Research Background Paper

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Implications for Policy and for a Children and Youth Savings Account Policy Demonstration

Margaret Clancy

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George Warren Brown School of Social Work

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Margaret Clancy
mclancy@gwbmail.wustl.edu

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Center for Social Development
Washington University in St. Louis
One Brookings Drive, Campus Box 1196
St. Louis, MO 63130-4899
(314) 935-7433

The University of Kansas
School of Social Welfare
1545 Lilac Lane, Room 207
Lawrence, KS 66044-3184
(785) 864-2385

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In support of college saving, the federal government has created incentives for families to set aside money for college expenses. Implemented by the Small Business Job Protection Act of 1996, Internal Revenue Code Section 529 authorizes Qualified Tuition Programs (QTP). A QTP is established and maintained by a state, under which a person may make after-tax deposits to (1) prepay tuition benefits so that the beneficiary is entitled to a waiver or a payment of qualified higher education expenses—*prepaid tuition programs*, or (2) contribute to an account that is established for paying qualified higher education expenses of the beneficiary—*college savings plans* (U. S. Treasury, 1997).

A primary goal of the Children and Youth Savings Account Policy Demonstration (CYSAPD) is to operate in a cost-effective manner and to demonstrate a program that may eventually serve millions of people. Accordingly, consideration should be given in CYSAPD to using college savings plans for parents saving for the education of a child, and for teens interested in saving for post-secondary education. This paper addresses college savings plans, followed by design and research implications for CYSAPD.

I. COLLEGE SAVINGS PLANS

Approximately 35 states have qualified college savings plans in operation, and all but six of them are available to non-residents of the sponsoring state. An additional 6 states will open college savings programs by the end of the year (Johnston, Manson, & Smith, 2001). Typically, each state selects one professional money manager, such as TIAA-CREF or Fidelity Investments, to act as program manager and to provide a centralized accounting system for managing plan investments.

Qualified uses. College savings plans are designed to help people save for specific qualified expenses: tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution. An eligible educational institution is any college, university, vocational school, or other post-secondary educational institution eligible to participate in student aid programs administered by the U.S. Department of Education. Institutions include public and non-profit schools, but also privately owned profit-making post-secondary institutions (Internal Revenue Service, 2000). Recent changes have expanded qualified uses to include expenses of a special needs student that are necessary in connection with school attendance (Joint Committee on Taxation, 2001).

Tax benefits. In addition to providing a vehicle to save for future education expenses, college savings plans offer four attractive tax benefits. First, although formerly taxed at distribution, the Economic Growth and Tax Relief Reconciliation Act of 2001 (Tax Relief Act) excludes QTP earnings from federal taxes effective in 2002. Thus, earnings on college savings plan withdrawals will be free from federal income taxes.[1] Second, over 70 percent of plans feature state tax-free withdrawals. Third, approximately 40 percent of the plans offer annual state tax

[1] Since contributions to QTPs are after-tax, all qualified withdrawals are free of federal income tax.

deductions for qualified savings plan contributions (Johnston, Manson & Smith, 2001). Fourth, high-wealth individuals can make contributions on a beneficiary's behalf to reduce estate taxes. Non-taxable contributions to a QTP can exceed the maximum gift tax exemption of $10,000 per person per year, up to $50,000 per beneficiary in a single year [2] (Internal Revenue Code Section 529(c)(2)(B)).

Maximum lifetime contributions. State college savings plans set lifetime maximum contributions per beneficiary. Yet, given that contributors are not restricted to programs in their state of residence, contributions are ultimately limited not by an individual state's maximum lifetime contribution, but by the maximum amount necessary to provide for the higher education expenses of the beneficiary. For example, although New York sets maximum lifetime contributions of $100,000, a resident can take advantage of the maximum contribution in that state and then contribute to any of the other state college savings programs available to non-residents.[3] Accordingly, investment brokers are targeting affluent grandparents and professionals with high current income who are interested in reducing their tax burdens (Weinrich, 2001).

II. IMPLICATIONS FOR CYSAPD

Account ownership. College savings plan assets belong to the parent (or contributor), not the child. The contributor creates an account and designates a specific beneficiary.[4] Thus, the taxpayer making the contribution is the owner and benefits from any favorable tax treatment (deductions and/or tax-free growth). For youth accounts in CYSAPD, the account owner can also be the beneficiary.

If a college savings plan account is to be used in CYSAPD, restricted matching or achievement-based contributions by tax-exempt organizations will be made into a separate account. It is noteworthy that TIAA-CREF, the largest manager of QTPs, operates separate entity accounts, used for contributions by 501(c)(3) organizations or state and local governments.

For example, in California, TIAA-CREF Tuition Financing uses entity accounts to manage and administer the Governor's Scholarship Programs (separate from the college savings plan, ScholarShare). Monetary awards are deposited electronically into scholarship accounts for students who demonstrate high academic achievement on various exams. The accounts are owned by the state of California with the student named as a beneficiary. Students can view account information on-line and download forms to make qualified withdrawals. Accounts are invested in a guaranteed investment option and receive interest until they are withdrawn to pay for qualified higher education expenses (Golden State ScholarShare, 2001). TIAA-CREF processes the withdrawals and sends qualified awards directly to the eligible educational institution. With approximately 70,000 active accounts, the California Governor's Scholarship Programs may provide an excellent model for the planned CYSAPD matching or achievement-based contributions.

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[2] Any excess over $10,000 is spread ratably over a five-year period.
[3] Annual tax-free gifts are limited by IRS Code Sec. 529(c)(2)(B), as noted previously.
[4] College savings plan accounts can be established at any age, and unlike education IRAs, are not subject to a mandatory distribution age.

Low contributions, flexibility, and costs. The majority of college savings plans include features such as low minimum contributions and flexibility. Accounts may be opened with a $25 check, money order, electronic funds transfer, or with as little as $15 through an automatic plan deposit. Participants usually have the ability to access accounts on-line, to call a toll-free telephone number for assistance, to contribute every pay period using payroll deduction through participating employers, and subject to certain limitations, to change a beneficiary designation. Each state determines the cost structure of their plan, but contributors can choose to shop among states. In fact, due to their low fees and age-based investment options,[5] college savings plans in Utah, Michigan, Missouri, and New York are recommended to residents of any state (Johnston, Manson, & Smith, 2001). The combination of market competition and volume may help to keep fees reasonable.

Low contribution requirements, flexibility, and low costs are features that are well suited for either CYSAPD or a large-scale policy initiative. Also, the possibility of on-line account access could provide an opportunity for CYSAPD youth to experience computer technology.

Withdrawal restrictions. Internal Revenue Code Section 529(b)(3) states that the QTP must impose a "more than *de minimis* penalty on any refund of earnings from the account." Exceptions exist in the case of the beneficiary's death, disability, or receipt of scholarship. The refund penalty for a non-qualified withdrawal is typically—although it varies among plans—a state tax of 10 percent of the untaxed *earnings* (unlike a penalty of 10 percent of the pre-tax savings *balance* in a pre-tax 401(k) plan). In other words, since contributions to college savings plans are after-tax, the penalty amount on untaxed earnings is small compared to the penalty imposed on pre-tax 401(k) plan contributions and earnings.

Beginning in 2002, a new 10 percent of earnings federal penalty will be introduced, and the above-mentioned refund penalty requirement will no longer apply (Joint Committee on Taxation, 2001). Therefore, it is expected that many states will remove existing penalties (Hurley, 2001).

In the case of a non-qualified withdrawal, the earnings portion is taxed at ordinary income rates, and the contributor must pay state income taxes on deposits only if a deduction was allowed in the year of the contribution. Rhode Island imposes a $50.00 exit fee, passed on to their state program manager, for non-qualified withdrawals or for transfers between plans. Exit fees imposed by program managers may become more common to discourage movement of funds between state plans (La Croix, 2001). In addition, some programs require a minimum period (e.g., Missouri imposes a twelve-month month wait period) before qualified withdrawals may be taken (Missouri Saving for Tuition Program, 2001).

Research from the American Dream Demonstration (ADD) of Individual Development Accounts (IDAs) reveals that some participants use their IDA passbook savings accounts as transaction accounts (Schreiner et al., 2001). College savings plan restrictions may to some extent both harm and benefit CYSAPD participants by deterring them from making unqualified withdrawals. Based on the views of many ADD participants, contractual restrictions on withdrawals are likely to be viewed as more positive than negative.

[5] An age-based investment option gradually shifts the asset allocation from equity to fixed investments as the beneficiary ages.

Need-based financial aid. Savings balances and the effect on financial aid may pose a concern for CYSAPD in general. College savings plans are treated as the asset of the account owner, and gains from an account are treated as income to the beneficiary only in states without tax-free withdrawal rules.[6] Just as IDA account balances are not counted against public assistance needs tests, perhaps QTP account balances of low-income individuals—up to a certain threshold—should not be considered when determining eligibility for financial aid.

The law enacting the California Governor's Scholarship Programs states that awards shall *augment* and not supplant student financial aid from other California public sources. The accounts are not included in the federal needs analysis for student financial aid, as they are assets of the State of California and are not owned by the student (Golden State ScholarShare, 2001).

Creditor protection. Eleven qualified college savings plans are governed by express statutory language insulating the plans from creditors (Kwall, 2001); however, other state plans offer no protection against claims. While the threat of claims by creditors is a concern for participant IDA savings, match dollars are not subject to such threat since they are never commingled with participant savings. If contributions from friends or relatives are funneled into a CYSAPD college savings plan account through the contributor, the donors must be aware that the account is exposed to such risk.

III. TRENDS IN COLLEGE SAVINGS PLANS AND IMPLICATIONS FOR CYSAPD

College savings plans as employee benefits. The tax exemption on federal earnings, coupled with the desire of investment professionals to find an alternative to a saturated 401(k) market, create significant growth prospects for college savings plans (Johnston, Manson & Smith, 2001; Weinrich, 2001). Consequently, there is a trend toward incorporating college savings plans into corporate after-tax employee benefit offerings. Private or public employers hold meetings, explain the program, and facilitate employee participation through payroll deduction (Burzawa, 2000). Often the program manager will conduct employee educational seminars free-of-charge as part of their marketing efforts. Since the rules and features of college savings plans may seem complex to some potential participants, sales to less sophisticated investors are likely to occur through employers. In fact, one professional money manager notes that their current college savings plan breakdown is approximately 90 percent retail and 10 percent corporate, but he predicts that the split will reverse in the future (St. Goar, 2001).

It appears that college savings programs represent the new wave for tax-sheltered asset accumulation among high- to moderate-income individuals. Will college savings plans offered as employee benefits attract low-income employees? At what rate will low-income employees be offered the opportunity to participate? The answers to these questions will be critical to anyone concerned with inclusion in asset-building policies.

[6] The Tax Relief Act of 2001 eliminates issues related to federal gains, and the majority of states allow tax-free growth of earnings.

Given that marketing of the tax benefits of college savings plans may be directed toward high-wealth populations, financial information and educational materials targeted for low-income families may be a key to participation by that group. The experimental design for CYSAPD should measure the effects of outreach and financial education on participation and savings (Beverly & Clancy, 2001).

College savings plans and matching grants. Certain states provide additional college benefits to low- to moderate-income individuals. For example, concurrent with IDA saving, Vermont offers a match to low-income college savings plan participants. Similarly, for households with a family income of $80,000 or less, Michigan provides a matching grant of $1.00 for each $3.00 contributed by state residents to their college savings plan. The lifetime maximum state match is $200, available during the first year of enrollment only, if the beneficiary is six years old or younger (Michigan Department of Treasury, 2001). In contrast, at end of their IDA demonstration, Oregon allows participants to roll over participant savings and match funds into a college savings program.

Supplemental contributions to college savings plans for low- to moderate-income families presents some similarities to the design for CYSAPD; however, supplemental contributions are in early stages and are not fully tested. At this time, Vermont has raised limited funds and opened approximately fifteen accounts. Oregon plans to open the first separate match account in January 2002. Perhaps of concern, a recent ranking identifies Oregon as a leader among plans with the highest expense ratios—direct portfolio expenses in additional to broker-sold sales charges (Johnston, Manson & Smith, 2001). Michigan's plan may be comparable to CYSAPD design, although families must enroll young children to receive the benefit of the match. Additional research on each state's college savings plan is recommended.

IV. ADVANTAGES OF COLLEGE SAVINGS PLANS FOR CYSAPD

College savings plans provide advantages for CYSAPD for three reasons. First, there is an opportunity for a reduced amount of responsibilities of the CYSAPD sponsoring organizations. In college savings plans, one program manager typically holds accounts, creating a centralized accounting system. This arrangement differs fundamentally from the decentralized operations of Roth IRAs or passbook savings accounts generally used by IDA programs. If college savings plans are chosen as the savings vehicle for CYSAPD, participants will open an account, and a separate account will hold the restricted contributions by tax-exempt organizations. A distinct system for managing the financial data will not be required. In this case, the program manager—not the CYSAPD sponsoring organization—is responsible for tracking financial data and for processing qualified withdrawals. However, college savings plan program managers are not currently calculating match contributions; thus, achievement-based or fixed contributions may be best suited for this arrangement.[7]

[7] For further discussion of matching contributions, see Clancy, Johnson, and Schreiner, "Savings Deposits, Match Structure, and Management Information Systems: Implications for Research on CYSAPD."

A second advantage of college savings plans is that there is a precedent for supplemental contributions by 501(c)(3) organizations or state governments. A few states have already considered low- to moderate-income families in their current college savings plan design. Such precedent may facilitate changes to state policy post-CYSAPD.

Third, choosing college savings plans as the savings vehicle positions CYSAPD well beyond a short-term demonstration phase. College savings plans are established as long-term accounts, and state-hired program mangers plan to oversee qualified withdrawals well into the future.

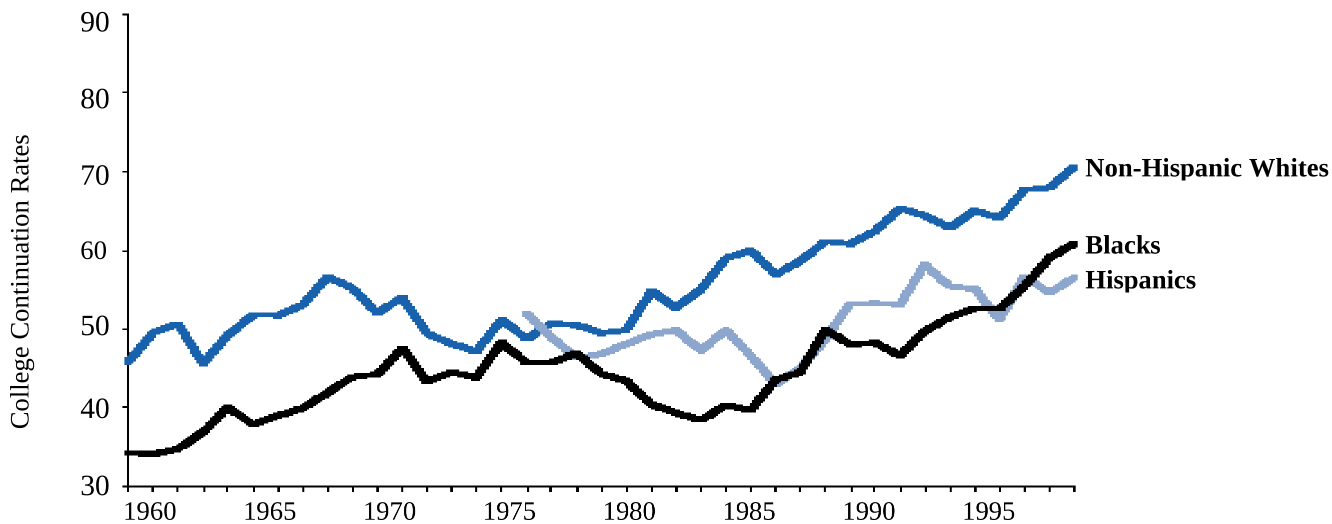
Implications for Policy

Over the past 25 years, enrollment in post-secondary education by high-school graduates has been rising among all racial, ethnic (Figure 1), and economic groups (Morenson, 2000). Yet at the same time, tuition has also been rising—much faster than inflation—and the cost of college attendance as a share of family income has increased most dramatically for lower-income populations (The College Board, 2000). In fact, while college costs as a percentage of income have remained relatively flat for the highest- and middle-income quintile families, costs have skyrocketed for families in the lowest-income quintile (Figure 2).

In college savings plans, enormous tax incentives have been created to encourage families to save for college expenses; however, these tax incentives primarily benefit upper- and middle-income families since low-wage earners do not have a great deal of tax liability. Furthermore, low-income families do not have significant wealth to transfer other savings balances into college savings plans. Smaller contributions may be made over time, but provide less opportunity for significant tax-free earnings accumulation. Wealthy individuals may make large deposits when the child is very young, and reap the benefits of long-term tax-free growth.

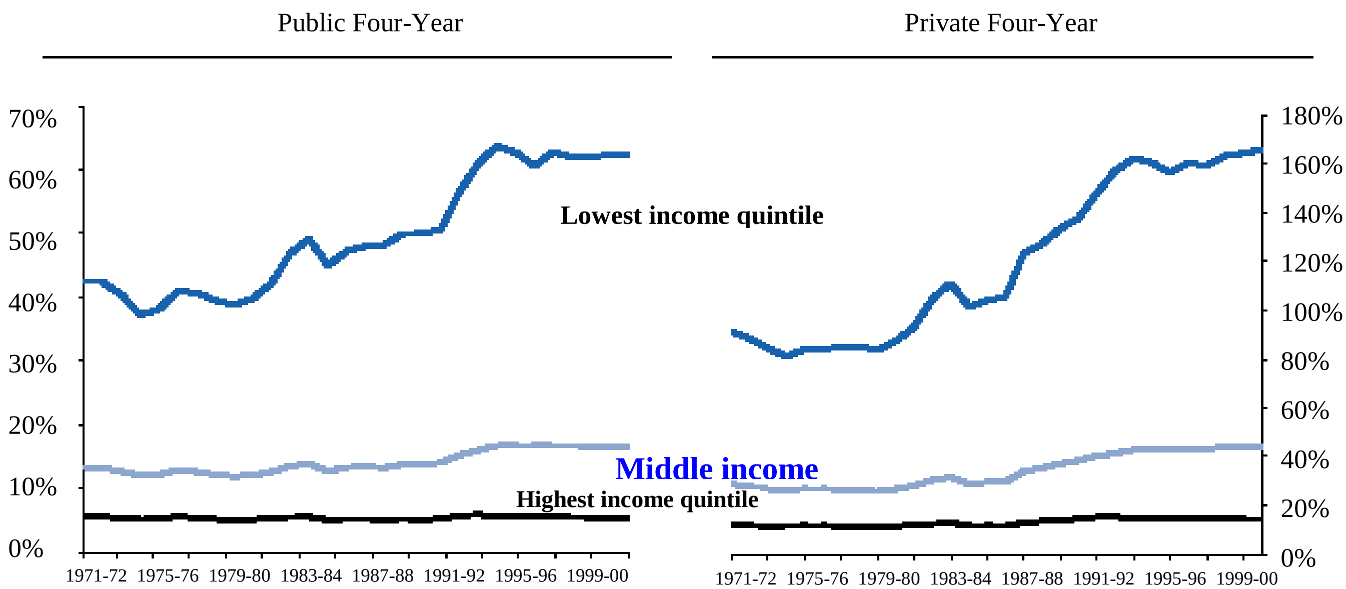
In conjunction with participant college savings, achievement-based or fixed contributions by government or non-profit organizations may well promote inclusiveness. Using CYSAPD to demonstrate the progressive potential of college savings plans could make a significant contribution to inclusive asset-building policy.

Figure 1: College Continuation Rates for Recent High School Graduates, by Race/Ethnicity, 1960 to 1998



SOURCE: Mortenson, T. (2000). *Postsecondary Education Opportunity*, Oskaloosa, IA. Analysis based on U.S. Census Bureau data.

Figure 2: Cost of Attendance as a Share of Family Income, 1971–1972 to 2000–2001



SOURCE: *Annual Survey of Colleges*, The College Board, New York, NY; data pre-1984–1985 from Integrated Postsecondary Education Data System (IPEDS), U.S. Department of Education, National Center for Education Statistics; income data from the U.S. Department of Commerce, Bureau of Labor Statistics.

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