Some 529 plans don't allow changing owners. If yours does, change the account owner from the student to the parent to receive a lesser reduction of aid eligibility based on the distributions.
- A grandparent or other relative can roll over a year's worth of 529 plan funds to a parent-owned plan after filing the FAFSA so the distribution won't be reported as untaxed income to the student on the next year's FAFSA.
- Wait until after graduation to take a distribution if it is unclear how long it will take the student to graduate. Since 2019, beneficiaries and the beneficiaries' siblings can each repay up to $10,000 in qualified education debts and can also repay loans from parents.

What if my student decides not to pursue higher education or gets a full scholarship?

Under federal rules you are entitled to change the beneficiary of your account to any qualified family member at any time. Also, the 529 money can be used to pay for any registered apprentice program if your child decides learning a trade is a better option than college.

Through careful planning, you can maximize saving for higher education costs. To learn more about how a 529 College Savings Plan can be incorporated as part of your overall financial plan, please contact your advisor.

[1] Hanson, M. (2022, August 15). Average Cost of College & Tuition. EducationData.org. Retrieved August 29, 2022, from https://educationdata.org/average-cost-of-college.

[2] SEC's Office of Investor Education and Advocacy. (2018, May 29). An Introduction to 529 Plans. SEC.gov. Retrieved August 29, 2022, from https://www.sec.gov/reportspubs/investor-publications/investorpubsintro529htm.html.

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