

► **Financial Planning**

Should Employers “Provide” Section 529 Plans to Employees?

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► Due to rising college prices and the recent additional tax benefits afforded to 529 college savings plans, employers are receiving requests to assist employees with 529 plan recommendations and/or payroll arrangements. *This article outlines an employer’s various choices in “providing” a 529 plan, highlights critical considerations for determining an employer’s level of desired involvement in doing so and provides sources for additional information to employers wishing to assist employees with their college savings needs.* ◀

In this era of rapidly escalating higher education costs, qualified state tuition programs, more frequently called Section 529 college savings plans,¹ have recently been promoted by the press, mutual fund companies and elsewhere as effective college savings tools. Although they have been in existence since 1996, the recent popularity of 529 college savings plans is largely due to additional tax benefits created by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), which are effective in 2002. These include tax-free earnings accumulation and withdrawals for “qualified” higher education costs, increased rollover ability and the removal of a dollar limit on “qualified” room and board expenses.² Added to this, many states no longer restrict use of accounts to in-state schools.

Although 529 college savings plans are, by law, state-sponsored programs,³ many employees may perceive these programs as benefits that their employers could provide to help them meet skyrocketing college expenses. As a result of this perception and Section 529 plans’ recent popularity, employers are receiving requests to assist employees with plan recommendations and/or payroll arrangements. The focus of this article is to guide employers in deciding to what extent, if any, they want to “provide” 529 plans to respond to their employees’ perceived needs.

Before exploring an employer’s choices in “providing” a 529 plan, a brief review of college costs and an overview of 529 plans are in order.

ESCALATING COLLEGE COSTS

College prices are rising at an enormous rate. Since 1980, college costs have been rising at a rate of at least two to three times the consumer price index.⁴ Over the period from the 1990-1991 academic year to the 2000-2001 academic year, after adjusting for cumulative inflation of approximately 27%, average tuition and expenses rose an additional 40% at public four-year colleges and an additional 33% at private four-year colleges.⁵

For the one-year academic period from 2000 to 2001, average tuition at public four-year colleges increased by 7.7%, from \$3,487 (for the 2000 academic year) to \$3,754 (for the 2001 ac-

ademic year).⁶ During that period, average tuition at private four-year colleges increased 5.5%, from \$16,233 (for the 2000 academic year) to \$17,123 (for the 2001 academic year).⁷ Charges for room and board in 2001 were up 6.6% from 2000 at four-year public colleges (from \$4,931 to \$5,254) and up 4.7% at four-year public colleges (from \$6,168 to \$6,455).⁸

In light of these escalating college prices, employees may be considering 529 plans as a vehicle for accumulating savings for college expenses.

529 COLLEGE SAVINGS PLANS

A 529 college savings plan is similar to a Roth IRA: It is a savings account to which after-tax contributions are made; earnings and “qualified” withdrawals are free of federal income tax. Under a 529 savings plan, an individual account owner (typically, a parent or grandparent)⁹ makes after-tax contributions to the plan to fund “qualified” higher education expenses¹⁰ for a named beneficiary. There are no income limits or age restrictions on who can invest in the plan. Currently, all contributions must be made in cash.¹¹ Further, most plans allow investments of at least \$100,000 per beneficiary, although this varies from state to state. Contributions are eligible for the annual gift tax exclusion, and in most cases, the accounts are excluded from the estate of the account owners.¹²

The plan’s investments are selected by the state, generally with assistance from a mutual fund company or other provider that acts as a professional investment manager on behalf of the state. Although the account owner cannot control the investment management of the plan,¹³ most plans allow the account owner to select among different investment strategies provided by the plan. Most plans provide an age-based asset allocation portfolio¹⁴ and a fixed asset allocation portfolio.¹⁵ Also, many plans allow account owners to reallocate their funds to different investment categories once a year. The ultimate amount available to the beneficiary for higher education costs depends upon the performance of the investments, although some plans guarantee a minimum rate of return.¹⁶

Because they are state-sponsored plans, many 529 plans allow a state income tax deduction for

part or all of the money contributed.¹⁷ However, at the time this article was written, no state permitted residents who invested in out-of-state plans to deduct the amount of contributions.¹⁸ Many states exempt earnings generated from in-state plans from state income taxes, and a few states provide a state income tax exemption for earnings to residents who invest in other states’ plans.¹⁹ Many states exempt withdrawals from plans of any state. A few states match part of the contributions, subject to income and other restrictions.²⁰ Further, some states offer scholarships for students with state 529 plans who attend in-state schools.²¹ Many states no longer require proceeds to be used at in-state public schools.²² Proceeds may be used at accredited private schools or out-of-state public or private schools, although penalties may apply.²³

FEDERAL TAX CHANGES EFFECTIVE 2002

EGTRRA made several favorable tax changes to 529 plans, effective January 1, 2002²⁴ adding to their appeal. Highlights include:

- **Tax-free earnings accumulation and withdrawals.** Starting January 1, 2002, earnings accumulation and withdrawals for “qualified” higher education expenses are free from federal tax.²⁵ Under prior law, the beneficiary was required to pay income taxes on the accumulated earnings upon withdrawal.
- **Increased rollover ability.** Rollovers between 529 plans of different states (or the same state) for the same beneficiary are permitted once every 12 months.²⁶ Prior to

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this change, a rollover was permitted only to change the beneficiary to another family member.²⁷ The increased rollover ability makes college savings assets more portable and increases flexibility in selecting among program providers and investments. For example, if the account owner were dissatisfied with the investment performance of a current plan, the account owner could change the provider or investment mix of the savings plan by rolling over the account to another state plan, thus retaining some degree of control over the investments of the plan.

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- **Coordination with education IRAs and Hope Learning credit.** Excise taxes are no longer imposed on combined contributions to education IRAs and 529 plans for the same beneficiary.²⁸ But *distributions* are coordinated for 529 plans, education IRAs and the Hope and Lifetime Learning credits.²⁹
- **Penalty on nonqualified distributions.** Although not necessarily good news, the same 10% federal additional tax on accumulated investment earnings that applies to non-qualified withdrawals from education IRAs is extended to 529 plans (exclusions for certain withdrawals, such as disability, death, receipt of scholarship continue).³⁰ EGTRRA does, however, eliminate the requirement that the state impose a penalty.³¹
- **Removal of dollar limit on qualified room and board expenses.** There are no dollar limits on “qualified” room and board ex-

penses, as under prior law. Instead, an educational institution is permitted to determine the appropriate dollar amounts for students living at home, living off campus and for those living on campus.³²

EMPLOYER INVOLVEMENT: VARIOUS APPROACHES

Employers may find 529 college savings plans appealing because they could be a relatively inexpensive way to “provide” a new benefit to employees in many instances; however, 529 plans also present some complexities and may create additional obligations or liabilities for the employer. Careful thought, therefore, should be given to the extent of an employer’s “involvement” with a 529 plan. In view of this, the following approaches appear to be the most viable.

Minimal Approach

This approach would be useful for employers who want to be somewhat responsive to employees with 529 plan questions, but who believe that individual decision elements, including state residence, income level, investment objects and estate planning concerns, as well as additional employer obligations or liability, make it difficult or undesirable to assist individual employees with 529 plan requests. Under the “minimal” approach, an employer would assist employees who have 529 plan questions by referring them to various Internet sites³³ or other information resources for 529 plans. This may be a good approach for employers that do not want to use their administrative resources for 529 plan purposes, such as providing payroll withholding, especially since most 529 programs themselves offer the option and privacy of electronic transfers from personal savings and checking accounts.³⁴ This may also be a good approach for employers that do not want to get involved in understanding the intricacies of 529 plans.

Middle-of-the-Road Approach

This approach would be useful for employers who want to provide a vehicle to assist employees in setting up a 529 savings plan, but who do not want further involvement with the plan. Under this approach, an employer would accommodate payroll withholding for employees who want to contribute to a 529 plan, by

contracting with a state's 529 plan vendor to make direct deposits of withheld amounts.³⁵ Employers with employees in various states may need to be cautious, however. A major drawback to 529 plans is that while all plans enjoy the new favorable federal tax benefits, favorable state tax benefits are generally limited to residents of the state where the plan is sponsored. Therefore, employers with employees in various states may want to consider contracting with multiple state plan vendors to make sure that their employees get all available state tax benefits. If contracting with multiple vendors is not appealing, an employer could consider contracting with just a primary vendor. Even though that could result in assisting only a limited number of employees, an employer has that flexibility because a 529 plan is not an employer-sponsored employee benefit plan and is not subject to any nondiscrimination requirements under the Internal Revenue Code.

Proactive Approach

This approach is for employers that want to actively participate in assisting employees in setting up 529 plans and are willing to take responsibility for more intensive involvement. Under this approach, in addition to payroll withholding and direct deposits to a state plan (or multiple state plans), an employer might consider providing a match to employees who make 529 contributions.³⁶ In addition, employers could consider providing investment and other education to assist employees in making decisions about their selection of a 529 plan and investment strategy. This could include providing:

- Information on projected college costs
- A general explanation of the 529 plan concept, with a general comparison to other types of college savings programs (including a general description of tax and other benefits)
- A description and comparison of various 529 state plans, including a comparison of investments being offered by them
- A description of risk and return aspects of various types of investment portfolios over both long and short periods of time
- A description of general investment strategies, such as diversification and dollar-cost averaging.

Alternatively, employers might find it useful to contract with an investment manager to perform this service, rather than creating their own education program. Further, some employers that are concerned that they may be creating an additional responsibility or liability for themselves by providing this sort of information, may consider hiring an investment manager to perform a due diligence analysis (which would involve reviewing, comparing and testing the plans for costs, reputation of provider, and features) and to provide an investment analysis comparing various plans.

Next Steps for Employers

Before taking any final steps toward "providing" a 529 plan, an employer should analyze whether such a plan would be useful or practical for the employer's workforce. Here are some suggested steps for making that analysis.

Make a Workforce Diagnostic

Employers should evaluate the age and composition of their workforce to determine whether employees would benefit from a 529 college savings plan. (That is, would employees likely have children attending college during the next five, ten, 20 years?)

Review Existing Benefit Programs

This is an appropriate time for employers to determine whether their benefit programs are supporting their business goals. Questions should be asked such as "Which programs encourage continued employment?" and "What parts are attractive to an employee who is considering remaining with the company?" Before establishing what might be complicated 529 payroll withholding or investment education programs, employers should make sure that their basic programs are currently designed and communicated properly.

Evaluate Options

As discussed previously, there are various approaches to "providing" a 529 plan to employees. These should be reviewed and considered carefully.³⁷ Companies that agree to contract with specific plans may be able to negotiate lower management fees for employees.³⁸ Employers that operate in multiple states

should take into account that state income tax benefits generally apply only to residents of the particular state; therefore, employers may need to consider whether they want to offer payroll withholding to plans in various states to provide all or most employees with state tax benefits, and if so, the administrative ramifications and complexity of doing so. Employers wary of liability exposure in offering 529 investment education or offering payroll withholding to only certain plans may want to consult with legal counsel before taking any final steps.³⁹

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Get Employee Input

Whether “providing” a 529 college savings plan, and to what extent, will meet the needs of employees can best be determined by obtaining employee input. Getting input from employees helps define the best approach for a particular employer. However, meeting with or surveying employees should be undertaken near the end of the evaluation process to avoid raising expectations that may ultimately not be met.

Explore Internet Sites

Employers interested in assisting employees with Section 529 plans, to whatever extent, may be interested in the following Internet sites. These sites provide a wide range of material, including state-specific plans, alternative financing possibilities, state income tax treatment, and estate and gift tax considerations.

Two of the most popular sites on 529 plans are the following.

- www.savingforcollege.com/. This site allows individuals to find information about the plans available in specific states and specialists in the 529 market. A tool for comparing all the available plans based on questions of greatest interest to the individual is particularly helpful. Be sure to check out the “five cap rating” in the “compare 529 tab” which is cross-referenced on several other Web sites.
- www.collegesavings.org/. Sponsored by the National Association of State Treasurers, this site also provides links to state plans and answers frequently asked questions on Section 529 plans. It also provides a page of links with information about other financial options and official IRS information, including IRS Publication 970, which summarizes the tax benefits of various education options at www.collegesavings.org/federal_initiatives.htm.

Electronic Fund Transfers

As to electronic funds transfer options, many of the funds predominantly suggest payroll deductions and neglect to mention other options, although their enrollment material does offer the option of transfers from individual accounts (Vanguard). Fidelity handles the plans for a few states and clearly offers either option. Employers may wish to accommodate payroll withholding, or may suggest the more direct and personal option that employees can handle privately. Fidelity, for example, provides information on these plans at personal300.fidelity.com/planning/college/college_frame.html.

Other Tax-Favored Education Options/ Student Loans

Edfund, a private, nonprofit corporation committed exclusively to student loan services, offers an online brochure that includes charts comparing various tax options at www.edfund.org/pdfs/tax_guide.pdf. It also provides information on student loans at www.edfund.org.

Tax and Estate Issues

This link provides a technical discussion of the tax and estate issues surrounding 529 plans: www.ppcnet.com/news/articles/tax/2001/article489.htm.

CONCLUSION

Section 529 college savings plans are increasing in popularity and, as a result, employers are being asked to “provide” these plans to their employees. Employers, however, should exercise care in determining a strategy for best responding to their particular employees’ needs. Employers must carefully determine how much involvement they want in delivering a 529 college savings plan to their employees, particularly in view of the individual decisions that come into play in choosing a suitable program. Nevertheless, employers may find offering 529 plans an inexpensive way to “provide” a new benefit to employees. ◀

Endnotes

1. Section 529 plans are so named because they are codified under Section 529 of the Internal Revenue Code (IRC). Congress established qualified state tuition programs under the Small Business Job Protection Act of 1996, P.L. 104-188, as amended by the Taxpayer Reform Act of 1997, P.L. 105-34. There are two types of 529 plans: college savings plans and prepaid tuition plans. This article will focus on college savings plans, which are generally more popular. For a summary of prepaid tuition plans (which permit an individual to purchase tuition credits or certificates that may be used to pay the qualified higher education expenses of a designated beneficiary), see IRS Publication 970, “Tax Benefits for Higher Education,” Section 8. They are also discussed on various Internet Web sites provided in the text of this article.

2. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), P.L. 106-17, Sections 402 (a)-(g), amended IRC Sections 529 (a)-(e), effective as of January 1, 2002. All changes made by EGTRRA are scheduled to sunset after December 31, 2010, unless extended or otherwise amended. This could mean, for example, that 529 earnings would no longer be tax free after December 31, 2010, if the law is not extended or amended.

3. IRC §529(b)(1)(A)(ii).

4. The College Board, “Trends in College Pricing” 2001, page 4.

5. *Id.* at page 9, Figure 6.

6. *Id.* at page 5, Table 1.

7. *Id.* at page 5, Table 1 and Figure 2.

8. *Id.*

9. The account owner can be any individual, not just a parent or grandparent, and not even a relative of the designated beneficiary. Prop. Treas. Reg. §1.529-1(c).

10. “Qualified higher education expenses” include items such as tuition, fees, books, and room and board. IRC §529(e)(3)(B)(ii).

11. Contributions may be made by check, money order, credit card, or similar methods, but contributions, such as appreciated securities, closely held business interests, or anything other than cash, are prohibited. Prop. Treas. Reg. Section 1.529-2(d).

12. If an account owner’s contribution exceeds the annual gift tax exclusion amount (for 2002, \$11,000), the account owner may elect to take the excess into account ratably over five years. IRC §529(c)(2)(B). With regard to the estate tax, in general, assets held in a 529 plan are included in the estate of the designated beneficiary and excluded from the estate of the account owner. However, if an account owner dies within five years after making an election to spread the gift to the beneficiary over five years, the contribution is included in the account owner’s estate on a pro-rata basis. Prop. Treas. Reg. Section 1.529-5(b)(2). Note, however, that the full extent of gift and estate planning opportunities of 529 plans is beyond the scope of this article. Employees should consult with their financial advisors regarding individual planning issues.

13. IRC §529(b)(4).

14. For example, many funds permit an aggressive growth strategy (stock funds) for when the beneficiary is young that converts to a conservative growth strategy (bond funds) when the beneficiary nears college age.

15. A fixed asset portfolio would, for example, allow the account owner to choose to allocate contributions over three static portfolios, such as an equity, bond, or short-term bond/money-market portfolio.

16. C. Cropper & A. Tergesen, *BusinessWeek*, “College Savings Plans Come of Age,” pp. 102-105 (Mar. 12, 2001). For a continually updated status of the features of all state plans, including state tax treatment, see www.savingforcollege.com/.

17. *Id.*

18. As of the date this article was written, no state currently provides such a deduction. D. LeDuc, *Washington Post*, “Glendening Vetoes College Savings Bill.” (May 16, 2002).

19. C. Cropper & A. Tergesen, *BusinessWeek*, *supra*, at endnote 16.

20. *Id.*

21. *Id.*

22. *Id.*

23. *Id.* Also see www.savingforcollege.com/.

24. See endnote 2 above. As stated in endnote 2, all changes made by EGTRRA are scheduled to sunset after December 31, 2010 unless extended or otherwise amended. Therefore, for example, 529 savings plan earnings would no longer be tax free after December 31, 2010 if the law is not extended or amended.

25. IRC §529(c)(3)(B), as amended by EGTRRA.

26. IRC §529(c)(3)(C)(iii), as added by EGTRRA.

27. This type of rollover is still permissible (IRC §529 (c)(3)(C)(ii)) and is particularly useful if, for example, the first named beneficiary decides not to attend college. The account can then be transferred to another family member to cover that individual’s college costs.

28. IRC §4973(e)(1), as amended by EGTRRA.

29. IRC §529(c)(3)(B)(v) and (vi), as added by EGTRRA.

30. IRC §529(c)(6), as added by EGTRRA.

31. IRC §529(b)(3) was deleted by EGTRRA.

32. IRC §529(e)(3)(B)(ii), as added by EGTRRA.

33. A list of these extensive Internet sites is provided later in this article.

34. For example, Fidelity Investments provides information on several plans that offer payroll withholding and/or electronic fund transfer options at www.personal300.fidelity.com/planning/college/college_frame.html.

35. Note that under current law the 529 plan vendor can be hired only by the particular state that is sponsoring the 529 plan.

36. Employers should be aware that in all likelihood the match would represent taxable compensation to the employee (both for income tax and FICA/FUTA tax purposes) and could complicate payroll administration somewhat. In addition, it would appear that the match would be includable in determining the amount of the employee's annual gift tax exemption. (See endnote 12 and accompanying text.) However, the employer would be able to deduct the amount of the match as a compensation expense.

37. Employers should also note that there are other tax-favored vehicles for education savings, such as an education IRA, and that an employee's participation in one of these other programs may affect the tax advantages of also contributing to a 529 plan. These other programs are beyond the scope of this article, however. For more information on these other programs, see IRS Publication 970, "Tax Benefits for Higher Education." Employers should also be aware that financial aid and scholarship availability may be affected if a student is the beneficiary of a 529 plan. For information on this, see Edfund's online brochure that includes charts comparing various education tax options at www.edfund.org/pdfs/tax_guide.pdf. Also see its information on student loans at www.edfund.org.

38. For example, Merrill Lynch, Inc. reduced its management fee by 50% for those who "signed" up for a 529 plan through their employer. (The usual fee of \$50 was reduced to \$25.) Further, Merrill Lynch waives the management fee entirely for "corporate" plan holders who deposit \$2,500 in their 529 plans in one year, or whose account value grows to \$20,000. WSJ.com, "Workplace 529 Plans May Have Drawbacks." (May 9, 2002).

39. Consultation with counsel may also be advisable to ensure that deducting contributions does not violate any state wage withholding rules.

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