Publications

Employer-Sponsored College Savings Plans-An Attractive New Employee Benefit?

PUBLISHED
10/07/2002

SERVICES

With recent changes in law, College Savings Plans (CSPs) that qualify under section 529 may be the single most tax-favored way to save. CSPs appear to be free of many Federal regulatory restraints to which other savings vehicles are subject. However, CSPs are subject to investment and administrative limitations and are currently provided in complex formats at unnecessarily high costs. A well-designed employer (or union) sponsored CSP may be the best way to overcome these limitations while continuing to provide the tax and savings benefits of CSPs.

Tax Benefits

Most but not all of the tax benefits of CSPs are well understood. The tax treatment of College Savings Plans compares favorably to the taxation of Roth IRAs. Like the Roth IRA, contributions to CSPs are not deductible for Federal income tax purposes. Also like the Roth IRA, investment income that accumulates under the Plan is not currently taxed, and qualified benefit payments for expenses of post-secondary education are not taxed.

The Roth IRA is subject to annual contribution limits, generally, $3,000 to $15,000 depending on IRA type and year of contribution, while there are no annual limits on contributions to college savings plans. CSPs are subject to cumulative contribution limits which are established by each state. Contributions to a CSP cannot be made when the account balance of the beneficiary exceeds the sum necessary to fund higher education as determined by each state. Such limits currently run from a low of $146,000 under the Iowa plan to a high of $305,000 under the South Dakota plan ($250,000 is typical). Since the limits are per beneficiary, parents of a four-child family could contribute over $1 million for accounts for their four children. Also, anyone can make contributions for any beneficiary so that it is readily conceivable that wealthy grandparents could establish accounts for beneficiaries totaling millions of dollars.[1]

Of course, tax-free benefits cannot be achieved from Roth IRAs unless the distribution is made after age 59 1/2, death, disability or for first-time home purchases. And, as previously noted, distributions from section 529 CSPs are only tax-free when used for eligible educational expenses.

An important, but little noted advantage of both CSPs and Roth IRAs, is that non-qualifying distributions of accounts that have imbedded losses appear to qualify for ordinary loss treatment for tax purposes. That is because Code provisions governing nonqualifying distributions for both CSPs and Roth IRAs apply the general rules of section 72 to nonqualifying distributions, and interpretations of section 72 have held that losses realized on surrender of annuities entered into for profit are deductible against ordinary income.[2] This may be a particularly important tax attribute currently to some taxpayers since it seems likely that many holders of CSPs have invested in them during recent periods and have unrealized losses in their investments.[3]

A well-known advantage of CSPs is that account balances are not included in the gross estate of the account holder for Federal estate tax purposes.[4] Complex gift-tax rules do apply, but gift taxes should not be incurred by the well-tutored account holder.[5]

It should be noted that contributions to CSPs are deductible in a number of states when the contribution is made to a CSO sponsored by the taxing state. Generally, the deduction is subject to annual limits, such as $2,000, and some states allow unlimited carryovers and abolishment of limits upon the attainment of a specified age, such as age 70. However, this advantage should not be overemphasized because the monetary advantage of the deduction may well be less important than other features of the state's CSP.

Finally, as an instrumentality of the state, it appears that a College Savings Plan is not subject to Federal and state securities laws (although certain providers may be). Additionally, college savings plans appear not to be subject to ERISA because they appear not to be within the definition of pension or welfare plans.[6]

Problems Involving College Savings Plans

There are some distinct disadvantages with most existing state-sponsored plans. Section 529 prohibits the account holder or beneficiary from directly or indirectly directing the investment of contributions. Most state plans do nevertheless offer a choice of plan structures that do effectively permit the account holder to make some investment choices. For example, the Virginia Education Savings Trust (VEST) allows account holders to choose between evolving and non-evolving portfolios. The evolving portfolios are age-based and gradually evolve from a concentration in equity funds to a concentration in fixed-income funds. The non-evolving portfolios allow a choice between portfolios of different risk classifications. If, by way of further example, an account holder chooses the "Aggressive non-evolving fund," he knows that his investments will be in the "Vanguard LifeStrategy Growth Fund" which will be invested 50% in Vanguard Total Stock Market Index Fund, 25% in Vanguard Asset Allocation Fund, 15% in Vanguard Total International Stock Index Fund and 10% in Vanguard Total Bond Market Index Fund. In addition to an application fee of $85 and other administration fees, VEST charges an annual asset charge of 93 basis points for this option. By contrast, if an investor selected the same funds at retail, an average asset charge of 28 basis points would be charged by Vanguard. Undoubtedly, VEST is able to purchase the Vanguard Funds for a much smaller wholesale fee ¯ a small, single digit basis point charge would be expected. The difference of 65 to 90 basis points is used by VEST to defray its general operating expenses including marketing and printing expenses and something designated as operational funding for the "Virginia College Dream Foundation."[7]

While the funds chosen by VEST would be regarded as prudent selections by most investment managers, the above discussion indicates that savings vehicles for the Virginia college saving plan are provided at a charge about three times as large as the charge involved if the funds were purchased directly from Vanguard. Additionally, the account holder is given very limited additional choices if he wishes to use the Virginia sponsored funds, and, under tax rules, may only change his fund selection once a year. VEST also collects contributions periodically, but only invests contributions semi-monthly and credits no interest to funds held prior to investment.

One of the difficulties with section 529 plans is that the structure, investment choices, contribution limits, administrative fees and other features of the CSP vary from state to state. A few states provide plans with lower fees than Virginia's VEST while other states provide plans with substantially greater charges. As a result, a prospective contributor to a college saving plan should devote considerable time to researching and evaluating the various programs that are available.

One final word of caution is that the rules excluding distributions for qualified higher education expenses from income (and certain other section 529 rules) expire after 2010 so that amounts accumulated now for beneficiaries attending college after 2010 may be subject to tax. It is a reasonable bet, however, that politicians wishing to continue in elective office beyond 2010 will not allow that to happen.

Employer or Joint Employer-Union Sponsored College Savings Plans

We are currently exploring the possibility of establishing employer-sponsored or collectively bargained college savings plans. We note that some states currently offer the option of utilizing payroll deduction plans in which the employer withholds amounts for employees and remits contributions for use with an existing off-the shelf state plan. We believe that an employer sponsored plan with many of the features of a qualified defined contribution retirement arrangement could provide an attractive option for college savings plans. For example, under the plan we are developing, the sponsor would select the investment manager and administrative service provider. The plan could be voluntary or mandatory, employee pay-all or funded partially with employer matching contributions, and could charge fees that would fully cover plan costs or all or a portion of expenses could be defrayed by the plan sponsor.[8]

To qualify under section 529, such a plan would require the active participation of a state since to qualify under section 529 the state must "establish and maintain" a plan. We have tentatively reached agreement with one state to provide such a plan for employees of a multiple employer group. This project is a work-in-progress and there are a number of hurdles that must be cleared to successfully launch this plan. Legal issues include compliance with state law, section 529 qualification, and application of Federal and state securities laws, ERISA and the Taft-Hartley Act. While many of the issues are not simple, we are optimistic that they can be successfully resolved, and that the result will be the creation of a valuable new fringe benefit.

[1] The possibilities seem endless for example, it appears that one can establish a CSP for oneself or one's spouse or even one's grandparent! Also, since the limits are on contributions and not on accumulations, and since there is no time specified for the commencement of distributions, it appears that amounts in a beneficiary's account could accumulate indefinitely.

[2] See Rev. Rul. 61-201, 1961-2 CB 46; National Underwriter Tax Facts, Q 30 at p.38 (2002 ed.)

[3] It appears likely, however, that such items would be treated by the Internal Revenue Service as miscellaneous itemized deductions subject to the 2% AGI limitation. See IRS Publication No. 590, Recognizing Losses on IRA Investments, which takes this position with respect to Roth IRAs. Note, however, that losses under section 72(b)(3)(the deduction where annuity payments cease before investment is recovered) is excepted from this limitation.

[4] Apparently, however, amounts distributed upon the death of a beneficiary may be included in the beneficiary's estate. See Code ¤ 529(c)(4)(B).

[5] Contributions to a CSP are treated as a completed gift to the designated beneficiary, but the donor is allowed to anticipate five-year annual exclusions and join his spouse in the gift, currently providing an exclusion of $110,000. It is not clear that, where the designated beneficiary is a child of the contributor or is the contributor himself, the transfer would be subject to the gift tax since payment of college expenses for such beneficiaries would not be gifts for gift tax purposes. IRS officials have agreed with this position informally, but it is not written anywhere. It is also not clear what happens to the gift when the contributor withdraws the funds for his own use, or where an amount is withdrawn and then recontributed for the same beneficiary. Rules are provided as to the gift tax consequences of changes of beneficiaries.

[6] College savings plans do not provide retirement income or defer the receipt of income beyond employment; moreover, such Plans are not an enumerated welfare plan benefit. The most closely related enumerated welfare benefit is a "scholarship," but savings by an individual for his own benefit or for the benefit of a child or relative is not ordinarily regarded as a scholarship.

[7] Discussion based on Virginia Education Savings Trust Program Description (December 1, 2001) and Vanguard's published fee data.

[8] A possible advantage of employer payment of fees is that such payment would be deductible by the employer, but not included in employees' income.