



## The 529 Dilemma

By Mary Ann Lambert, Lambert Advisors

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Who would have thought it would be so complicated to save for something as basic as your children's education?

It isn't a simple undertaking, and one of the biggest dilemmas parents face is whether to use a 529 plan for that purpose. The "Great Unwind" jolted many 529 college plan savers. Especially hard-hit were age-based 529 portfolios and self-managed plans that were still invested in equities for students in or very near college in 2008 or 2009. Many are reconsidering whether 529s are right for them, and others are approaching the decision for the first time.

When considering using a 529 plan, start with the end in mind. What are the primary goals in saving for college? Traditionally, they have been:

Goal #1: have the saved principal be secure

Goal #2: achieve some growth of principal after inflation

The recent market decline coupled with, tax, custodial, management fees and estate planning issues make the decision to use a 529 plan less than straightforward. Let's briefly review the history of college savings plans and see how the current landscape favors 529s for some clients but not for others.

### Background

Years ago parents and grandparents salted away savings for college in an UTMA or UGMA. The accounts were probably in a bank savings account (remember the little passbooks the teller would stamp for us?), the taxes on earnings were negligible, if any (unless you were lucky and it was '74-'82), and the capital gains tax was not much of an issue because the funds were invested in CD's or r bank savings accounts.

Starting in 1999 the Federal Government created a series of vehicles to encourage more savings for post-high school education. The first was the Coverdell education saving account.<sup>1</sup> This provided a tax exemption for earnings and growth if the proceeds were used for specific educational purposes. It offered some estate tax sheltering and fuller parental/custodian control than a UGMA/UTMA. If the parent maintained control of a Coverdell, however, doing so nullified the potential financial aid

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<sup>1</sup> Surprisingly, Coverdell accounts are not universally available even at retail-oriented brokerage firms.



advantages of having the child be the owner. Also with a Coverdell both the adjusted gross income (AGI) and the annual gift limits are too low for many clients.

In 2001, Congress passed the [Economic Growth and Tax Relief Reconciliation Act of 2001](#) (EGTRRA), and with it the 529 plan came into prominence. The 529 improved on the Coverdell by removing AGI limits, meaningfully raising the annual gift amount, adding an estate tax sheltering election, and allowing transfers of funds among siblings. These enhancements afforded advantages over the potentially more costly approach of setting up individual trusts in order to retain parental control past the age of minority. Furthermore, trusts do not afford the potential tax exemption on income and growth of principal.

### **The allure of 529 plans**

Finally, in the 529 Plan, savers and advisors had a turnkey approach for investing in multiple asset classes and an excellent savings vehicle for our clients. The 529 Plan had the potential to meet the original two college savings goals and deliver on three more at the same time:

Goal #3: tax-exemption on income and capital gains <sup>2</sup>

Goal #4: custodial control past the age of minority<sup>3</sup>

Goal #5: more effective and flexible estate planning

In addition to enhancing the Coverdell account for college savers, the federal 529 legislation also afforded state and fund distribution companies with a lucrative new source of revenue. It was designed to be a win-win for all parties!

In the aftermath of the Great Unwind of 2008, the stock market is still 30% below the 2007 high. So let's push back and try to answer the question: "Have 529 plans delivered even the first two goals for the college savers or have they just delivered revenue for states and fund distributors?"

A recent tax letter from our CPA gives us a clue. One section titled "[Dropping out of a 529 plan](#)" has the following comment:

"Many 529 accounts are invested heavily in stock funds. Because stocks are much lower now than they were in 2007 and early 2008, your 529 might be showing a loss. If you have a loss on a 529 account, you may be able to get a tax break for 2009."

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<sup>2</sup> provided the funds are used for eligible education expenses;

<sup>3</sup> It is our understanding that in 2008 the age of minority was raised from 18 to 24 years



This was not anyone's goal!

We know what happened. The possibility of a massive and prolonged meltdown of the world stock markets was not on the risk management radar of most age-based plan sponsors or of individuals customizing their 529 plans and investing mainly for growth. Everyone lost track of the first two goals and went headlong into the pursuit of double digit growth. Shame on all of us!

There were (and still are) other contributors to the disappointing performance of most 529 plans. In a steadily rising stock market that produces average annual returns of double digits or more, state fees, fund expenses, 12B-1 trails and advisors fees are a relatively insignificant drag on long-term performance, but in a sagging economy those fees start to look more onerous.

In the current equity (and bond) market reality of mid- to high-single digit returns, however, those fees and expenses become a serious deterrent to the recovery of lost principal or to growth of new savings.

### **529 plans still work for some clients**

So what are we advisors to do? Do we recommend that clients use 529 plans or not? And for which clients are they appropriate?

Which clients should use them depends on the criteria below. If and when a 529 is appropriate, there are two decisions that are more critical now than ever: which type of 529 plan to use and how to allocate the funds.

For lower-income families, or families whose annual college savings contribution (including from other family and friends) is under \$2,000, we are guiding people to the Government II and EE plans.<sup>4</sup> For situations in which the AGI may be higher but the annual savings is not expected to be high enough to create a tax on income, we are emphasizing the UTMA/UGMA and index funds. If the annual contributions can later become larger,<sup>5</sup> UTMA/UGMAs can be rolled into a 529 plan before the child reaches the age of majority.

Clients whose annual per-child gifting could exceed the annual gift exclusion (of \$13,000 per spouse per child), or who could take advantage of the estate planning aspect of 529 plans, should consult their tax accountant or estate attorney. For clients

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<sup>4</sup> Series EE and II (TIPS) bonds achieve the #1 and #2 college savings goals. But their AGI and annual gift ceilings are too low for most of our clients. The client also needs to administer the account directly with the Treasury, and many savers may not be willing to bother.

<sup>5</sup> There is no income tax on the first \$850, and the next \$850 is taxed at the child's rate. Income above \$1,700 is taxed at the parent's rate. There is no exemption for capital gains in UGMA/UTMAs. Please consult your tax accountant, as these rates are subject to change.



who will be able to pay outright for college and not be subject to the gift exclusion, they might 'waste' the annual gift exclusion if it is put in a 529 plan that only has advantages when the funds are used for eligible education purposes.

Most of our clients are in the 28% tax bracket or higher. Soon they will be in higher tax brackets even if their income doesn't rise. Therefore, for many clients who do not have a sufficiently long time-horizon-to-college to employ equities and/or who do not have the risk tolerance to have their college savings in the equity market, a plain vanilla taxable account with municipal bonds or municipal bond ETFs makes good sense. This would certainly achieve the two primary goals. Buying one \$12,000 municipal bond each year may or may not be cost-effective, depending on the advisor's access to reasonably priced bonds. But today there is a sufficiently broad offering of municipal bond ETFs to enable an advisor to create an appropriate initial duration and then roll it down as the child approaches college.

If a 529 plan seems appropriate, review the tax advantages, if any, of 529 plans in your client's home state. Plans must be compared for internal fees, fund performance and asset allocation choices as well, since these can nullify tax advantages.

I have reevaluated the 529 plans my firm is recommending. Again, we start with the two primary goals in mind: to protect principal and to achieve after-inflation growth. We concluded that load funds are not an appropriate recommendation. In any absolute sense they are expensive.<sup>6</sup> In order to achieve the primary goals, we must drive internal expenses and our fees as low as possible.

To accomplish this, we are using no-load plans with index funds.<sup>7</sup> We have decided that advising our existing clients on 529 plans is an accommodation to them. Our oversight fees are significantly discounted for these assets. We have found that even clients who had pre-existing retail, no-load 529 plans outside of our firm are keen to have us help them now and a low fee facilitates the transition. This helps us and our clients keep track of all of their assets more efficiently. It also affords them advice that they would not normally have on their own, but which they are keen to have today.

The final critical piece in achieving our goals within a 529 plan is asset allocation. Admittedly it has been hard to get clients to dial down their equity allocation. It is also enticing for us as advisors to run a model (assuming constant linear growth, unfortunately) and be tempted to recommend an allocation that hypothetically grows the savings a lot. Everyone would like to save the least and have it grow the most! But because of the jolt of reality that the Great Unwind delivered, we are finding that clients are much more receptive to allocations that are consistent with the primary goals for college savings.

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<sup>6</sup> Barclay's iShares 529 plan website: <https://ishares529.s.upromise.com> has a sophisticated tool for comparing load funds to Barclays' no-load, Advisor plan.

<sup>7</sup> There are some no-load brokerage houses which offer direct access for retail clients to index funds.



As advisors, we were trained to use rules of thumb with clients who asked how to invest their funds. If a client came to us and said, “I have this pot of money to use to buy a house in the next three years, how should I invest it?” we used to tell them not to put it into the stock market because liquidity and principal protection were paramount.<sup>8</sup> Hmm... Guess we forgot our rules of thumb! Why else would an age-based plan for a child three years from college have any equity???

Some plan sponsors have quietly modified their age-based allocations to reduce their equity allocation. This is definitely a move in the right direction. But we have seen only a few plans that have as low an equity allocation as we would recommend across the ‘age-based’ spectrum. As a result, we have our own age-based models for clients and use 529 plans that allow us to customize appropriately.

Also we look closely at the diversification within the equity allocations of prospective 529 plans. Many plans still have only a token allocation to non-US developed equities and few have any allocation to emerging markets. This is true whether you are selecting an age-based approach or a building a customized portfolio.

When the time-to-college is greater than five years, consider a plan that incorporates TIPS.

As fiduciaries we have a responsibility to roll-up our selves and assist clients in addressing their college saving dilemma. Unless we review all of the college savings options in light of the current environment, we are not truly adding all of the value that we might.

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<sup>8</sup> After the Tech Wreck of 2001, a 5 year horizon, not a 3 year horizon really seemed more prudent. But how many clients would sit with a CD for 5 years!



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