529 Accounts –
The New Frontier for Private School Choice: What YOU Need to Know

March 8, 2018
PRESENTERS:

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TODAY’S DISCUSSION

- 529 Background  4
- Plan Benefits  9
- Access and Use of Savings Plans  17
- K-12 Implementation and Considerations  21
Section 1.

529 Background
To address college affordability, several States created tuition prepayment plans relying on State statutory authority and tax-exemptions:

- Florida (1987)
- Michigan (1988)
- Ohio (1989)
- Alabama (1990)
- Kentucky (1990)
- Alaska (1991)
- Pennsylvania (1993)
- Massachusetts (1995)
- Texas (1996)
- Virginia (1996)

In 1988, the IRS began taxing the earnings on the Michigan Education Trust, with MET suing for a tax refund in 1990.

In November 1994, the Sixth Circuit Court of Appeals held that MET is a tax-exempt agency of the State of Michigan and earnings would be exempt from federal taxation.

In 1996, Senators Graham (D-FL) and McConnell (R-KY) introduced legislation that created Section 529.
Key Federal Legislative and Regulatory Actions

• Congressional Acts authorize and enhance Section 529:
  • Small Business Job Protection Act of 1996 (creates 529)
  • Taxpayer Relief Act of 1997 (expands tax advantages)
  • Economic Growth and Tax Relief Reconciliation Act of 2001 (provides tax exemption with a 2010 sunset)
  • Pension Protection Act of 2006 (makes permanent the tax-exempt treatment)

• Regulatory Support:
  • Treasury Department and IRS continually refine rules and regulations through Private Letter Rulings and Notices to simplify recordkeeping and penalty payments, and expand investment options
  • SEC No-Action Letters confirm States’ exemptions from certain securities laws
  • Municipal Securities Rulemaking Board rules guide marketing and disclosure and establish best practices for industry on a whole
Net Effect of Federal Actions

• Two Types of 529 Plans:
  • Savings plans – akin to defined contribution plans
  • Prepaid tuition plans – akin to defined benefit plans

• Market Development:
  • Forty nine States offer at least one 529 plan
  • Twenty nine States offer a deduction or credit for contributions to their 529 Plans
  • Six States offer tax benefits for contributions to ANY plan
  • Other benefits offered (e.g., creditor protection, financial aid preferences, matching grants or scholarships)

• Opportunities for Investment and Wealth Managers:
  • “Sticky” assets would lead to steady revenues
  • Financial planning would enhance product sales
Snapshot of the TOTAL 529 Market

Plan Types
- 81% Savings
- 19% All Prepaid

Assets
- 92% Savings
- 8% All Prepaid

Accounts
- 91% Savings
- 9% All Prepaid

<table>
<thead>
<tr>
<th></th>
<th>Savings</th>
<th>All Prepaid</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plans</td>
<td>89</td>
<td>22</td>
<td>111</td>
</tr>
<tr>
<td>Assets</td>
<td>$251,874,448,245</td>
<td>$23,221,081,761</td>
<td>$275,095,530,006</td>
</tr>
<tr>
<td>Accounts</td>
<td>11,767,502</td>
<td>1,113,511</td>
<td>12,881,013</td>
</tr>
<tr>
<td>Average Account Size</td>
<td>$21,404</td>
<td>$20,854</td>
<td>$21,357</td>
</tr>
</tbody>
</table>

Sources: College Savings Plans Network ("CSPN") and certain States including DC, ME, PA, SD and VA as of December 31, 2016. Prepaid data includes open and closed Plans. Number of Plans data is current as of March 6, 2018.
Section 2.

Plan Benefits
Overview of 529 Plan Benefits

• Significant **Federal Tax Advantages:**
  • Tax-deferred growth and tax-free withdrawals for income tax purposes
  • Treated as a completed *gift* but account owner retains control
  • Generous *estate-tax* planning possibilities

• **No Income Limits** and Flexible Contribution Limits:
  • Anyone can contribute to a 529 account
  • Five years of gifts can be accelerated into one year
  • Maximum account balance limits can be as high as $500,000

• **Control:**
  • Account owner can withdraw the funds if needed, subject to income and penalty taxes on earnings
  • Can change the beneficiary to another family member
Detail on Federal Tax Benefits

- **Tax-deferred Growth:**
  - Earnings on withdrawals are income tax-free if used for Qualified Higher Education Expenses at Eligible Educational Institutions
  - Tuition and mandatory fees, certain room and board, books, supplies and computers

- **Gift and Estate Tax Exclusions:**
  - Allows gifts up to $15,000 per individual ($30,000 per married couple) for gift tax exclusion
  - *Accelerated gifting* allows contributions of up to $75,000 per individual ($150,000 per married couple) at one time*

- **Contributions Represent Completed Gifts:**
  - Completed gifts are excluded from the contributor’s estate

*All contributions in excess of $15,000 / $30,000 (individual / married couple) are pro-rated over a 5-year period for the purpose of accelerated gifting. If the Account Owner dies before the end of the five-year period, the portion of the contribution allocable to the calendar years remaining (beginning with the calendar year after the Account Owner's death) would be included in the Account Owner's estate for federal estate tax purposes.*
• **Flexible Withdrawals:**
  • Earnings on nonqualified withdrawals are subject to federal income tax and may
    be subject to a 10% federal penalty tax, as well as state and local income taxes
  • Certain exceptions to penalty tax include death, disability, scholarships or
    attendance at a US service academy

• **Account Owner Control:**
  • May change investment options twice per calendar year
  • May transfer assets to a new beneficiary (who is a “member of the family” of the
    current beneficiary)
Power of Tax-Deferred Compounding

Assumptions: (i) 18-year investment horizon beginning with $100,000; (ii) 4% investment return; and (iii) 35% tax rate for taxable account.

$43,854 Added Benefit of 529
## State Tax Benefits At Work

<table>
<thead>
<tr>
<th>After-tax Contribution</th>
<th>No State Tax Benefit</th>
<th>State Tax Deduction</th>
<th>State Tax Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Texas</strong></td>
<td>$10,000</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td><strong>New York</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Indiana</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>State Tax Benefit</th>
<th>Deduction</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Texas</strong></td>
<td>$5,000 (Individual)</td>
<td>20% Credit ($5,000 limit)</td>
</tr>
<tr>
<td><strong>New York</strong></td>
<td>$10,000 (Joint)</td>
<td>$1,000 maximum</td>
</tr>
<tr>
<td><strong>Indiana</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Assumed State Tax Rate</th>
<th>Deduction</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Texas</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>New York</strong></td>
<td>8.82%</td>
<td></td>
</tr>
<tr>
<td><strong>Indiana</strong></td>
<td>3.3%</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Reduction in State Taxes Paid</th>
<th>Deduction</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Texas</strong></td>
<td>$0</td>
<td></td>
</tr>
<tr>
<td><strong>New York</strong></td>
<td>$441 (Individual)</td>
<td></td>
</tr>
<tr>
<td><strong>Indiana</strong></td>
<td>$882 (Joint)</td>
<td>Up to $1,000</td>
</tr>
</tbody>
</table>

Source: [www.tax-brackets.org](http://www.tax-brackets.org)

New York Assumed Rate for highest tax bracket, 2017; Indiana is a flat 3.3%.
Impact of Withdrawal Frequency

- General Assumptions:
  - 18-year investment horizon, with starting balance of $10,000
  - Annual contributions of $10,000 made at beginning of the year
  - Net investment return of 4%

- Scenarios:
  - Annual distribution of $10,000 beginning age 6
  - First distribution is made for college in year 19

<table>
<thead>
<tr>
<th></th>
<th>Scenario 1</th>
<th>Scenario 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beginning Balance in Year 1</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
<tr>
<td>Total Contributions</td>
<td>$180,000</td>
<td>$180,000</td>
</tr>
<tr>
<td>Distribution Prior to Year 18</td>
<td>$130,000</td>
<td>$0</td>
</tr>
<tr>
<td>Ending Balance in Year 18</td>
<td>$120,702</td>
<td>$286,970</td>
</tr>
</tbody>
</table>
Assumptions: (i) 18-year investment horizon, $10,000 starting balance; (ii) $10,000 in annual contributions; and (iii) 4% investment return. Scenario 1 assumes $10,000 annual distribution beginning age 6.
Section 3.

Access and Use of Savings Plans
Opening a 529 Savings Account

- Enrollment Channel Options:
  - Invest directly with a State Plan online or through the mail
  - Work with a financial professional

- Direct Plans Generally:
  - Typically include indexed investment options (e.g., underlying funds from Vanguard or similar fund companies)
  - Usually six to twelve or so investment options
  - Relatively low-cost investments and moderate management fees

- Advisor Plans Generally:
  - Typically include active investment options
  - Broader choices of investment options (ten to as many as thirty)
  - Investments tend to be more expensive
  - Additional distribution fees apply

- Observation: investors increasingly open accounts in Direct Plans
  - 6.6% average increase in Direct Plan accounts vs 1.5% in Advisor accounts over seven years

Average Annual Increase

<table>
<thead>
<tr>
<th></th>
<th>Direct</th>
<th>Advisor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$11.9B – 14% Growth</td>
<td>$7.4B – 9.1% Growth</td>
</tr>
<tr>
<td>Accounts</td>
<td>332K – 6.6% Growth</td>
<td>76K – 1.5% Growth</td>
</tr>
</tbody>
</table>

Sources: CSPN and certain States as of December 31, 2016
Using a 529 Savings Account

• Design of Investment Options:
  • Every 529 Plan offers an age-based option, geared to the expected year of college enrollment
    • Approximately 59% of Direct Plan assets are invested in age-based options
    • Approximately 33% of Advisor Plan assets are as well
  • Most Plans offer a short-term cash or similar option geared to immediate cash needs

• Additional Advisor Plan Elements:
  • 529 Plans use "share classes", which have different fees
  • Share classes are designed to take into account different investment horizons
  • Compliance Departments are increasingly focused on using the appropriate share class for each investor

Source: Strategic Insight for age-based percentages as of December 31, 2017
Section 4.

K–12 Implementation and Considerations
Status of State Implementation

- Overview of States that offer tax benefits:

<table>
<thead>
<tr>
<th>Allow K-12 Withdrawals</th>
<th>State Legislation Pending</th>
<th>Other Decision Pending or Treatment Unclear</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arizona</td>
<td>Alabama</td>
<td>Arkansas</td>
</tr>
<tr>
<td>Georgia</td>
<td>Indiana</td>
<td>Colorado</td>
</tr>
<tr>
<td>Kansas</td>
<td>Iowa</td>
<td>Connecticut</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>Nebraska</td>
<td>District of Columbia</td>
</tr>
<tr>
<td>Maryland</td>
<td>New York</td>
<td>Idaho</td>
</tr>
<tr>
<td>Mississippi</td>
<td>Wisconsin</td>
<td>Illinois</td>
</tr>
<tr>
<td>Missouri</td>
<td></td>
<td>Louisiana</td>
</tr>
<tr>
<td>Ohio</td>
<td></td>
<td>Michigan</td>
</tr>
<tr>
<td>Oklahoma</td>
<td></td>
<td>Minnesota</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td></td>
<td>Montana</td>
</tr>
<tr>
<td>Rhode Island</td>
<td></td>
<td>North Dakota</td>
</tr>
<tr>
<td>South Carolina</td>
<td></td>
<td>New Mexico</td>
</tr>
<tr>
<td>Utah</td>
<td></td>
<td>Oregon</td>
</tr>
<tr>
<td>Virginia</td>
<td></td>
<td>Vermont</td>
</tr>
<tr>
<td>West Virginia</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Program Description Statements, websites and available legislative summaries as of March 6, 2018
Considerations Moving Forward

• Possible Federal Legislation:
  • Re-introduction of home schooling expenses to K-12
  • Technical corrections for Section 529 definitions –
    • Qualified Higher Education Expenses
    • Eligible Educational Institutions

• Possible State Legislation:
  • Clarity on recapture of tax benefits
  • Minimum holding periods for investments

• Other Potential Concerns:
  • Impact on Fiscal 2018 revenues where late deductions are allowed for Tax Year 2017
    • Georgia, Iowa, Mississippi, Oklahoma, Oregon, South Carolina and Wisconsin
  • Suitability of investment options and share classes
  • Tracking and substantiation of aggregate withdrawals
529s for K–12

A MESS FOR STATES,
LITTLE HELP FOR SCHOOL CHOICE

NAT MALKUS
AMERICAN ENTERPRISE INSTITUTE
MARCH 8, 2018
My Perspective

• School choice supporter
• Hard to do well
• Progress has been state-led
  – Design flaws
529 Design Flaws

• Based on Long-term savings
  – Investment vehicle
• Only available to families who can save
• Don’t save families much
Limited Benefits

Federal 529 Tax benefits, by school level

- Elementary: $2,363
  - Age Three: $542
  - Birth: $1,821

- High School: $6,031
  - Age Three: $3,621
  - Birth: $2,410

- College: $8,303
  - Age Three: $5,278
  - Birth: $3,025

$250/mo. From birth, Earn 5%
## Limited Benefits

<table>
<thead>
<tr>
<th>Start Spending 529 Funds</th>
<th>Amount Spent/Year</th>
<th>529 Funds Run Out</th>
</tr>
</thead>
<tbody>
<tr>
<td>Elementary School</td>
<td>$10,000</td>
<td>4&lt;sup&gt;th&lt;/sup&gt; Grade</td>
</tr>
</tbody>
</table>
| High School              | $10,000 for 4 years of high school  
                           | $20,000 for 2 years of college | 3<sup>rd</sup> year of college |
| College                  | $20,000           | $35,000 left over for grad school |

$250/mo. From birth, Earn 5%
Supporters Reaction

• Yes
  – There is little federal help
  – State tax incentives make it work
If 529s for K–12, how?

• 1. *Standalone* 529 for K–12 vs.
• 2. Adding K–12 to *existing* 529s
  – Shifts purpose of 529s
  – Existing state tax breaks
  – Can spend existing 529 $ now
How does this impact families?

<table>
<thead>
<tr>
<th></th>
<th>Families NOT in Private Schools</th>
<th>Families IN Private Schools</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in Price</td>
<td>Minor</td>
<td>Minor</td>
</tr>
<tr>
<td>Change in Choice</td>
<td>Marginal increase</td>
<td>None</td>
</tr>
<tr>
<td>Applies to...</td>
<td>Those closest to going to private school</td>
<td>All</td>
</tr>
<tr>
<td>Result</td>
<td>Small benefits, small uptake</td>
<td>Small benefits, <strong>dramatic uptake</strong></td>
</tr>
</tbody>
</table>
How does this impact states?

• Calculated tax liability

  # Currently eligible for tax advantages
  \[ \times \ $ \text{ State tax incentive} \]
  = Tax base liability

• Calculate tax revenue liability

  \$ \text{ Tax base liability}
  \[ \times \ \% \hspace{1pt} \text{ Marginal state tax rate (@ $80K AGI)} \]
  = $ \text{ Tax revenue liability}
State Examples

States with largest income tax lost due to change in federal tax law, estimates

<table>
<thead>
<tr>
<th>$0 million lost</th>
<th>$50</th>
<th>$100</th>
<th>$150</th>
<th>$200</th>
</tr>
</thead>
<tbody>
<tr>
<td>N.Y.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ind.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pa.</td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Ill.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>La.</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Mo.</td>
<td></td>
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<tr>
<td>Mich.</td>
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</tr>
<tr>
<td>Ga.</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Iowa</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Va.</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Federal Cost:
JCT $60M per year

State Liability:
AEI ~$915M per year

Source: The American Enterprise Institute
What’s the big deal?

• Not a huge amount of money
  – Hard to replace
• Transfer state rev. to private school families
• Spends a great deal on “school choice”
  – But does not buy much school choice
What should states do?

- Welcome the changes
- Sidestep the changes, & ready to fight
- Redefine 529 rules
  - Return to old system
- Cancel tax incentives
Questions?
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Appendix
529 Benefits Compared to Traditional Savings Vehicles

• Traditional ways to save for college:
  • Education Trusts
  • Custodial Accounts (UGMA / UTMA)
  • Coverdell Education Savings Accounts

• Income, gift and estate tax treatment:
  • Earnings taxed annually in trusts and custodial accounts
  • Gifts cannot be recalled or redirected or accelerated in any other vehicle

• No income limits or contribution limits:
  • Coverdell accounts are subject to income limits and an annual $2,000 limit per beneficiary

• Control over the account:
  • In a custodial account, the beneficiary owns the funds and can use them as he wishes at the age of majority
## Snapshot of the AVAILABLE 529 Market

### Plan Types
- Direct: 58%
- Advisor: 30%
- Open Prepaid: 9%

### Assets
- Direct: 51%
- Advisor: 41%
- Open Prepaid: 8%
- Total: 51%

### Accounts
- Direct: 42%
- Advisor: 51%
- Open Prepaid: 8%
- Total: 51%

<table>
<thead>
<tr>
<th></th>
<th>Direct</th>
<th>Advisor</th>
<th>Open Prepaid</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plans</td>
<td>59</td>
<td>30</td>
<td>13</td>
<td>102</td>
</tr>
<tr>
<td>Assets</td>
<td>$139,195,815,506</td>
<td>$112,678,632,739</td>
<td>$21,842,563,321</td>
<td>$273,717,011,566</td>
</tr>
<tr>
<td>Accounts</td>
<td>6,461,334</td>
<td>5,306,168</td>
<td>992,447</td>
<td>12,759,949</td>
</tr>
<tr>
<td>Avg Account Size</td>
<td>$21,543</td>
<td>$21,235</td>
<td>$22,009</td>
<td>$21,451</td>
</tr>
</tbody>
</table>

Sources: CSPN and certain States as of December 31, 2016
Number of Plans data is current as of March 6, 2018