How to get the most out of your 529 plan

Blog

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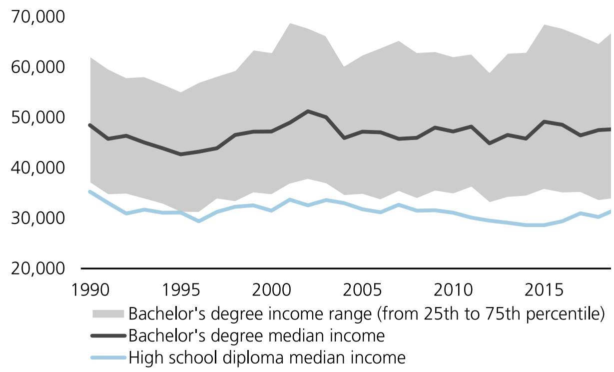
- The cost of college can be daunting, potentially representing one of the largest single investments that a family makes during their lifetime.
- By some measures, college may cost more than USD 25,000 per year, on average, to attend in-state public college, and more than twice that for private college. For many programs, the cost can be much higher than these averages.
- In this report, we will look at the cost of college and answer several frequently answered questions.

Is college actually worth it?

Despite the "sticker shock" that comes with some college cost estimates, research shows that a college degree can still be worth the cost. First, a college degree often comes with a much higher level of income than the income available for a high school graduate (see Figure 1).

Figure 1 - College adds to income potential

Distribution of annual wages for recent college graduates, in USD



Source: UBS, US Census Bureau, US Bureau of Labor Statistics, as of 9 February 2022.

Over the course of an entire career, this higher earnings potential adds an average USD 1 million to lifetime income for workers with bachelor's degree when compared to high school graduates, according to research from the New York Federal Reserve. As a result, the NY Fed also estimates that college delivers an average return on investment of 14%—which is a much higher return than most traditional investments can offer.

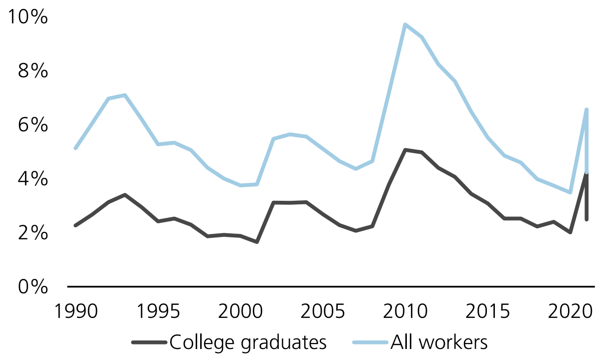
In addition to higher earnings potential, workers with college degrees also have access to careers with better workplace benefits, tend to experience fewer and shorter-lived bouts of unemployment (see Figure 2), and have greater capacity to earn a return on their savings due to greater financial security. As a result, the additional wealth afforded by a college degree can lead to a much better lifestyle and earlier retirement, on average, than entering the workforce with a high school diploma.

The COVID-19 pandemic and the currently tight labor market helps to underscore these benefits. College graduates are more likely to work in a field that offers remote work, which allowed them to continue working even during COVID-19 lockdowns. By contrast, high school graduates were more likely to face a disruption to their earnings and were more likely to be forced to dip into their long-term savings.

Going forward, greater access to remote work may allow college graduates to reduce the cost of their commute or live in a lower cost of living area, which could enhance their savings power even further or give them the financial freedom to upgrade their lifestyle in other ways.

Figure 2 - College graduates find new work more quickly than high school graduates, which boosts their financial security

Unemployment rates



Source: UBS, US Census Bureau, US Bureau of Labor Statistics, as of 9 February 2022.

See *The Labor Market for Recent College Graduates* for more information from the NY Federal Reserve.

How should I save for college?

Everyone knows it's important to save for college, but not everyone knows where to start. To help get you started —and to raise awareness ahead of National 529 College Savings Plan Day (cleverly scheduled on 5/29 each year)—we have put together a quick Q&A to answer some questions about 529 College Savings Plans, which can be one of the most effective ways to prepare for this massive investment into the next generation of our families.

529 college savings plans can help reduce the burden of education expenses by encouraging families to save and invest earlier, and by providing two key tax benefits. First, contributions are tax-deductible, or come with tax credits, in over 30 states (though not at the federal level). Second, 529 investment earnings grow tax-free and distributions aren't taxed if they are used for qualified education expenses.

These tax benefits are an important feature, because their benefits compound over time. For example, let's look at a USD 10,000 contribution, invested for 20 years at a 5% annualized return. Invested in a 529 account, this approach would result in **USD 26,500** that can go toward qualified education costs, 17% more than the **USD 22,600** from a USD 10,000 investment in a taxable account subject to a 23.8% long-term capital gains tax at the end. In reality, this likely understates the advantage of tax-free growth, because it doesn't account for any state deductions or credits for your contributions, or the tax drag from income and dividend taxes in your taxable account. This benefit could also grow larger in the future if capital gains tax rates go higher.

Which 529 distributions are "qualified"?

Surprisingly, according to the IRS guidance, 529 college savings plans aren't just for college. The general guidelines are tuition, fees, books, and room and board at eligible education institutions. Computer technology, equipment, or service costs can also qualify as long as they are used while the plan beneficiary is enrolled at the eligible education institution. Additionally, families can use up to USD 10,000 per year for tuition at elementary or secondary public, private, or religious schools.

Principal and interest payments toward qualified higher education loans are now also considered qualified 529 plan expenses, up to the lifetime limit of USD 10,000 per beneficiary and USD 10,000 for each of the beneficiary's siblings. However, the portion of student loan interest that is paid with 529 assets is not eligible for the student loan interest deduction.

If you do make nonqualified distributions from your 529 account, any gains in the account will be taxed as income, with an additional 10% penalty. Some states may also impose taxes or restrictions on certain distributions, so make sure you consider your state's policies.

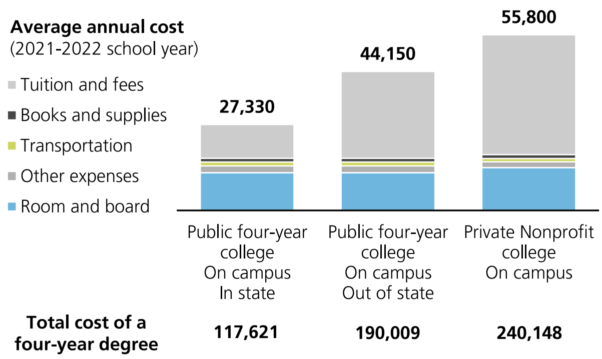
How much do I need to save? What if I save too much?

When it comes to estimating college costs, and therefore evaluating the amount that you should save and invest for future college expenses, there are many variables that you should consider:

1. How many children will you send to college? Which type of school will each child attend? Will they receive a scholarship?
2. How much are we willing to cover for each child? What about graduate school?
3. Will you be eligible for financial aid?
4. How much will college cost in the future?

To help answer question #4, we need to look at current college costs and make an estimate for the rate of inflation. Based on data from the Bureau of Labor Statistics, the "sticker price" of college (tuition and fees, including room and board) has increased 4.9% annually, rising 294% in total since 1993. If we assume that tuition inflation continues at this pace, Figure 3 shows the projected cost of college in today's dollars. These projected costs can be helpful when planning your college savings for a newborn, but as your children grow older you will have a clearer outlook on which type of program they're likely to attend.

Figure 3 - The choice of college can have a major impact on cost



Source: UBS, Bloomberg, CollegeBoard "Trends in College Pricing & Student Aid 2021" report, as of April 2022.

Saving and investing early can help you get the most value out of the tax-free growth in a 529 account, but one potential risk is that the account could grow to be over-funded relative to your family's educational needs. Putting too much into 529 accounts can be costly because nonqualified distributions trigger income taxes—and a 10% penalty—on the investment earnings.

With this in mind, here are a few strategies to help you get the most out of a 529 plan's tax benefits while mitigating the risk that you will end up paying a penalty:

1. **Diversify your college savings across account types.** In addition to funding a 529 plan, consider setting aside funds for college in a Roth IRA and other account types with more flexibility. If you will be older than age 59 1/2 when your children go to college—and you wait at least five years between your first contribution and your first withdrawal—then growth in a Roth IRA will be tax-free if you use the funds for college expenses. Roth IRAs will also have more investment options than a 529 plan.

2. **Use 529 funds for K-12 tuition.** As mentioned above in the "qualified distributions" section, your family can use up to USD 10,000 towards K-12 tuition each year. If your children are approaching college age and your 529 accounts appear to be over funded, this strategy may allow your family to use the 529 funds for tax-free educational expenses without incurring the penalty.

3. **Change beneficiaries.** A 529 account can have only one beneficiary at a time, but this designation can be changed once a year without tax penalties or consequences. For smaller families, a single account can be "handed down" to the next sibling (or other qualifying family members, such as a first cousin or niece/nephew) once the first beneficiary's costs are covered. For larger families, it may be better to set up multiple accounts, especially if two or more children will be in college at the same time, to allow for more flexibility.

Whenever you contribute to a 529 account, there is a risk that you will not need the funds for college education expenses. Your children may get a full-ride scholarship, or decide not to attend college. This is a risk that you should consider. On the other hand, even if you do end up paying taxes on the investment growth in the 529 account (along with a 10% penalty), you will still likely be better off than if you had not invested the funds earmarked for college expenses. After all, you will still benefit from tax-deferred growth on the investments, and receive your initial investment principal back on a tax-free basis.

Will 529 assets have an impact on financial aid?

Students' and parents' assets and income are counted in the formula for financial aid, so parent-owned 529 plans will have an impact on financial aid. As it stands today, distributions taken from grandparent-owned 529 plans also impact the student's needs-based financial aid eligibility. However, in the coming years, cash support and other types of income will no longer have to be reported on the Free Application for Federal Student Aid (FAFSA), including funds from a grandparent-owned 529 plan. The Department of Education and Financial Student Aid expect to complete the FAFSA simplification in time for the 2024-2025 award year. However, they haven't yet provided a detailed timeline for all the changes they plan to implement.

How should I invest my 529?

The 529 account's asset allocation should be driven by the beneficiary's goals and time horizon. Funds for a newborn's college expenses have ample time to enjoy significant growth from an aggressive portfolio over the next two decades. We generally recommend that funds that are needed in the next three to five years be removed from equity market risk, so as a beneficiary enters high school it makes sense to begin derisking the portfolio by adopting a more balanced asset allocation.

That being said, it's also important to coordinate your 529 plan with your overall financial plan and investment strategy. Investors who have saved very little for education outside the 529 plan will want to take on less risk in that part of their portfolio; for investors with ample room to make up for shortfalls with other assets, getting the most out of the tax-free growth is the primary goal, and the portfolio can take on more risk.

Do I need to invest in my state's 529 plan? What if I move?

While 529 plans are administered and offered at the state level, you are not required to participate in your state's plan. Nor does the beneficiary need to attend school in the same state in which the plan is administered. As previously mentioned, over 30 states provide tax deductions or credits for contributions to the state plan, so if you reside in one of those states you may want to take advantage of this triple tax advantage (contributions, growth, and qualified distributions are not taxed). Additionally, there are seven states, such as Pennsylvania, which offer tax parity for 529 contributions, meaning contributions to any plan (not just your home state) will qualify for a state income tax deduction or credit. If you live in one of these states you have the flexibility to use any state's plan while still receiving a tax benefit for your contribution.

Given the portability of 529 plan funds families do not need to worry about moving states while saving for college. There are many options as it pertains to rolling funds from one state's plan to another, or simply opening a second 529 account for the beneficiary in your new home state. However, all of this flexibility comes with tax considerations, so we recommend consulting with your tax advisor before making any decisions.

Where can I learn more?

UBS has partnered with EverFi, a leading education technology firm, to produce the UBS Financial Education Program, a series of short lessons about key investment and planning topics, including a 5-minute guide to 529 plans. To learn more, visit ubs.com/thecode.

Appendix

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