Sigma Investment Counselors

Sigma Summaries

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The 529 College Savings Plan

The following Sigma Summary is the third in a series of articles dealing with a broad range of financial and estate planning issues. Please keep in mind that we are not accounting, tax or insurance specialists and we defer to these other professionals when an action step is required.

Every day we are inundated with the news of rising prices of such items as gasoline, utilities, food, medical expenses and perhaps most striking, the cost of a college education. College tuition has been increasing at an average annual rate of 5%, which is nearly double the Consumer Price Index (CPI) rate. It is projected that the cost of attending a four-year public college in 18 years will be nearly $110,000 without factoring in inflation. Count on the cost being around $234,000 if your child attends a four-year private college.

Over the years, a number of investment options have been introduced as a means of saving for college. These plans include Education IRAs, The Uniform Gift to Minors Act (UGMA), and qualified state tuition programs, which include state-sponsored college-tuition prepaid plans and college savings plans. While each option has benefits, the college savings plan may be best suited to meet your needs.

The Education IRA's primary shortfall is that you are only allowed to save a maximum of $500 per year, per beneficiary. This limitation prevents you from saving enough to cover the cost of college tuition. The Uniform Gift to Minors Act (UGMA) does not restrict the lifetime amount contributed. However, the account is legally the beneficiary's once they reach adulthood, usually 18 years old. At this point, the child has complete discretion over how the funds are used and may not follow your original intention of applying the funds towards college. The state-sponsored college-tuition prepaid plan allows you to pay tomorrow's tuition at today's prices. Few states offer this program and those that do require you to attend a college or university located within the specific state offering the program.

The 529 college savings plan, named after a section of the Internal Revenue Service tax code, has been around for more than a dozen years. This type of savings plan became a viable investment option as a way to save for college after the Taxpayer Relief Act of 1997 broadened the range of schools for which the savings can be applied and the kinds of expenses, such as room and board, which are now covered. The 1997 act also cleared the way for $10,000 gift contributions.

Some of the most appealing features of the 529 plan are that you can participate in this program regardless of your income level, the funds must be used to pay for college related expenses and the contributor maintains control of the funds even after the beneficiary turns 18 years of age. Also, when the funds are withdrawn for qualified expenses, the earnings are taxed at the beneficiary's tax rate. Some additional advantages include low minimum contributions, high contribution limits per beneficiary and professional money management.

Currently, there are over 40 states that offer the 529 college savings plan. In our analysis of the various plans, we found that they vary considerably, particularly in two important areas: the amount of fees that are charged and the investment options.

A table at the end of this piece summarizes what we believe to be the six best 529 college savings plans currently being offered. For those who wish to explore the features of other state plans, the following websites may be useful in providing general information:
www.collegesavings.org
www.savingforcollege.com

Since the majority of Sigma's clients are located in Michigan and we believe Michigan offers one of the best plans, we will focus on the characteristics of the Michigan Education Savings Plan or MESP. The following information can be found at the MESP web site at www.misaves.com.

Professional Money Management - The Michigan Department of Treasury uses TIAA-CREF Tuition Financing, Inc (TFI) as its program manager of the Michigan Education Savings Program. TIAA-CREF manages the MESP investments and provides investment advisory services. TIAA-CREF has over $290 billion in assets under management.

Flexibility in Using the Funds - The funds can be used to pay for your child's education in state or out of state, at a private or public college or university, or a trade or graduate school; the funds in the account may be used at any eligible educational institution in the nation. The savings may be applied towards tuition as well as related required expenses such as books, supplies, fees, and certain room and board costs.

Investment Options - The Michigan Education Savings Program provides a core managed allocation option plus two supplemental options. Once a contribution has been made to one of the options, that contribution plus any earnings cannot be transferred to another investment option unless you change the beneficiary of that account or transfer the funds to an account of a different beneficiary. Following are the three investment options offered:

- **Managed Allocation Option** is invested according to the age of the beneficiary. The younger the child, the more equity exposure is maintained in the account. Once the child turns 16 years of age, the account will have 50% in a money market fund, 35% in bonds and 15% in equities. The managed allocation option is the core investment option for the Michigan Education Savings Program.
- **Guaranteed Option** initially will be invested in the TIAA-CREF Institutional Money Market Fund, which offers competitive rates. Upon receiving regulatory approval of the funding agreement in the near future, the guaranteed option will invest in a vehicle that guarantees both principal and a minimum credited interest rate of 3%, plus the opportunity for additional returns beyond the minimum rate. This option provides additional security that people may want for a portion of their college investment.
- **100% Equity Option** provides a blend of domestic and international stock mutual funds. This option invests approximately 80% in the TIAA-CREF Institutional Growth and Income Fund, and 20% in the TIAA-CREF Institutional International Equity Fund. The 100% Equity Option may be appropriate for people who can tolerate greater risk and volatility for at least a portion of their college investment in exchange for potentially higher returns over time.

Fees - An annual asset-based management fee will be paid to TIAA-CREF Tuition Financing, Inc. (TFI) to cover the cost of investment management and administrative services. This fee is computed at an annual rate of 0.65% of the program's average daily net assets. No other fees or charges apply.
No Income Limits - Any person may open an account and contribute to the MESP on behalf of a beneficiary regardless of their income level.
Tax Advantages - The amount you contribute each year can be deducted from your Michigan taxable income up to a maximum of $5,000 per individual and $10,000 for joint filers. The account earnings grow on both a Federal and State tax-deferred basis until the beneficiary is ready to attend college. Upon distribution, federal income taxes will be imposed on the earnings portion of

the withdrawal and will be based on the beneficiary's tax rate rather than the account owner's tax rate. Earnings will be exempt from Michigan income taxes if a withdrawal is used for a beneficiary's qualified higher education expenses

Low Minimum Contribution - An account may be opened with a $25 check, cashier's check or money order, electronic funds transfer, or Automatic Contribution Plan. You also can contribute just $15 per account per pay period using payroll deduction through participating employers. Each account may have only one account owner and one beneficiary. You may, however, open separate accounts for as many different individual beneficiaries as you wish.

Contribution Limit - There is no annual maximum contribution limit for the Michigan Education Savings Program. However, a lifetime limit applies to all accounts opened for a beneficiary. The total balance of all of a beneficiary's accounts may not exceed $125,000.

Matching Grant - The beneficiary may be eligible for a matching grant of $1 for each $3 contributed up to a maximum $200 grant if the beneficiary resides in a household with a family income of $80,000 or less. The beneficiary must be 6 years old or younger and a resident of the State.

Transferability - If your child or beneficiary decides not to attend a higher educational institution, the account owner may transfer funds in the account to another eligible beneficiary. To avoid penalty and income tax, the new beneficiary must be a member of the family of the original beneficiary as described in the MESP Disclosure Booklet.

Withdrawals - Only the account owner may direct withdrawals from an account. A withdrawal from an account will be classified as (a) a qualified withdrawal, (b) a withdrawal due to death, disability or scholarship (c) a non-qualified withdrawal or (d) a rollover distribution.

- **Qualified Withdrawal** is a withdrawal from the account that is used to pay the qualified higher education expenses of the beneficiary. Upon distribution, federal income taxes will be imposed on the earnings portion of the withdrawal and will be based on the beneficiary's tax rate. The earnings will be exempt from Michigan income taxes.
- **Withdrawal due to Death, Disability or Scholarship** requires the earnings portion to be taxed at the account owner's rate for federal income taxes. However, no state income tax is due on these withdrawals.
- **Non-Qualified Withdrawals** require the earnings portion to be factored for computing the federal and state income tax liabilities of the account owner. In addition, the portion of this withdrawal that is attributable to contributions that were previously deducted for state income tax purposes will be included in computing the state taxable income of the account owner. Finally, a 10% penalty on both the earnings and contribution amount of the withdrawal will be charged.
- **Rollover Distributions** to a different beneficiary is not subject to taxation or penalty as long as the rollover occurs within 60 days.

Estate Planning Considerations - Contributions to the MESP are considered gifts for federal tax purposes and are, therefore, potentially subject to federal gift taxation. However, if contributions from an individual to a beneficiary, together with all other gifts, are less than $10,000 per year ($20,000 for a married couple), no federal gift tax will be applicable.

If the size of the gift is in excess of the annual $10,000 gift tax exclusion, there is the possibility that gift taxes may apply. There is also the possibility of estate and/or generation skipping taxes although the likelihood of this appears to be small under most circumstances. Individuals are encouraged to consult their tax advisors prior to making substantial gifts or changing beneficiaries.

It is important to keep in mind that this type of investment vehicle has a very specific purpose. This is not the type of investment you would use to transfer wealth from one generation to the next. Instead, these funds must be used for college tuition and other qualified higher education expenses of the beneficiary. If these funds are withdrawn for uses other than these, the penalties can be severe. Therefore, we would advise you to purposely under fund this plan and use alternative funds to complete the payment of college expenses if needed. Please feel free to call us to discuss the above plan or other options.

Written by: Steven A. Catallo