529 Plans for More Than College Education

By Patrick H. Yanke, CFP®

A 529 Plan is a tax-deferred tool for transferring wealth between generations, primarily for funding a college education. The most common source of funds for a 529 Plan is the parents of the prospective student. There are considerable estate planning benefits that may entice grandparents as well.

Often in estate planning, there are goals to transfer wealth prior to death to build a legacy while living or reduce the taxable estate at death. Many people meet this challenge by making direct gifts to their heirs. The problem with making gifts, though, is that these assets are no longer available to the giver, should the need arise. It is possible to accomplish all of these goals at once; providing higher education for heirs, removing assets from the estate, and maintaining control of those same assets.

Limits

There are limits to the amount that may be contributed to 529 Plans. These limits vary by plan and by state. In general, plans will accept the annual gift tax exclusion amount annually ($14,000 per donor per recipient in 2017). Unique to the 529 Plan is the ability to front-load five years of this exclusion in a single year. This means that as much as $70,000 (in 2017) may be gifted per donor and per recipient up front. The IRS will consider each year's gift completed annually over the ensuing five-year period. Death of the contributor prior to the end of the five-year period may result in a portion of the contribution being included in the contributor's estate.

Flexibility

Anyone may open a 529 Plan for anyone else (not just family) and contribute fully. There is no limit on the number of beneficiaries that may be selected.

Control

The account owner retains control of the assets in the account and may determine the amount and timing of withdrawals. Those withdrawals may be for the benefit of the either the beneficiary or the account owner. Beneficiaries may be changed without penalty as long as the new beneficiary is in the same family.

Taxes

Assets within the plans grow tax-deferred until withdrawn. If withdrawals are made to fund post-secondary education, they will be tax-free. Withdrawals for any other reason will incur taxation similar to early withdrawals from an IRA funded with after-tax dollars; income tax on the amount removed that is considered gain in the account as well as a 10 percent penalty on that amount.

Before investing, it's important to consider whether the investor's or designated beneficiary's home state offers any state tax or other benefits only available in that state's qualified tuition program. Investors should consult a tax adviser about any state tax considerations of an investment in 529 plans before investing. Tax laws and provisions may change at any time. Unfortunately, North Carolina is no longer offering these benefits to its citizens.

Case Study

Consider a married couple with a sizeable estate. Their goal is to help their four grandkids with college funding, transfer wealth out of their estate, and protect their assets in case of future need. Each spouse has the ability to fund each account and may front-load five years of the gift tax exclusion amount. In this case, $280,000 may be immediately removed from the estate and available for the grandkids' education needs. Since the lump-sum was considered five years of gifts, each year they will be able to do another gift and keep rolling it forward.

Caution

If the grandparents want to shelter even more wealth in a tax-deferred vehicle, they may choose their own kids as beneficiaries and even look outside of their family. However, if they die with non-family member beneficiaries they might end up sharing their estate outside of the family. It will be important to maintain successor-owner designations on these accounts to retain recipient control.

As investment vehicles, these plans may lose money or not perform well enough to cover the costs of college, as anticipated. Rules and laws governing 529 plans are varied and subject to change.

It's also important to note that although the 529 Plan is a powerful estate planning tool, it is not very good for Medicaid planning. Since the owner maintains control of the assets, these assets may be considered available for funding long-term care needs. In this scenario, the owner would have to pay taxes and the 10 percent penalty on the growth in the plans while spending-down the assets.

A 529 Plan can do much more than fund a college education. It is a powerful tool for estate planning in transferring assets between generations while retaining control for the account owner. Please consult a qualified tax professional to discuss tax matters.

Patrick Yanke is a Raleigh financial planner with a simple business philosophy: Treat others as he wants to be treated. He has a national business with clients in every American time zone. He delivers newsletters, and speaking programs on a wide range of financial topics. Opinions expressed here are Patrick Yanke's and not necessarily those of Raymond James. You should discuss any tax and legal matters with the appropriate professional. www.yankefinancial.com.