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The Pros & Cons of 529 Plans

Learning Objectives: Upon completion of this segment, the user should: (1) be familiar with the benefits and drawbacks of IRC §529 plans; and (2) be aware of the tax treatment for distributions that are not used for qualified higher education expenses.

Executive Summary: Marnie Aznar founded Aznar Financial Advisors, a fee-only financial planning firm and a registered investment advisor in the state of New Jersey, out of her desire to assist individuals who she felt could benefit most from her services—middle-income professionals in the accumulation stage of their financial lives who are in need of sound and objective financial advice.

She earned her MBA from Fairleigh Dickinson University in Madison, New Jersey in May of 2000 and received authorization to use the CFP® marks of distinction in January of 2001. Marnie is an adjunct professor at Fairleigh Dickinson University where she teaches finance courses at the undergraduate and graduate levels. She also teaches a course on the basics of personal finance to a group of high school students in the "Discover Business Teen Camp" program offered annually at Fairleigh Dickinson University. More information can be found on her Web site at www.aznaradvisors.com.

In our program this month, we join program host Gregory J. Lane, CPA, CFP, regular expert commentator Dr. William L. Raby, CPA, CFP, and Marnie Aznar, CFP, of Aznar Financial Advisors in Morris Plains, New Jersey, for an in-depth discussion of IRC §529 plans. These plans are known as college savings plans. Our panel's last examination of the topic focused on abuses in the 529 industry. Today, we focus instead on how college planning can be successfully integrated into a financial planning practice.

In our first segment today, our panel looks at our guest's unique market niche of young professionals and how her college planning skills fit into such a practice. Then, our panel reviews the advantages and disadvantages of 529 plans. First, let's ask our guest, Marnie Aznar, CFP about her financial planning practice.

Ms. Aznar

I am a fee only financial advisor located in New Jersey. I work primarily with young professionals, ranging in age from their mid-30s to their late 40s, who are attempting to balance a variety of different financial planning needs, including educating young children, retirement planning, and caring for elderly parents. I have been in business for 5 years. I have about 65 clients, and I work either on a full retainer or on an hourly-basis with my clients.

Dr. Raby

Do you have an office in your home?

Ms. Aznar

Yes, I have a home-based office.

IN THIS ISSUE

The Pros & Cons of 529 Plans
Interview with Marnie Aznar, CFP
Page 1 ♦ Time 32:45

**Prepaid Plans, Coverall
Accounts & Financial
Aid Implications**
Interview with Marnie Aznar, CFP
Page 8 ♦ Time 12:09

**Tax Credits & Deductions to
Consider When Paying for
College Expenses**
Interview with Marnie Aznar, CFP
Page 10 ♦ Time 9:20

*Featuring Expert Commentary
by Gregory J. Lane, CPA, CFP, and
William L. Raby, PhD, CPA, CFP*

Also in this issue

Study Questions
Page 13

Study Answers
Page 15

CPE Quizzer
Page 17

Mr. Lane

I have to thank you for the very nice compliment. You said that you work with young professionals and your age bracket went all the way up to the late 40s. Since I am 48, I guess I would still be considered "young."

Ms. Aznar

Absolutely. You are very young.

Mr. Lane

Thank you for that comment. You have been in practice for 5 years. Is there a particular niche of financial planning you do? Is it mostly investment advice or is it comprehensive?

Ms. Aznar

I do comprehensive planning. Investment advice is a small piece of my practice. Oftentimes, prospective clients come in primarily concerned with their investments. Once we start discussing their financial planning needs, they realize that investments should be one of their last concerns. We begin to talk about insurance needs—life insurance, disability, and long-term care. We talk about their property and casualty insurance, cash flow, retirement planning, and education funding. Oftentimes, estate planning is a big issue with young families. It is incredibly comprehensive. Investment advice is just a piece of the planning that I do.

Mr. Lane

You said you are a fee-only advisor, so you accept no commissions.

Ms. Aznar

That is correct.

Mr. Lane

What made you decide to work without commissions?

Ms. Aznar

When I initially decided to go into business for myself, it was something that I felt more comfortable doing. I looked at it from the prospective client's point of view, and I think they are more comfortable knowing there is no conflicting advice; the advice they are getting is completely objective. I am more comfortable providing advice that way.

Dr. Raby

I noticed from your background that you worked with Ayco and PriceWaterhouseCoopers doing financial planning. Are both of those fee-only type operations?

Ms. Aznar

Actually, since I have left Ayco, it has been taken over by Goldman-Sachs. It is very different now than it was when I worked there.

Dr. Raby

I was remembering what I had read about you, and it seemed that you did not have much experience with an alternative type of operation.

Ms. Aznar

Actually, Ayco is not fee only. They are fee based, so they have a combination of fees and commissions.

Dr. Raby

Was that their fee structure when you worked there?

Ms. Aznar

Yes.

Mr. Lane

Is Ayco a financial planning firm also?

Ms. Aznar

Yes.

Mr. Lane

You do a fair amount of work with IRC §529 plans. Is this an area that comes up often with your clients?

Ms. Aznar

Yes.

Mr. Lane

Why is that?

Ms. Aznar

Many of my clients have young children, so education planning is obviously an issue. When I have a discussion about education planning with my clients, I mention many vehicles that are available to them. Oftentimes, we discover that the IRC §529 plan is the most appropriate choice. One reason is that many of my clients are high-income earners and they are phased out of some plans, such as a Coverdell education savings account (CESA).

Mr. Lane

The IRC §529 plan allows fairly large contributions.

Ms. Aznar

That is correct.

Mr. Lane

Let's talk about IRC §529 plans. What is an IRC §529 plan?

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Ms. Aznar

An IRC §529 plan is an investment plan that's operated by a state and designed to help families save for future college costs. If it satisfies basic requirements, IRC §529 provides beneficial tax treatment.

Mr. Lane

You said it's a state plan, but most people think a mutual fund company puts these plans together.

Ms. Aznar

The plans are actually sponsored by the states, but many of the investments are managed by a mutual fund company.

Mr. Lane

The state contracts with a mutual fund company to handle the plan.

Ms. Aznar

That's correct.

Dr. Raby

Does the state get any concessions out of the mutual fund company, or are we dealing with "mutual fund clones?"

Ms. Aznar

No, for the most part, states do receive some compensation from the mutual fund company.

Dr. Raby

Do they have lower minimum requirements for making investments than a mutual fund?

Ms. Aznar

Yes. If an individual were to go directly to the mutual fund company, they may need to invest a minimum of \$3,000 to invest in one of the mutual funds run by that fund family.

Mr. Lane

Are IRC §529 plans typically part of the comprehensive package you offer clients? Do you ever see stand-alone IRC §529 engagements, where clients come in to specifically discuss IRC §529 plans?

Ms. Aznar

I have had a few stand-alone engagements to address only IRC §529 plans, but most often, when I'm addressing education funding and IRC §529 plans, it's part of a comprehensive engagement.

Mr. Lane

Okay, then let's talk about the advantages of IRC §529 plans. Do you want to run through some of those?

Ms. Aznar

Sure, absolutely. One of the major advantages of IRC §529 plans is the federal tax-free status afforded to distributions for

qualified higher education expenses. When an individual puts money into an IRC §529 plan, it is similar to an IRA. Although they don't get an up-front tax deduction, unless there's a state tax deduction, which I'll talk about later, they do not have to pay tax on the earnings. They also do not have to pay tax on the distributions, assuming the distributions are used for qualified higher-education expenses.

Dr. Raby

How does the distribution work? Let's say I have an IRC §529 plan. As with some of the trust devices that we use, does the tuition have to be paid by the plan, or can the parent pay the tuition and get reimbursed from the plan? How does that work?

Ms. Aznar

It actually depends on the state plan. Every state operates slightly differently. Some plans allow the parent to pay the tuition directly and then receive a reimbursement. Other plans will make the payments directly.

Mr. Lane

It's not just tuition that can be paid out of the IRC §529 plans, right?

Ms. Aznar

That's exactly right. When you're talking about the IRC §529 savings plans, the qualified higher-education expenses include: tuition, fees, books, supplies, and equipment that are required for enrollment or attendance of a student at an eligible institution.

Mr. Lane

Would that include room and board?

Ms. Aznar

That does include room and board if the student is at least a part-time attendee.

Mr. Lane

From personal experience, being that I have an 18- and 20-year-old child in college, tuition oftentimes is a minor portion of the costs. We want to be clear that the IRC §529 plans also cover the real expenses of college, which is having a roof over your kids' head and feeding them three times a day.

Dr. Raby

What about transportation and recreation?

Mr. Lane

It could include transportation. The IRS has not been aggressive in auditing the expenses out of an IRC §529 plan.

Ms. Aznar

I think you're correct. I'm not sure that will continue to be the case. Since these plans are still relatively new, everything's

changing. It's difficult to know what will happen in the future.

Dr. Raby

How do we handle things like scholarships in the context of this? Somebody pays their tuition and then they are granted a scholarship. Do they get a "rebate" on the tuition?

Ms. Aznar

If a distribution is taken from an IRC §529 plan for something other than qualified higher-education expenses, the earnings are subject to income taxes and a 10-percent penalty. The 10-percent penalty would be waived in the event of a tax-free scholarship. Although they would still be subject to tax on the earnings from the distribution, they would avoid that 10-percent penalty in the event of a scholarship.

Mr. Lane

That's good to know. What are some other advantages of IRC §529 plans? You mentioned that some states offer an up-front state tax deduction.

Ms. Aznar

That's exactly right. There are about 20 states that offer a partial up-front state tax deduction and about 5 states that offer a full tax deduction. For individuals who live in states that offer an up-front state tax deduction, I suggest they look at their state first. It's not a definitive reason to use the plan, but it's certainly a reason to look at that plan first. There actually have been some investigations by the NASD surrounding this issue. Many residents of states that could receive an in-state tax deduction are being sold out-of-state plans.

Mr. Lane

The key is to look at your client's state IRC §529 plan first because s/he may get a state tax deduction from it.

Ms. Aznar

Yes.

Mr. Lane

Does New Jersey offer a state tax deduction?

Ms. Aznar

No, New Jersey is not one of the states that offers an up-front state tax deduction.

Dr. Raby

How about New York?

Ms. Aznar

New York actually offers a deduction of up to \$5,000 for a single filer and up to \$10,000 for a joint filer.

Mr. Lane

That's a good benefit because New York has high tax rates.

Ms. Aznar

Yes, that's true. Typically, when I have a client who is a resident of New York, I look at that plan first for that reason.

Dr. Raby

Participating in one of these plans is similar to buying a mutual fund, isn't it? They're making an investment in the plan. Is it similar to a mutual fund in that they can roll it over into another plan if the plan they went into doesn't seem to do work?

Ms. Aznar

Yes, they can. This was a provision of the 2001 Tax Act. Prior to that act, they couldn't, but at this point in time, an individual participant is allowed to roll over funds to another plan once every 12 months.

Dr. Raby

If I was a New York resident and I invested in a plan that was not a New York plan, would I still be able to get a front-end deduction for that?

Ms. Aznar

No, unfortunately you can only get that up-front state tax deduction if you are a resident of the state that provides the up-front state tax deduction and you invest in that plan.

Dr. Raby

If I'm still a New York resident and I roll my Michigan plan into the New York plan, will New York then give me a deduction?

Ms. Aznar

That's a great question. I know that some states will offer the deduction and some states won't. Unfortunately, I'm not certain about New York.

Mr. Lane

Should we tell our clients to check out the website for the state of New York's IRC §529 plan? That's where they would get that type of technical detail.

Dr. Raby

They have a high level of flexibility. The point I'm trying to make is, if they make a mistake at the start, they're not married to that mistake for the next 30 or 40 years.

Ms. Aznar

That's exactly right. Not only can they roll the funds over to another plan once every 12 months, but they can also change the investment strategy once every calendar year. If they want to keep their investment in the same plan, but want to change the investment strategy that they initially chose, they're also able to do that.

Dr. Raby

I'm under the impression that there are some plans that have a "life stage" approach; if they have small children, they will

have a different investment mix for them compared to children that are going to college or close to going to college.

Ms. Aznar

That's one of the nice benefits of IRC §529 plans, especially for individuals who don't work with financial advisors on an on-going basis. Many of the IRC §529 plans offer what's called an age-based allocation, which starts out quite aggressive when the child is young and then, as the child nears college age, becomes more and more conservative.

Mr. Lane

Those are almost a no-brainer for many clients, because they tell the mutual fund company the age of their child and the investment is picked for them.

Ms. Aznar

Some of the states offer a variety of age-based allocations ranging from very aggressive to very conservative, so an individual can choose their level of aggressiveness.

Mr. Lane

Let's continue with the advantages of IRC §529 plans. What other advantages should we be aware of?

Ms. Aznar

Another great advantage is that the owner retains control over the ultimate use of the funds as opposed to something like a Uniform Gifts to Minors Act (UGMA), or Uniform Transfers to Minors Act (UTMA) account where the minor becomes the owner at the age of majority. With an IRC §529 plan, the owner can ultimately decide how those funds are used. For example, if they decide to change the beneficiary or to pull the funds back, they're allowed to do that.

Mr. Lane

You mentioned the UTMA and the UGMA. Many clients already have these accounts set-up; they set-up the accounts many years ago. Some clients come in and say, "I'll just take my UTMA and transfer it into an IRC §529 plan. I will have more control over it, and I don't have to give my child the assets when they turn 18." It's not that simple, is it?

Ms. Aznar

No, unfortunately, it's not that simple. Not all IRC §529 plans accept funds from a UTMA or UGMA. You would first want to check with the specific IRC §529 plan to make sure they will accept a rollover. Secondly, the client isn't going to get the control they're looking for because it was a UTMA, and technically, an asset of the child's. It remains an asset of the child and the parent is not able—assuming the owner is the parent—the parent is not able get control of it. Although they still get the tax and investment benefits of an IRC §529 plan, they will not get control. The plan would also be considered an asset of the child for financial aid purposes, so the plan is assessed at a higher rate than it would be if it were considered an asset of the parents.

Mr. Lane

Is it true that IRC §529 plans only accept cash as a contribution?

Ms. Aznar

Yes.

Mr. Lane

When they roll the UTMA or UGMA into an IRC §529 plan, they would first have to sell the underlying investments in the UTMA or UGMA and they may have capital gains to pay.

Ms. Aznar

That's right. They definitely want to assess the tax consequences of the sale before selling it.

Dr. Raby

If they do roll it over, they would have capital gain. Since the income within the plan is supposed to be tax-exempt, is that capital gain tax-exempt? Is that the implication?

Ms. Aznar

No, it would have to be sold while it was still in the UTMA or UGMA umbrella, so the tax consequences would be based on the amount of income for that child that year.

Mr. Lane

Once the cash rolls over into the IRC §529 plan, the IRC §529 plan is tax-free and grows tax-deferred like we discussed earlier.

Ms. Aznar

The caveat around that is the tax law that gives the IRC §529 plans their tax-free status is scheduled to sunset as of December 31, 2010.

Dr. Raby

Many other tax provisions are set to expire.

Mr. Lane

Time sure flies. We're already into the spring of 2005, and I remember we started talking about the sunset provisions years ago. I hope that we will have you back on the program to explain how to adjust our planning if we need to.

Dr. Raby

Can I ask a question about the application? When we talk about retaining control of the use of funds, the picture that comes into my mind is the 30 year-old professional earning a fairly good income. S/he has two small children and is funding the IRC §529 plans. Years later, after the children complete college, there is money left in the IRC §529 plans. S/he is now 60 years old. Can the money in those plans be kept in the IRC §529 plan until they're ready to withdraw the funds as retirement income later on?

Mr. Lane

Are you asking if the assets in an IRC §529 plan can stay there forever?

Dr. Raby

That's what I'm asking. There must be a beneficiary, but that could be our grandchild or something like that. Could we use the assets in the IRC §529 plan for our own retirement?

Mr. Lane

They would be subject to the 10-percent penalty because they are not using the funds for qualified education expenses.

Ms. Aznar

That's correct.

Mr. Lane

They can use these for their own education expenses, isn't that true?

Ms. Aznar

That is true.

Mr. Lane

If they went back to school to take some courses later on, they would avoid that penalty in income tax.

Dr. Raby

That sounds pretty good, too.

Ms. Aznar

The account can be transferred to any family member of that original beneficiary. For example, if there are significant dollars left over and an individual wants to avoid the tax and penalties associated with a withdrawal that's not specifically for qualified higher-education expenses, they may consider transferring the account to a family member of that original beneficiary. It could be themselves, their child's children, a cousin of that child, etc. If they used the funds for their own retirement, they would be subject to taxes on the earnings, as well as a 10-percent penalty.

Dr. Raby

Would they be subject to tax on the principal?

Ms. Aznar

No.

Mr. Lane

They would not be subject to tax on the principal because they did not receive an income tax deduction upon the contribution.

Ms. Aznar

That's exactly right.

Mr. Lane

Are there any other advantages that we need to be aware of?

Ms. Aznar

Yes, one of the wonderful advantages of an IRC §529 is the unique estate planning opportunities. The IRC §529 plan

allows an individual to make a contribution up to \$55,000 in one tax year for the benefit of one beneficiary. In essence, they're allowing them to use 5 years worth of their annual gift tax exclusion in one year. They can get that money out of their estate and into an account growing for the benefit of their grandchildren's education.

Mr. Lane

That sounds like a great benefit. They can jumpstart these plans by contributing \$11,000 times five, or \$55,000, into a plan.

Ms. Aznar

That's exactly right. Oftentimes, that's something that we do talk about because I'm working with younger professionals. If they have grandparents who are very wealthy and who are looking to reduce the size of their estates, this is a wonderful opportunity. Actually, a married couple can gift-split and put up to \$110,000 into a plan in one year. They just need to be aware that they shouldn't make any additional gifts over the course of the next 4 years ...

Dr. Raby

... to those same children.

Ms. Aznar

That's right, to those same beneficiaries.

Mr. Lane

It does sound like there are quite a few advantages to the IRC §529 plans. Judging from the sales of the IRC §529 plans, people seem to be aware of most of the advantages. Are there some downsides to IRC §529 plans?

Ms. Aznar

Yes, and I think it's really important for people to be aware of the downsides also. One of the downsides is that as a participant in the plan, they don't have any direct investment control. When the client is initially making the choice of which plan to invest in, they can choose from over 70 plans in terms of the mutual fund company. They can choose an age-based allocation, a fixed type of investment, or 100 percent equities, but they can't, specifically on an on-going basis, buy and sell investments within that plan. They are subject to the investment options that are offered by the plan.

Mr. Lane

It's almost like a company IRC §401(k) plan where your choices are limited, but there are plenty of investment to choose.

Ms. Aznar

Right, that's a great comparison.

Mr. Lane

What are the other disadvantages for IRC §529 plans?

Ms. Aznar

Many plans have high administrative costs. I think it's really important for investors to be aware of this because that can make a very significant difference in the ending balance of the account. You want to make sure that they understand whether there are sales charges involved. If you're buying an advisor-sold plan, how high are the annual operating expenses? There are plans that are incredibly inexpensive, and there are plans that are incredibly expensive. The expenses that they pay have a significant impact on the total dollars that accumulate by the time your child is going to college.

Mr. Lane

You mentioned the up-front costs of buying into a plan. Some plans assess a commission for purchasing the plan. You said you're a fee-only advisor. How do you deal with IRC §529 plans? From what I've read, most IRC §529 plans are actually sold by commissioned brokers. How do you direct your clients in this regard?

Ms. Aznar

My guess would be that more people are buying advisor-sold plans because they're being sold by advisors, but I simply direct them to direct-sold plans.

Mr. Lane

Are there some direct-sold plans available to clients, so they don't have to pay a commission?

Ms. Aznar

Yes, there are many direct-sold plans that don't involve any commission.

Mr. Lane

The companies that traditionally are no-load mutual fund companies generally also work in the IRC §529 area. Your clients can get into an IRC §529 plan by using the no-load mutual fund companies.

Ms. Aznar

That's correct.

Mr. Lane

Those are the companies that you typically deal with for your clients?

Ms. Aznar

Yes, I typically work with no-load mutual funds for my clients.

Mr. Lane

What other disadvantages are there?

Ms. Aznar

Something else to be aware of is that distributions taken from IRC §529 plans should be specifically used for post-high

school education. If they have children who will possibly go to a private elementary or high school, an IRC §529 plan is not the appropriate vehicle. They might want to consider a Coverdell education savings account. Distributions from a Coverdell are permitted for qualified elementary or high school expenses.

Dr. Raby

Not all kids are college material or want to go to college. When you say post-high school or post-secondary school, are we talking about things like truck driver school or medical transcription school? Are we just talking about the university college system?

Ms. Aznar

The list of eligible educational institutions does include vocational schools and other post-secondary educational institutions. Basically, they're eligible to participate in the student aid programs. There are lists online that you can access to see if the vocational school or other post-secondary school is considered an eligible educational institution.

Mr. Lane

Would you tell us about the biggest disadvantage to IRC §529 plans?

Ms. Aznar

I think it's what we've addressed already, which is the issue that a distribution from an IRC §529 plan that is not used for qualified higher-education expenses is subject to ordinary income taxes and the 10-percent penalty. You want to make sure that they're funding the account for the appropriate reasons.

Mr. Lane

I have seen studies that demonstrate individuals still come out ahead even when they pay the 10-percent penalty if they keep the money in the account for a long time. The tax deferral aspect allows them to come out ahead, even paying the penalty.

Ms. Aznar

That's something to consider, but that wasn't the original intent of these plans. I would be careful about trying to use them as retirement vehicles.

Dr. Raby

As long as we have the 15-percent dividend tax and the 15-percent capital gains tax, people who are investing in plans that are throwing off dividend income and capital gains are not going to have the same amount of "bang for their buck." When it comes out of the plan, it's coming out as full ordinary income.

Mr. Lane

With the low tax rates outside of the IRC §529 plans, some people are wondering whether it's worth tying up their

money and being subject to these restrictions. Clients ask if they should just leave it in the old mutual fund family and then they can do whatever they want with it. Are you seeing that discussion come up sometimes?

Ms. Aznar

Sure, and I think it's important to have that discussion and talk about the fact that this will be converted to ordinary

income in the event that it's used for something other than qualified higher-education expenses. Oftentimes, what I end up doing with my clients is having them put, perhaps, 50-percent of what they project they'll need for college into an IRC §529 plan, and then save the remainder in a taxable account to make sure they are investing in a highly tax-efficient portfolio. ■

Prepaid Plans, Coverall Accounts & Financial Aid Implications

Learning Objectives: *Upon completion of this segment, the user should: (1) be familiar with independent IRC §529 plans and Coverdell education savings accounts; and (2) understand the financial aid implications for the education savings accounts.*

Executive Summary: *In our next segment, our panel looks at another method of college savings called the prepaid tuition plan offered by many states. Then, we discuss the implications of financial aid on college savings accounts and the uses of the Coverdell Education Savings Accounts. Let's ask Marnie if she sees much activity with prepaid college tuition plans.*

Ms. Aznar

I personally do not because I live in a state that does not offer a prepaid tuition plan; however, I think that advisors who live in states that do offer these plans should be familiar with them.

Mr. Lane

How many states offer prepaid tuition plans?

Ms. Aznar

There are about 20 plans in existence right now.

Mr. Lane

Do these plans allow clients to make a deposit that will guarantee the tuition later on? Is that how they work?

Ms. Aznar

That is exactly how they work. It guarantees that the purchase will increase in value at the same rate of college tuition. It is based on the public in-state universities.

Mr. Lane

What happens if your client's children go to private universities?

Ms. Aznar

If that's the case, your clients probably want to steer away from the prepaid plan. The other thing that's important to note about the prepaid plan is that it's only for undergraduate tuition and fees. As you mentioned earlier, that's such a small

portion of the actual money involved. It doesn't cover books. It doesn't cover supplies, room and board, etc.

Mr. Lane

Tuition, in many cases, is waived from students' fees. Depending on the type of scholarship arrangement, there may not even be a tuition cost. Of course, the non-tuition costs sometimes are the most expensive. Isn't there a private prepaid tuition plan, as well, for the private universities?

Ms. Aznar

What you're referring to are the independent IRC §529 plans. Those were launched in the end of 2003. There are about 240 private colleges involved. It's the same concept; it's a prepaid tuition plan. The tuition that your clients purchase today is guaranteed to satisfy the cost at the time their child enrolls. If they think their child may attend one of those 240 schools, it may be something that they want to consider. One of the biggest caveats with the prepaid plan is the distributions from a prepaid IRC §529 plan are considered a resource for financial aid purposes, and it reduces the eligibility for need-based financial aid dollar for dollar. For clients who expect to receive some level of financial aid, I think this is something they probably want to avoid.

Mr. Lane

That is in contrast to the IRC §529 plan?

Ms. Aznar

That's correct. Depending on the methodology that you're looking at, whether it's federal financial aid or institutional financial aid, they oftentimes are treated as an asset of the owner. For example, if a parent sets up an IRC §529 savings plan for her/his child, the account would be assessed at 5.6 percent. Some people are planning around this by putting the account in a grandparent's name or an aunt's name because now, for federal financial aid purposes, the account would be completely ignored as an asset.

Mr. Lane

For financial aid purposes, the IRC §529 savings plan is much more favorable than the prepaid tuition plans. Are there other advantages to the prepaid tuition plans?

Ms. Aznar

I think the main advantage is the piece of mind for knowing they've locked-in tomorrow's tuition at today's prices. They just want to know that it's covered. They don't necessarily know that with an IRC §529 savings plan.

Dr. Raby

Is it possible to combine the plans?

Ms. Aznar

Yes, I think that's a great idea. That's what people should be doing who invest in a prepaid plan. Because a prepaid plan is covering only the tuition and fees, they should invest separately in an IRC §529 savings plan for all the other expenses associated with the education.

Mr. Lane

Let's take an in-depth look at the financial aid implications of an IRC §529 plan. For those clients who have sons or daughters in college, the early part of the year is the time when people fill out the free federal financial aid forms online. There are financial aid implications as to how you save for college expenses. Even if your client has a 2-year-old or a 4-year-old, decisions you make today can influence what happens 10 or 15 years from now. What are some of the financial aid implications of IRC §529 plans?

Ms. Aznar

When you're looking at the federal financial aid formula, the IRC §529 savings plan is assumed to be an asset of the owner. If the parent establishes a plan for the benefit of the child as a beneficiary, the federal financial aid formula would assume that 5.6 percent of that account would be used to pay for college.

Mr. Lane

It's no different than if a client had a large CD in the bank in the parent's name. It's treated as the same type of an asset. It's an asset of the parent.

Ms. Aznar

That's exactly right.

Mr. Lane

Federal financial aid rules say if you have a bunch of assets sitting in the bank, you must use some of those before federal aid kicks in.

Ms. Aznar

Right.

Dr. Raby

That is a reason why having the IRC §529 plan owned by the grandparents would be desirable, because that would take it out of this particular problem. Is that right?

Ms. Aznar

That's correct, but I think that people need to be aware that the institutional method of calculating financial aid, which is used by about 325 private schools, will oftentimes ask specific questions to find out if there is an IRC §529 plan in existence that's owned by someone else. Although it may be a good move from a federal financial aid perspective, it may not necessarily work from an institutional aid perspective.

Dr. Raby

If the grandparents establish a plan, can other family members contribute to that plan? Am I limited to putting money into only the plan that I establish? Can I, as the parent of the child, actually contribute? After all, they're not deductible anyway.

Ms. Aznar

Yes, you can. Anyone can contribute to an IRC §529 plan for the benefit of another beneficiary. Some states do [examine] the deposits. There may be an issue with certain states, but anyone can contribute to an IRC §529 plan for the benefit of that beneficiary.

Mr. Lane

The trick would be to let the grandparents know that the IRC §529 is already opened. That might be an appropriate place to make a birthday gift, bar mitzvah gift, or something like that.

Ms. Aznar

Absolutely.

Mr. Lane

Are there any other financial aid implications for the IRC §529 plans?

Ms. Aznar

There are some strategies that we need to be aware of as advisors. One, which I think I mentioned earlier, is to avoid putting money in the child's name. If there's a possibility that your client's going to be eligible for financial aid, the assets in a child's name are assessed much more heavily at 35 percent for the federal financial aid formula. Your clients want to avoid doing that to the extent possible.

Mr. Lane

Don't put the money in the child's name, because not only more of it has to be used for education costs according to the federal government, but also your kid can spend it as they wish at some point, maybe at age 18 or 21.

Ms. Aznar

That's exactly right. They can do whatever they want with that money.

Mr. Lane

I have a daughter who's going to turn 21 soon. I hope she doesn't listen to this tape. I have to deplete that account as quickly as possible. Is that the advice you're giving me?

Ms. Aznar

Right. Another thing to do is spend down the student's assets and income first. Oftentimes, I think people go into this process thinking that there's no way they'll be eligible for financial aid. I think that, in and of itself, is a mistake. There are many variables that play into whether an individual is eligible for financial aid, and to submit the application for federal student aid is an important first step for everyone. If you have multiple children in college at the same time, then the possibility of getting financial aid is even greater.

Mr. Lane

That's true. The Coverdell education savings account is often overlooked. Why is that?

Ms. Aznar

One of the reasons is the maximum annual contribution limit is \$2,000. Unfortunately, when we're talking about the dollars necessary to send a child to public or private university, \$2,000 a year doesn't seem very significant. One of the really nice things about the Coverdell is it can be used for qualified higher education expenses, elementary, or secondary education expenses.

Mr. Lane

This can be used for those parents who have very young children and want to put away the \$2,000 a year in anticipation of the child going to a private, religious high school. How do you integrate the Coverdell education savings account with an IRC §529 plan? What do you say to clients?

Ms. Aznar

We talk about both. Clients may choose to set up a Coverdell to accept the first \$2,000 of contributions and then an IRC §529 savings plan for the rest of their savings for the year. Oftentimes, I find that people really want to keep things as simple as possible. Even though it may make sense to put the \$2,000 into the Coverdell, they don't want another account, so they set up one IRC §529 savings plan to cover everything. The Coverdell was treated as an asset of the beneficiary, which meant it was assessed more heavily from a financial aid perspective. In January of 2004, there was a letter written by the Department of Education changing that treatment as an asset of the owner; the Coverdell and an IRC §529 savings plan are now treated equally from a financial aid perspective.

Mr. Lane

Is it still a good idea to bring up both accounts to clients and let them decide?

Ms. Aznar

Yes, absolutely. ■

Tax Credits & Deductions to Consider When Paying for College Expenses

Learning Objectives: *Upon completion of this segment, the user should: (1) be familiar with the Hope credit and the Lifetime Learning credit; and (2) understand how the education credits can be incorporated into an education savings account.*

Executive Summary: *In our last segment, we look at the federal income tax deductions and credits available to help families plan for college expenses. We also discuss how to advise clients on choosing the best college savings plan to meet their goals. Finally, Marnie discusses the balancing act her young professional clients experience when dealing with the conflicting financial objectives of today's society. First, let's take a look at some federal income tax credits.*

Ms. Aznar

The Hope credit allows an individual to take a credit up to \$1,500 for tuition and related expenses for the first 2 years of post-secondary education. As long as the student carries a minimum part-time course load and has expenses of at least \$2,000, the Hope credit is a credit for 100 percent of the first

\$1,000 of expenses and 50 percent of the next \$1,000 of expenses.

Mr. Lane

Are there other credits also?

Ms. Aznar

Yes, there's also a credit called the Lifetime Learning credit. Undergraduate, graduate, and professional degree courses qualify for this credit. It allows an individual to take a credit for a maximum of 20 percent of the first \$10,000 of expenses, so the maximum credit is \$2,000. In terms of how these credits relate to IRC §529 plans, your clients need to know if they're eligible for the credits. The credits are phased out as income levels increase. If they're eligible for the credits and they're taking a distribution from an IRC §529 plan, they may consider reducing the amount of the distribution to keep enough dollars available to take full benefit of those credits. For example, if you have \$25,000 of expenses and you want to take the Hope credit, the Hope credit in essence uses up \$2,000 of expenses, so you may decide to just take \$23,000

out of the IRC §529 plan and keep \$2,000 available to take that Hope credit.

Mr. Lane

It sounds like you need to do some advanced planning when it comes to higher-education costs and the tax effects.

Ms. Aznar

Absolutely.

Mr. Lane

The software that's available can be pretty comprehensive, especially for the tax preparation software. It has tools that can help clients figure out the various credits and deductions. There are also deductions for some of the higher-education costs, isn't that true?

Ms. Aznar

Yes, there's a deduction for student loan interest paid; that's up to \$2,500 of interest paid annually. All of these deductions and credits have phase-outs, so you want to look at the phase-out limits to see if your client is eligible. There's also a higher education expense deduction; depending on the level of modified adjusted gross income, it can be as high as \$4,000.

Mr. Lane

The tax implications of college expenses are complex. That's why we often cover it in this program. How do clients decide which plan to invest in?

Ms. Aznar

There's a couple of different things to look at. The things that I focus on are plans with low expenses to maximize my client's rate of return, plans that are very well diversified, and plans that are managed by fund companies with high fiduciary ratings. You want to make sure you're choosing a plan that's inexpensive, well diversified and looking out for the client's best interests.

Mr. Lane

Are there certain publications that rate their plans? I know there's Morningstar and Joe Hurley's website, SavingforCollege.com.

Ms. Aznar

Joe Hurley's website is a great resource. He has Cap ratings for all the various plans and does a nice summary of the different plans. It allows you to compare the two—if there are two plans you are considering, you can look side-by-side at the two plans. Morningstar's fund investor issued a list of best and worst plans in February of 2004. Some of the best plans were based primarily on low fees and good performance; they were Utah, Nevada, Virginia, Michigan and Alaska. They also rated the worst plans. In April of 2004, Kiplinger's had a list of the best plans which were an overlap of the plans mentioned by the Morningstar list including: Alaska, Nebraska, Utah and Virginia, and some others.

Mr. Lane

That list can change all the time, so we advise listeners to check it out whenever they're ready. As you mentioned in the beginning of the program, you always advise clients to look at their own state's plan first? That's because some states provide an income tax deduction on the state income tax return, but clients do not get an income tax deduction on their federal return. Is that correct?

Ms. Aznar

That is correct.

Mr. Lane

Let's back up a little bit. Your practice deals with a lot of young professionals and many of them have young children. They want to save for college, but they also want to save for their own retirement. Don't they? They may have elderly parents, not the type of parents who are going to be depositing large sums of money into an IRC §529 plan for their grandchildren, but in fact, these parents may need financial support themselves. How do these young professionals save for college, save for retirement, and help their elderly parents? Is that almost impossible to do?

Ms. Aznar

It's definitely a difficult balancing act. One of the most important steps is to make sure they understand that clients can get financial aid for education. They can get loans, grants, scholarships, and work study; but they're not going to get any of those things for retirement. It's incredibly important to make sure clients are putting their retirement savings first by setting aside sufficient funds annually to meet their target retirement date. If you're fortunate enough to have money left after that, then they should set the money aside for education. If clients cannot do that, we discuss whether they are willing to make changes in their spending habits so they have sufficient money available to save for retirement as well as their children's education?

Mr. Lane

That's a great point. You tell clients that there is a lot of financial aid available for college and for higher education expenses, but there's not a lot of financial aid for your retirement. With kids working through college, getting student loans, or federal financial aid, there seems to be a way to get a college education as long as there's a will.

Ms. Aznar

Yes, that's exactly right.

Mr. Lane

Do you see many young professionals faced with these goals of helping their parents, saving for their own retirement, and saving for their children's education?

Ms. Aznar

Yes, most of my clients are struggling with all three of these. Fortunately, many of my clients have high income so they're

fortunate to be in a position to save aggressively for their own retirement as well as their children's education. In terms of balancing the needs of elderly parents, I often discuss long-term care insurance with my clients. I'm not necessarily discussing it for their purpose, but we discuss the possibility of purchasing long-term care insurance for their parents. We talk about the possibility of them either paying the premiums themselves, if they're in a position to do so, or I educate them so they can bring that proposal to their parents who may be in a position to pay for the long-term care insurance themselves.

Mr. Lane

What additional resources we can provide our listeners about college savings plans and about your own firm?

Ms. Aznar

We mentioned Joe Hurley's website, SavingforCollege.com, which I think is a great first step if you're looking to do some research about IRC §529 plans. FinAid.org has a lot of great information about financial aid and IRC §529 plans as well. Another good website is CollegeSavings.org, the College Savings Plan Network.

Mr. Lane

Those are the websites you would recommend?

Ms. Aznar

Yes.

Mr. Lane

Your own firm has a website, right?

Ms. Aznar

Yes, my website is AznarAdvisors.com.

Mr. Lane

You're located in New Jersey?

Ms. Aznar

That's correct. ■

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Study Questions

1. According to Marnie Aznar, an advantage of an IRC §529 plan is:
 - A. Distributions used for qualified higher education expenses are not subject to federal income tax.
 - B. There is no annual contribution limit.
 - C. Distributions used to fund an individual's retirement are tax-free.
 - D. Funds are controlled by the beneficiary, not the account owner.

2. According to Marnie Aznar, New York state offers a maximum up-front deduction for state income tax purposes of _____ for a single individual that contributes to an IRC §529 plan.
 - A. \$2,500
 - B. \$5,000
 - C. \$10,000
 - D. \$12,500

3. According to Marnie Aznar, a disadvantage of a prepaid IRC §529 plan is:
 - A. Funds cannot be used to pay for a private college.
 - B. Distributions are considered a resource of the beneficiary for financial aid purposes.
 - C. Few institutions offer independent IRC §529 plans.
 - D. Funds can only be used for books and supplies.

4. According to Marnie Aznar, a benefit derived from using a Coverdell savings account for educational expenses is:
 - A. The maximum annual contribution limitation is higher than an IRC §529 plan.
 - B. The account is treated as an asset of the beneficiary and assessed differently for financial aid purposes.
 - C. Distributions can be used for elementary and secondary education expenses.
 - D. All of the above

5. According to Marnie Aznar, the Hope credit allows an individual to take a credit up to _____ for tuition and related expenses for the first two years of post-secondary education.
 - A. \$1,500
 - B. \$2,000
 - C. \$2,500
 - D. \$4,000

Study Answers

1. **A. Correct**
- According to Marnie Aznar, one advantage of an IRC §529 plans is the federal tax free status of distributions for qualified higher education expenses. [*The Pros & Cons of 529 Plans*]
- B. Incorrect**
- According to Marnie Aznar, one advantage of an IRC §529 plans is the federal tax free status of distributions for qualified higher education expenses. IRC §529 plans have a contribution limitation of \$55,000 per beneficiary for the first year, but no contributions can be made in the next four years. [*The Pros & Cons of 529 Plans*]
- C. Incorrect**
- According to Marnie Aznar, one of the major advantages of an IRC §529 plans is the federal tax free status of distributions for qualified higher education expenses. Distributions that are not used for qualified higher education expenses are subject to a 10 percent penalty and income tax on the earnings. [*The Pros & Cons of 529 Plans*]
- D. Incorrect**
- According to Marnie Aznar, one of the major advantages of an IRC §529 plans is the federal tax free status of distributions for qualified higher education expenses. The account owner has control of the account, not the beneficiary. [*The Pros & Cons of 529 Plans*]
2. **A. Incorrect**
- According to Marnie Aznar, New York state offers a maximum up-front deduction for state income tax purposes of \$5,000, not \$2,500, for a single individual that contributes to an IRC §529 plan. [*The Pros & Cons of 529 Plans*]
- B. Correct**
- According to Marnie Aznar, New York state offers a maximum up-front deduction for state income tax purposes of \$5,000 for a single individual that contributes to an IRC §529 plan. [*The Pros & Cons of 529 Plans*]
- C. Incorrect**
- According to Marnie Aznar, New York state offers a maximum up-front deduction for state income tax purposes of \$5,000, not \$10,000, for a single individual that contributes to an IRC §529 plan. [*The Pros & Cons of 529 Plans*]
- D. Incorrect**
- According to Marnie Aznar, New York state offers a maximum up-front deduction for state income tax purposes of \$5,000, not \$12,500, for a single individual that contributes to an IRC §529 plan. [*The Pros & Cons of 529 Plans*]
3. **A. Incorrect**
- According to Marnie Aznar, a disadvantage of a prepaid IRC §529 plan is distributions are considered a resource for financial aid purposes. Prepaid IRC §529 plans may be used to fund a private college. [*Prepaid Plans, Coverdell Accounts & Financial Aid Implications*]
- B. Correct**
- According to Marnie Aznar, a disadvantage of a prepaid IRC §529 plan is distributions are considered a resource for financial aid purposes. [*Prepaid Plans, Coverdell Accounts & Financial Aid Implications*]

C. Incorrect

According to Marnie Aznar, a disadvantage of a prepaid IRC §529 plan is distributions are considered a resource for financial aid purposes. More than 240 private colleges offer an independent IRC §529 plan. [*Prepaid Plans, Coverdell Accounts & Financial Aid Implications*]

D. Incorrect

According to Marnie Aznar, a disadvantage of a prepaid IRC §529 plan is that distributions are considered a resource for financial aid purposes. Funds can be used to pay for tuition costs. The plans do not cover the cost of books, supplies, room and board, etc. [*Prepaid Plans, Coverdell Accounts & Financial Aid Implications*]

4. A. Incorrect

According to Marnie Aznar, a benefit derived from using a Coverdell savings account for educational expenses is the distributions can be used to pay for elementary and secondary education expenses. The maximum annual contribution limitation is lower than an IRC §529 plan. [*Prepaid Plans, Coverdell Accounts & Financial Aid Implications*]

B. Incorrect

According to Marnie Aznar, a benefit derived from using a Coverdell savings account for educational expenses is that the distributions can be used to pay for elementary and secondary education expenses. The Coverdell and the IRC §529 savings plans are treated equally from a financial aid perspective. [*Prepaid Plans, Coverdell Accounts & Financial Aid Implications*]

C. **Correct**

According to Marnie Aznar, a benefit derived from using a Coverdell savings account for educational expenses is that the distributions can be used to pay for elementary and secondary education expenses. [*Prepaid Plans, Coverdell Accounts & Financial Aid Implications*]

D. Incorrect

According to Marnie Aznar, a benefit derived from using a Coverdell savings account for educational expenses is that the distributions can be used to pay for elementary and secondary education expenses. The maximum annual contribution limitation is lower than an IRC §529 plan and both plans are treated equally from a financial aid perspective. [*Prepaid Plans, Coverdell Accounts & Financial Aid Implications*]

5. A. **Correct**

According to Marnie Aznar, the Hope credit allows an individual to take a credit up to \$1,500 for tuition and related expenses for the first two years of post-secondary education. [*Tax Credits & Deductions to Consider When Selecting a College Savings Plan*]

B. Incorrect

According to Marnie Aznar, the Hope credit allows an individual to take a credit up to \$1,500, not \$2,000, for tuition and related expenses for the first two years of post-secondary education. [*Tax Credits & Deductions to Consider When Selecting a College Savings Plan*]

C. Incorrect

According to Marnie Aznar, the Hope credit allows an individual to take a credit up to \$1,500, not \$2,500, for tuition and related expenses for the first two years of post-secondary education. [*Tax Credits & Deductions to Consider When Selecting a College Savings Plan*]

D. Correct

According to Marnie Aznar, the Hope credit allows an individual to take a credit up to \$1,500, not \$4,000, for tuition and related expenses for the first two years of post-secondary education. [*Tax Credits & Deductions to Consider When Selecting a College Savings Plan*]

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Choose the best response and record your answer in the space provided on the answer sheet

1. According to Marnie Aznar, an IRC §529 plan is an investment sponsored by _____ to help families save for college.
 - A. The states
 - B. The federal government
 - C. Mutual fund companies
 - D. All of the above

2. According to Marnie Aznar, if a child receives a scholarship after distributions were taken from an IRC §529 plan to pay for her/his tuition, the distributions are subject to the 10 percent penalty.
 - A. True
 - B. False

3. According to Marnie Aznar, many IRC §529 plans offer _____ that is more aggressive when the beneficiary is young and less aggressive as the beneficiary nears college age.
 - A. An age matrix
 - B. An actuarial age calculation
 - C. An age-based allocation
 - D. An actuarial college age calculation

4. According to Marnie Aznar, an IRC §529 plan allows an individual to make a maximum contribution of _____ in one tax year for one beneficiary.
 - A. \$10,500
 - B. \$25,000
 - C. \$45,000
 - D. \$55,000

5. According to Marnie Aznar, the maximum annual contribution limit for a Coverdell education savings account is _____ for 2004.
 - A. \$2,000
 - B. \$5,000
 - C. \$10,000
 - D. \$15,000