DON'T OVERFUND YOUR CHILD'S COLLEGE SAVINGS PLAN

By: Andy Hoffman, CTFA, CFP®, Private Client Advisor

It's no secret a college degree comes with a hefty price tag. Perhaps that's why you opened a 529 Plan for your son on his first day of kindergarten and another one when your daughter was born.

Through the years these investment accounts have provided tax-free growth for children who wouldn't be needing college funds for quite some time. If you made regular deposits to the accounts based on your projected funding calculations, you took advantage of years of compounding growth—and the earnings are also potentially tax-free as long as you use withdrawals to pay for qualified education expenses.

But now there seems to be a glitch in your best-laid plans. As your son begins to go through the whole college process, you discover you've socked away too much money in his 529 Plan.

Initially, it seems like a nice problem to have. Maybe your son received college scholarships or decided to attend a community college for a year before heading off to the university. In either case, his overall tuition bills and fees could be reduced significantly—and you find he has excess money in his 529 account.

FIVE WAYS TO FIX THIS

Unfortunately, you can't just withdraw the excess funds and use them for a non-educational purpose without being penalized by the Internal Revenue Service (IRS). You may want to consider one or more of the following options that fall within the 529 Plan guidelines.

Designate a new beneficiary.

Fortunately, there are several choices available to you if you decide to go this route—without tax consequences. If you have another child who may need funds in the future for college education expenses—or even an extended family member such as a niece or nephew who might need financial assistance—you're allowed to transfer the 529 funds to another beneficiary.* Also, if you want to use the money for tuition and fees to continue your education under qualifying programs, you can designate yourself as the beneficiary on the account.

Use the funds for a child's private K-12 grade expenses.

The Internal Revenue Service Code rules now allow families to use state-sponsored 529 college savings plans to pay for expenses such as tuition, books, and tutoring for grades kindergarten through high school (K-12). Up to $10,000 annually can be distributed tax-free per child if used for these expenses.

Note: This rule change was made at a federal level several years ago under the Tax Cuts and Jobs Act reform legislation, but not all states follow the federal definition for 529 accounts. Some states, Illinois for example, define the use of 529 Plans as solely for "college." You should check with your tax professional and financial advisor about guidelines for your 529 Plan before making any distributions for elementary or high school expenses to avoid unfavorable consequences at the state tax level.

If a beneficiary has more than enough money saved inside a 529 account for college, then you might want to consider withdrawing funds for grade school or high school expenses. Additionally, if it's allowed by your state of residence, you may want to deposit and distribute funds in the same year to take advantage of potential state tax deductions.

Keep in mind, however, that distributing funds early for grade school or high school decreases the growth potential of the account. The main advantage of a 529 account is it allows the tax-free growth of money over time for future expenses. The more money distributed earlier in the beneficiary's lifetime, the less time the money has to grow inside the account.

Open a separate 529 account dedicated to K-12 expenses.

Depending on how your account is invested, opening a separate account might be another way to approach the K-12 option. Many individuals use the "age-based" investment option within 529 accounts. Similar to a retirement target-date fund, these investments become more conservative as the beneficiary gets closer to college when the funds will be needed. Because the time horizon for elementary school or high school is much shorter, it might be sensible to carve out a portion of the account and give it a more conservative allocation.

Provide an educational legacy for your grandchildren.

One of the advantages of a 529 Plan is there's no time limit on when you have to spend the funds in the account. If your own children or extended family members don't need the money for their education—and you have no plans for continuing yours—you can save the remaining balance in the account for your future grandchildren. The best part is your money continues to grow tax-free until it's withdrawn. If you're seriously considering this option, you may want to consult with your tax professional and financial advisor about the gifting benefits of incorporating the 529 funds into your estate plan.

Take a non-qualified distribution.

If you decide to withdraw funds from your 529 account for any purpose other than qualified education expenses, the IRS will penalize you 10% on the earnings portion of your account distribution. However, you will not be taxed or penalized on your principal contributions.

FOLLOW UP

Before you decide on how to manage the overflow funds in your 529 college savings account, contact Commerce Trust Company to learn more about how the recent legislation impacts your individual situation. We can discuss these and other options to help you evaluate how distributions from your 529 Plan fit into your overall financial planning strategy.

* The new beneficiary must be a "qualified family member," and be in the same generation as the current beneficiary. If not, gift and generation skipping taxes may apply.

The opinions and other information in the commentary are provided as of November 17, 2020. This summary is intended to provide general information only, and may be of value to the reader and audience.

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Andy is a private client advisor for Commerce Trust Company. He serves as a consultant and relationship manager providing clients with personalized objective advice and oversight across all of our services, including trust administration, financial advisory services, private banking, and investment management. Andy facilitates all aspects of relationship management for the client team, including administering complex trusts, maintaining client communication, and coordinating with internal and external partners to deliver a superior client experience. He joined Commerce in 2016 with ten years of industry experience. Andy received his bachelor of science degree in finance/economics and MBA with a concentration in finance from Rockhurst University. He has achieved the designations of Certified Trust and Financial Advisor and CERTIFIED FINANCIAL PLANNER™. Andy is a member of St. Ambrose Catholic Church and the Crusaders Club at St. Ambrose.