Reforming 529 College Savings Plans to Better Reach Low-Income Families

Margaret Clancy, Center for Social Development, Washington University
Leslie Parrish, Asset Building Program, New America Foundation

March 2006

Qualified Tuition Plans, commonly called "529 plans" after the applicable section of the federal tax code, were implemented in their present form in 2001. These state-sponsored plans can help families save for their children's college education, or an adult can open an account to use for their own post-secondary expenses. Generous contributions can be made to these accounts—up to $300,000 in some states—and anyone can open an account regardless of income. Currently, up to $267,580 can be withdrawn free of federal taxation. As of the end of 2005, over 7 million accounts have been opened across the country, with assets in these plans exceeding $68 billion. By 2010, $300 billion is expected to be invested in 529 plans. Federal tax expenditures on 529 plans are estimated at $620 million for 2007 and are expected to cost the federal government almost $4.1 billion in lost tax revenues over a five year period.

Under current law, earnings and qualified withdrawals are exempt from federal income tax liability. Because these tax incentives are scheduled to expire after 2010, Congress intends to act to make these provisions permanent. This reauthorization of the federal incentives for 529 college savings plans presents an opportunity to improve upon these accounts and make them a better option for those low-income families who have the greatest need to save for and attend college.

Some states have reached out to low-income families through the design of their 529 plans. Inclusive features such as targeted outreach, no or low enrollment fees, low minimum initial and subsequent contributions, automated features like direct deposit and payroll deduction, affordable management fees, and an "age adjusted" investment option are a few examples. In addition, seven states—Colorado, Louisiana, Maine, Michigan, Minnesota, Rhode Island and Utah—provide matching grants to low-income savers funded by general state appropriations or non-resident user fees. With 529 legislation pending, Congress has an opportunity to partner with states and others to encourage the adoption of inclusive policies nationwide. Some suggestions, ranging from low/no cost to comprehensive changes, are outlined below.

LOW COST

Require a low-cost investment option. States generally offer two types of 529 college savings plans to choose from: a direct sold plan and a broker sold plan. The direct sold plan generally has more inclusive features, such as lower fees, lower contribution requirements, and relatively conservative investment options such as age-adjusted and guaranteed return portfolios, which could be attractive to lower-income families. States should be required to offer at least one direct sold plan with these and other inclusive features. Direct sold plans offered by Alaska, Michigan, and Utah—which have consistently been among the best direct sold plans according to Morningstar—could serve as models.

Facilitate better disclosure and comparison of 529 plans. Thanks to pressure from policymakers and the public, progress has been made over the past year on 529 plan disclosures. Because they are created by state governments, 529 plan investments are not subject to federal security laws such as those covering most mutual funds. In addition, research shows that individuals saving in broker-sold plans were frequently doing so in out-of-state plans, even if they would potentially benefit more from saving in their in-state plans because of state tax incentives. This raised the question of whether brokers were recommending plans that would benefit themselves rather than seeking the best plan for their client. At a minimum, brokers should be required to inform clients about any benefits that exist from utilizing their own state's 529 plan. In addition, the federal government should support efforts to allow the easy comparison of all plans in a particular state and among states. Websites, such as savingforcollege.com, provide a simple comparison of 529 plans which could be promoted or serve as a model. Finally, states should be encouraged to market their direct-sold plans to their residents, which are usually a less expensive alternative to the broker-sold options.

Collect better data on who saves and benefits from 529 plans. Because data is generally not collected about 529 plan accountholders' socioeconomic details, we do not know how plan ownership varies by income and which segments of the population benefit from these tax incentive the most. If this data were collected, it could help shape improvements to 529 plan policies in the future, helping to ensure that tax breaks and other incentives are serving their intended purpose. Useful data about the saving habits of low-income families in 529 plans could be gained from those states offering matching grants, since an application disclosing income must be provided.

Provide more flexibility for plan owners who need to change a beneficiary. Currently, if a person named as a beneficiary does not use any or all of the funds designated for them in a 529 plan, that plan can only be transferred to a member of that beneficiary's family, such as a sibling, parent, or cousin. While this can work well for parents saving for a child, it may be unnecessarily inflexible for a charitable organization, such as a 501(c)3 nonprofit organization, which wishes to save for a particular beneficiary. For example, if a charity wanted to open up 529 plans for kids and then one of the beneficiaries did not use their account, it would have to be transferred to one of his family members, rather than another child the charity wanted to help. This provision should be expanded so that a non-profit organization can name any other person as a beneficiary instead of having to keep the 529 plan within just one family.

MEDIUM COST

Exclude 529 plans savings from public benefit eligibility consideration. Currently, savings in 529 plans generally count towards asset limits in public assistance programs such as SSI, TANF, Food Stamps, and Medicaid. Families needing to go on temporary public assistance therefore may need to spend down these accounts even if they face a penalty in doing so. Instead of penalizing low-income individuals who sacrifice to save for a post-secondary education and the higher incomes that can result, savings for such life-transforming assets as a college education should be allowed and encouraged. States already have the flexibility to exclude 529 plans from consideration in TANF and Medicaid programs, but the federal government could take action so that these accounts are universally excluded across all assistance programs.

Create an innovation fund for state 529 plans. A variety of states and private sector actors have enacted innovative programs within their 529 plans to primarily help low-income kids access college. For example, a few non-profit organizations have offered matches to families saving for college through parallel 529 scholarship accounts. In Oklahoma, 1,000 kids will receive a 529 plan with a starter deposit of $1,000 and their families will be provided with financial education in hopes that they will continue to save for a post-secondary education. Coalitions are being formed in states such as Kentucky and Michigan to look into the possibilities of universal 529s for every child in the state with progressive savings incentives incorporated to help low-income families. The federal government could encourage these types of innovative activities by sponsoring a competitive grant process where states could receive awards to help seed these initiatives.

Add 529s to the list of products eligible for the Savers Credit. The Saver's Credit currently provides a 50% match—in the form of a non-refundable tax credit—to low- and moderate-income people who contribute to a retirement account such as a 401(k) or IRA. To further promote savings in general, a range of savings products, including 529s, could be added to the list of products that trigger this credit. Certainly one could argue that pre-retirement assets – especially a post-secondary education – are critical elements of retirement security, and it should be noted that all IRAs already permit tax- and penalty-free withdrawals for post-secondary education.

HIGHER COST

Support matching grants to low-income savers. The federal government could support states that choose to offer matching grants targeted low-income families saving in 529 plans by reimbursing those states through direct grants. More ambitiously, the federal government could set up formula so that states with the lowest rates of college attendance would receive more federal matching funds for contributions to 529s.

Alternatively or in addition to providing funding to states offering matching funds, the federal government could encourage private companies to offer incentives to their employees to save in 529s. The Education Savings Act of 2005 (HR 3585), introduced by Rep. Jon Porter (R-NV), would allow employers to provide matches directly to their employee's 529 plans without the employee having to pay income tax on their employer's contribution. The Oklahoma legislature considered a proposal (OK Senate Bill 927) to give tax credits to employers who provide matches or other donations directly to their employees' 529 plan accounts. These proposals represent two viable strategies to encourage employers to support the 529 savings of their employees.

Require an ERISA-type balance between higher- and lower-income 529 plan owners. The Employee Retirement Income and Security Act (ERISA) requires that employers who offer a retirement plan must meet certain minimum standards such ensuring lower compensated employees have as much of an opportunity to fully participate as their more highly compensated counterparts. These principles of ensuring a balance between lower and higher income savers could be applied to state's 529 plans, with only states that meet some sort of inclusive minimum standard having their plans qualify for federal tax benefits.