IDEA BRIEF

EDUCATION | FEBRUARY 2010

Relief for College Savings Accountholders

By Tess Stovall, Anne Kim, and Ryan McConaghy

Among the many Americans still reeling from last year's financial crisis are the parents of school-age children with 529 college savings accounts. From 2007 to 2008, parents lost more than $23 billion saved in these accounts because of the financial crash. As a result, thousands of students who had been counting on these savings to help pay for college are now facing an unexpectedly bigger burden. Moreover, many parents will end up locking in the losses on their accounts because current law limits the allowable uses of 529 funds and will force them to cash out their accounts before the markets fully recover. Expanding the allowable uses of 529 account funds to include loan repayment could help provide relief to these students and their parents.

THE PROBLEM

College savings balances have dropped but college costs keep rising

The market crash that accompanied last year's financial crisis devastated the wealth of millions of middle-class families, many of whom saw large portions of their retirement savings or their children's college savings accounts virtually vanish overnight. For parents who've done the right thing in saving for their child's education, this deep and unexpected hit only increases the burden of paying for college.

Families saving for college have lost billions of dollars in wealth.

From December 31, 2007 to December 31, 2008, the S&P 500 plummeted 38.5%—the third worst year in history.[1] In 2008, household wealth dropped by $11 trillion or 18% of total wealth.[2] For the one-third of parents who rely on tax-preferred "529 savings plans" to save for college,[3] account balances dropped by an aggregate total of more than 20% in 2008.[4] This means that for the average family holding an account balance of $13,500 in December 2007,[5] the losses were equivalent to the cost of nearly one semester's tuition at a public university.[6]

Families face escalating college tuition bills.

Parents with young children may have a number of years for the balances in their 529 accounts to recover, but for parents of soon-to-be high school graduates, the massive decline in their balance could mean a delay in college for their children or an increased reliance on student loans.

The cost of going to a public university has risen 80% in just the past 10 years.[7] In 2009-2010, the average bill for just one year of tuition, fees, room and board at a public university was $15,213,[8] and for private schools, the annual average college bill was $35,636.[9] And with the recent economic decline taking a toll on state budgets, tuition and fees are expected to rise even higher for the 2010-2011 school year.[10]

THE SOLUTION

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Under current law, funds from 529 accounts can only be used to pay for qualified higher education expenses, which are defined by the Internal Revenue Code to include tuition, fees, books, supplies, equipment, and, in certain cases, room and board.[11] Qualified expenses do not now include student loans.

Third Way proposes temporarily expanding the definition of qualified higher education expenses to include the repayment of student loans. Thus, families would have the choice of using 529 account funds in the short-term to pay for immediate college expenses or to use the funds in the long-term to help their child repay loans after he or she graduates (after an account recovers its value). This repayment option would be available for four years.

This proposal would help families recover their savings and avoid locking in losses.

This proposal would give families more flexibility in financing their children's education. Under current law, parents of soon-to-be college freshmen will have to withdraw funds from their 529 accounts and realize their losses in the near future in order to use the funds for education expenses that currently qualify for tax-free withdrawal. However, assuming average annual growth of 7%, a family could rebuild its assets to their 2007 level in about four years[12] – roughly the amount of time it would take a child to complete college. Under this proposal, such a family would be able to avoid losses and bring their savings back to a break-even point while a child attended school. The family could then use the recovered savings to repay college costs as originally intended, and, in turn, shorten and lighten the burden of student debt obligations.

This proposal would cost the federal government virtually nothing.

Expanding the allowable uses of 529 accounts would have negligible impact on the federal government's tax expenditures or revenues. This proposal is designed primarily to help families who've already set money aside and have suffered losses, and it is unlikely to affect the amount of savings that families put into 529 accounts in the future.

THE ROLLOUT

Ideas for launching and publicizing relief for college savings accountholders

- **Hold a press conference/speech** with a local high school senior and his or her family who have been investing in a 529 savings account.
- **Hold a press conference/speech** at a local college or university with current students.

CRITIQUES & RESPONSES

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This will force more students to take out student loans.

Because of the losses so many families have taken on their college savings accounts, they likely would have taken out more loans than anticipated anyway. This proposal gives families more flexibility to let their account balances recover and use the funds to pay back student loans more quickly.

Having funds in a savings account will cause students to get less in financial aid.

Funds in a 529 savings plan have minimal effects on a student's federal financial aid assessment. Under the Deficit Reduction Act of 2005, 529 savings accounts are classified as assets of the parents, not the dependent student, if the parent is the owner of the account or plan.[13] This distinction is important because approximately 5% of assets owned by parents are calculated into the expected family contribution (EFC) under the federal financial aid assessment while 20% of the assets owned by students are calculated into the EFC.[14] This proposal would have minimal effects on a student's financial aid package.

Isn't this just allowing people to game the system—waiting until they regain their profits before using the funds?

Not at all. Under current law, the Internal Revenue Code only dictates what the funds from a 529 plan can be used for but not what timeframe they need to be used in. A family could keep funds in a 529 account until a child's senior year in college to maximize the growth potential, and then withdraw the funds to cover all of the tuition for the senior year of college. This proposal gives families the choice of using the funds in their 529 plans to pay for college expenses while a child is in school or helping to repay student loans after a child graduates.

Won't this create new and complicated administrative burdens for states and 529 plan managers?

No. Currently, 529 savings accounts are available to individuals of any age and enrollment is open, so allowing individuals to keep funds invested in 529 savings accounts for a longer period of time will not threaten to "max out" the system. Enrollment fees, administrative fees, and contribution guidelines would not be impacted by this proposal, and distribution for student loan repayment would be no different than distribution for expenses that currently qualify.

APPENDIX

Background on 529 Savings Plans

Qualified tuition programs, or 529 plans (named for the section of the Internal Revenue Code that created them), are college savings accounts that have specific tax advantages. Parents have the option of choosing between the more traditional prepaid tuition plan, in which payments are typically made into a state-backed fund on the basis of current tuition costs, or the more popular college savings plan, which operates in a manner similar to a 401(k) and allows invested funds to grow based on market returns.[15] The plans are administered by individual states, but a parent can start a plan in any state.[16] The account funds can be withdrawn tax-free as long as they are used for qualified education expenses as defined in the Internal Revenue Code.[17] In most cases, two parents can invest up to $26,000 per child, or $13,000 per tax filer.[*]

529 accounts have become increasingly popular since their introduction in 1996.[18] In 2001, only 7% of parents reported using a 529 plan for college savings, versus one-third of parents today.[19] Currently, qualified higher education expenses, or allowable uses of 529 accounts funds, include tuition, fees, room and board, books, supplies and equipment required for enrollment at a college or university.[20] Funds withdrawn that are not used for the above qualified expenses are subject to income taxes as well as a 10% penalty owed on the earnings.[21]

* Contributions to 529 savings accounts fall under the federal annual gift tax exclusion rule. In 2009, a taxpayer can contribute up to $13,000 in a year to a single individual without having to pay taxes on the gift. A taxpayer can also make a special five-year election which means they can make a $65,000 lump sum contribution to a 529 account and treat it as if the gift were made over a five-year period. See http://www.savingforcollege.com/529_news/?page=plan_news&plan_news_id=943.

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ENDNOTES

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