Reducing College Expenses for Government and Nonprofit Workers

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IT'S THAT TIME OF YEAR AGAIN when Morningstar reviews and ranks college savings plans *(https://www.morningstar.com/articles/950079/rating-the-top-529-college-savings-plans)*. Though they are not the only driver in selecting a plan, the study is well executed and informed and can play a part in your decision-making.

What other factors should you apply in selecting a plan? The most important is the tax benefits, an area that is often and easily misunderstood. All plans are tax-deferred and provide for tax-free withdrawals for qualified expenses — essentially a Roth IRA for college — however some states incentivize taxpayers with state tax breaks, though not all states and not in the same way. In many cases that would mean a state tax deduction, but in most cases the deductions/credits are offered only if you use a plan sponsored by their state. But you are not required to use the plan sponsored by your state, and your state's plan might not be on this list of Morningstar's best.

While most states offer a tax deduction, some offer a tax credit. For example, say you are in a 10 percent tax bracket. If you have $50,000 of taxable income, and you received a tax deduction of $10,000, that would reduce your taxable income to $40,000, which would translate to $1,000 in tax savings. If you instead received a $5,000 tax credit, that's a credit against the tax you owe, saving you $5,000 in taxes. Understand, however, that while a dollar of tax credit is generally more valuable than a dollar deduction, there are usually a bunch of limits, caps and rules around that credit that may not make it more beneficial. The devil is in the details.

STATES AND TAXES

Indiana, Utah and Vermont are the only states that offer a tax credit for a college savings plan. Minnesota offers one as well, but there is a calculation based on your adjusted gross income that determines whether you get a deduction or credit.

In states with no income tax — Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming — there is no tax savings incentive to use a specific plan. You have no reason not to use the best plan, regardless of the state sponsor or where you live.

Some states that have income tax do not offer any break at all for their residents — California, Delaware, Hawaii, Kentucky, Maine, New Jersey and North Carolina. This again frees you to choose the best plan without considering incentives.

Seven states that do have state income taxes offer what is called "tax parity." Tax parity in this case means you can use any state's plan and receive these state's tax break. Tax parity states are Arizona, Arkansas, Kansas, Minnesota, Missouri, Montana and Pennsylvania.

The remaining income tax-based states offer deductions, but they vary dramatically. For example, Rhode Island only allows a deduction of $1,000 for a joint taxpayer, where Colorado doesn't limit the deduction, meaning a $25,000 contribution is a $25,000 state income tax deduction.

For more on your state's college savings plan deductibility, go to: *https://www.invesco.com/college-bound-529-plan/529-tax-benefits#d8c8cca2-4007-4da5-acb7-4c14b99bb39e*

THOUGHTS AND STRATEGIES

What if you live in a state like North Dakota where they historically have a very poorly rated plan, but a single taxpayer can deduct up to $5,000 for using the state's college savings plan? If you are behind on savings and/or your child is older and you need to save more than $5,000 per year, you could use Idaho's plan for the $5,000 per year to maximize your deduction and set up a second, more ideal plan.

Should you put money into a 529 plan if you have only a year or two until withdrawals? From a "growth" and tax-free incentive perspective, probably not. There just isn't enough time to grow the base to make it beneficial. That being said, if you live in a state with a tax incentive, then you probably should. Most of the states do not require you to leave the money in the plan for a fixed amount of time. In other words, you theoretically could make the contribution in the same year you withdraw it and get the tax break. Again, the devil's in the details and states rules vary.

Finally, of the plans we regularly talk to clients about, Utah and Virginia continue to be the medalists. But my state, Florida, is moving up the list, though historically we haven't recommended that plan. Plans do change, but good plans with consistent track records stand out.

Like most planning, you don't have to get everything perfect, but you do want to avoid bad decisions. Not paying attention to the tax consequences of a plan is a mistake. Instead, make a good decision to work with an advisor who has your best interests at heart and the knowledge to help you optimize this opportunity.

We're here to help. For more information or to schedule a meeting, call us at 772-287-4110, or email me at rfurtwangler@hbkswealth.com.

Sources:
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