6 Reasons Why 529 Plans are the WORST WAY Way to Save for College

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For more than 20 years, millions of families have used 529 accounts to save for their children's college education. The reasoning behind them makes sense – college tuition and expenses have skyrocketed far beyond what the average family can pay on its own. If a family can save to get ahead of those expenses or at least reduce them, then reason would suggest that it's a smart decision to pump tens of thousands of dollars into a 529 savings account.

But what if those millions of families were wrong all along? Or perhaps better said, are the millions of families using 529 plans aware of their many drawbacks? Do you know that using 529 plans can actually *increase* the amount of money you have to pay for your child's college education?

This report pulls the curtains off 529 savings plans and exposes them for what they really are – the worst way to save for college. Here are six reasons why.

Reason #1: Too. Many. Choices.

Have you ever looked at a menu that was too large and had a hard time deciding what to eat? The menu of 529 plans is similarly preposterous. Each of the 50 states (plus the District of Columbia) has a least one to choose from. Plans vary from state to state. For example, one state may offer better investment options and project better return rates than another. Many states allow you to deduct 529 contributions from your state taxes if you are a resident (more on this later). Some have easy-to-use websites that take the stress out of setting up and monitoring an account. And nearly all states allow you to open a 529 plan in their state without even being a resident in it.

While all these choices can be considered a positive, consider this: think about all the time and effort you have to spend researching and comparing the different plans offered by each state. Investment risk options, sales charges, account fees – all differ between more than 50 separate plans. The overload of options and the time you spend researching each can be a serious source of stress that causes you to delay even starting a fund.

Reason #2: Lack of Control Over Your Investments

When doing your research on 529 plans, you'll be presented a flood of different investment options. But the truth is that you only have one – market-based mutual funds. That's it. Your "choice" is basically which levels of risk/return you wish to pursue and – depending on the plan you choose – what proportion of your savings account you wish to allocate to certain levels of risk/return. That's the extent of your control over your own money.

Who exactly are the people investing your money? Great question. Good chance you'll never know who he/she is, let alone get a chance to speak with them. Accounts are managed by money management firms contracted by each state. Those firms set up your selection of mutual fund options. Your plan's manager determines how and where to invest your 529 account funds.

As you probably know, a mutual fund's performance depends a great deal on how the stock market performs. Since 1996, yes, the stock market has done very well. It's done so well, in fact, that you may have forgotten about some of the major stock market setbacks since then. Depending on when you wish to cash out your child's 529 account, a recession or prolonged bear market can wipe out as much as tens of thousands from the savings account.

For example, let's say that your daughter was set to begin college the fall of 2009. Since the late 1990s, you've pumped $150,000 into her 529 account hoping that will cover much of her college expenses so that she (or you) won't be saddled with a six-figure loan after she graduates. Your plan was dependent on the success of the stock market, which did well until the fall of 2007. The Great Recession soon followed and the market continued to fall through all of 2008 before beginning to recoup losses in the spring of 2009. Repeat – *all* of 2008. The

Dow dropped 33.8% that year. The S&P 500 fell 38.5%. And the Nasdaq plunged 40.5%. Nothing was safe.

Imagine the headache and heartbreak of seeing your daughter's entire college savings lose money day-by-day, month-by-month for 15 months straight! This demands a very difficult question: Are you willing to risk tens of thousands of dollars that the stock market "behaves" in the months before you plan to start withdrawing?

Reason #3: Penalties for Certain Withdrawals

Speaking of withdrawing, you can be charged for that. If you withdraw money from a 529 account for a reason other than paying for "qualified higher education expense," you'll have to pay tax on those earnings PLUS a 10 percent penalty. But what exactly is a qualified higher education expense? And what isn't considered a qualified higher education expense? Plans have different answers for those questions, again making the process of choosing even more difficult. A wrong decision can cost you thousands.

We all know that college expenses don't stop at tuition, room, board, and books. Such a big gray area of uncertainty is often not worth the risk of paying unexpected taxes on a big-ticket item that is college-related to you but not according to the guidelines of the 529 plan. For example, if your daughter goes to college in another state, it's likely that you'd buy her a car too. But does that count as a qualified expense? It's a valid question. But unfortunately, it's hard to get a clear answer on it.

Let's use a stock market crash as another example. It would seem to make sense to pull your money out of a 529 account if the stock market tanks, right? But again, withdrawing money from a 529 account for this purpose is not an educational expense, and therefore your earnings will be taxed (assuming you have any earnings left at this point) and levied a 10 percent penalty.

Reason #4: Contribution and Account Limitations

Plans vary greatly from state to state, and some put a cap on how much you can contribute to a 529 plan. For all plans, contributions have to be cash only. Stocks and mutual funds can't be rolled over into a 529 account. Also, all states require only one beneficiary for each account. If you are a grandparent, you can't have a pool account for all of your grandchildren. Each potential college student has to have their own account, which means you'll have to manage a separate account – the contributions, withdrawals, account monitoring, etc. – for each child.

Reason #5: New Tax Law May Undercut State Tax Deduction

As stated earlier, many states try to encourage more people to save with 529 plans by offering an incentive – 529 contributions can be deducted from your state taxes. Thirty-three states offer this plan, and states have different limits to how much can be deducted. When families in those states make a contribution, they get back some of that money when they file their state taxes. But provisions in the new tax law puts these 33 states between a rock and a hard place when it comes to offering these tax breaks.

Here's why. The new tax law expanded what kinds of education that 529 plans can be used for. Previously, 529 accounts were only for college savings. But now they can be used to save for private schooling from kindergarten through high school. Now, this appears to be a big win for everyone. On an individual level, more people get tax breaks for education savings. On the corporate level, more accounts means that investment fund managers will collect more fees. Win-win, right?

But for those 33 states that offer local tax breaks, it's a huge loss. With the tax law change, the biggest perk of 529 plans – state tax deduction – is in jeopardy of continuing. The worry is that millions of people will now open 529 plans for their children's K-12 education. On this fact alone, states will have to bump up their staff and payroll to handle the flood of new accounts.

Then let's consider investor behavior when tax breaks are dangled on a stick right in front of their noses. By nature, paying for a child's private kindergarten tuition is a short-term investment compared to longer-term investments such as college savings. So even a gigantic stock market run up won't produce meaningful returns because the money is barely in the savings account for a couple years, if even that.

So why would a family even use a 529 account to pay for private kindergarten? Tax avoidance and tax refunds. There is no minimum time frame that money has to stay in a 529 account in order to get a tax refund. You can make a $1,000 deposit today, withdraw $1,000 tomorrow to pay for kindergarten, and still claim $1,000 in 529 account contributions on your state taxes. And by the letter of the law, it's perfectly legal, so who can blame anybody for doing exactly this?

In effect, 529 plans will no longer be just long-term savings vehicles, but also a place to dump money directly from your paycheck (federal tax avoidance), withdraw the money to pay for private kindergarten, and then claim those contributions at the end of the year (state tax refund). Everybody gets a tax break! Seems like a great thing, right? No. Again, the sweeping changes in the new law will create a flood of new 529 accounts, which means those 33 states will be giving back much more tax revenue each year. Experts believe this will hit state budgets hard. As a result, they may be inclined to reduce or eliminate the state tax breaks for 529 plan contributions.

Take Pennsylvania for example. It has the highest deduction limit for 529 account contributions. But it's also one of the most politically volatile states. Government shutdowns happened on the watches of the state's last three governors – 2007, 2013, and 2016 – because they couldn't agree on a budget with lawmakers. Every year, what goes and what stays in the state's budget is a fresh mess. But both sides can agree that the stampede of new 529 accounts will bleed money from the state's budget. That makes it more likely that plan's tax breaks are put on the budget's chopping block. You can only imagine how many families are counting on an annual state tax refund – one of the few actual good perks of 529 plans – and this refund could disappear overnight because states may now deem them unaffordable to maintain.

Reason #6: Endanger Your Child's Ability to Qualify for Financial Assistance

Finally, and perhaps most importantly, a well-funded 529 plan can reduce your beneficiary's ability to receive income-based financial aid. Years from now – if not already –

you will fill out the Free Application for Federal Student Aid (FAFSA) application. What you write on the FAFSA will determine which forms of financial assistance your child qualifies for – scholarships, grants, work-study jobs, loans, etc. Obviously, the totality of a family's assets (i.e. what a family can contribute on their own toward tuition) plays a big factor in this.

A significant portion of a 529 account's assets – 5.64% to be exact – counts as expected family contribution in the FAFSA application. This could disqualify your child from a variety of financial assistance that could knock thousands off their tuition bill or qualify him/her for low-interest loans that will save thousands over the course of decades.

If you scraped and saved as much as you could and threw it all in a 529 Plan, the net result could be that your child's college education may cost more.

Time to Rethink the 529 Strategy

There is no perfect investment. Every strategy has some drawbacks and risks no matter how safe it seems. Taking a hit on your investment portfolio is one thing. You have to expect that to a certain degree. But when your children's college savings starts losing value, it's time to rethink your strategy.