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College Savings Accounts: How Arizona Can Help More Families Afford College Education

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EXECUTIVE SUMMARY

Our nation faces a crucial dilemma: postsecondary education is increasingly a requisite to meaningful participation in an information economy, but college costs are skyrocketing, placing such education out of financial reach for many. If we do nothing to solve the problem at the front end, we will face a Hobson's choice of importing increasing numbers of college-educated workers from abroad, outsourcing professional jobs, or increasing taxpayer subsidies to college students.

Arizona can avoid that dilemma by making it easier for families to save for their children's college education. The vehicle is a college savings account commonly called a 529 plan, into which parents or others can make after-tax contributions that can be redeemed tax-free, so long as the money is used for postsecondary education. Last year, Congress made permanent the tax-free redemption status of 529 plans. Thirty-two states provide deductions or credits from state income taxes for 529 contributions. Income tax deductions are a low-cost means for states to encourage families to provide for their children's educational future.

Arizona is one of the few states that does not provide deductions for 529 contributions. Given our booming population and the fact that most of Arizona's postsecondary institutions are publicly financed, taxpayers face enormous costs unless the state facilitates family savings for college. By examining and adopting policy innovations from other states, Arizona quickly could step to the front of the parade, setting a national standard for promoting family self-sufficiency in postsecondary education.

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The Backdrop

Introduced in the late 1990s, 529 college savings accounts were designed to address the problem of college costs increasing at twice the rate of inflation. The accounts are similar to Individual Retirement Accounts (IRAs) or 401(k) retirement savings accounts in that earnings grow tax-free toward a specific goal. However, 529 plans are better than traditional IRAs because the savings can be withdrawn tax-free, so long as they are used for college expenses. Anyone can open a 529 account for a designated beneficiary, and the account owner directs the investments. But unlike IRAs, investors must choose a plan sponsored by one of the 50 states.

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Congress initially adopted a temporary timeline for federal tax-free withdrawals from college savings accounts, for qualified expenses. Last year, it made that tax-free redemption status permanent.[1] By the end of 2006, Americans had invested over $90 billion in their children's future education through 529 plans.[2]

Every state has set up contracts with one or more investment firms to provide 529 plans (or have created their own state-run programs). Typically, up to $341,000 can be invested in the plans. The plans are owned and directed by the investor, usually a parent, and revert to the owner, who can recover the funds and pay taxes on them if the funds are not used for education. Savings can be invested in any state's plan, not just the beneficiary's home state plan.[3] The 529 plans typically provide an array of investment options, usually mutual funds, that range from age-based plans that grow more conservative as the student reaches college age, to plans that correspond with the account owner's tolerance for risk.

Initially, many of the funds (including Arizona's) were beset by high fees and limited investment options, offsetting the tax benefits. But fierce competition for the deposits has resulted in reduced fees and greater investment options; therefore, some states, including Arizona, dropped their high-cost, poor-performing plans. As a result, the underlying annual expenses for funds in 529 plans have fallen by between one-third and one-half, and most plans have dropped enrollment fees, which were as high as $90. Many funds waive annual fees for in-state investors, for those with high account balances, or for those who use direct deposit. As a result, most 529 plans now are a vehicle for low-cost, low-minimum investments. Because roughly 70 percent of existing 529 contracts with states—representing $42 billion in assets—expire in 2010, fierce competition should result in lower

fees and wider choices that will make the deal even better for families.[4]

Tax policy appears to influence investments in 529 accounts. A survey last fall by Fidelity Investments found that more than half of parents with children age ten or younger were more likely to open 529 college savings accounts because Congress made the income tax-free redemption status permanent. After this policy was made permanent, Utah's plan took in $84 million between Thanksgiving and the year's end, a 47 percent jump from the same period the year before.[5] State tax policy likewise could help induce families to save for their children's college education.

State Policies

Arizona is one of only nine states with a state income tax that does not provide deductions or credits for 529 college savings contributions.

Thirty-two states provide income tax deductions or credits for contributions to 529 plans. Of the 18 that do not, half have a good reason: they do not have income taxes. So Arizona is one of only nine remaining states with a state income tax that does not provide deductions or credits for 529 college savings contributions.[6]

The specifics for the tax benefits vary widely among the 32 states that offer them.[7] Lately, the trend is to create more generous tax incentives and broader choices for families saving for college. Arizona could catapult from laggard to leader in promoting college self-sufficiency for families by combining the most progressive elements from other states.

- ***Credits versus deductions.*** Most states offer state income tax deductions (which decrease tax liability), but others sweeten the incentive by providing income tax credits (which reduce the amount of tax owed). Thirty states offer deductions—for example, Vermont has established a 10 percent income tax credit up to $2,500, and Indiana has created a 20 percent tax credit for contributions up to $5,000.

- ***Cap versus no limit.*** Most states offering tax incentives do not limit the income level of eligible families or the maximum tax deduction, but some do. Given that four years of college can cost over $160,000—and graduate school easily can double that amount—it makes sense to encourage all families to save, so that subsidies, loans, and scholarships can be reserved for the truly needy.

- ***Deductions for account owners versus deductions for all.*** Thirty-one states that provide tax benefits for 529 college savings plans limit them to account owners, typically parents. But one state, Louisiana, this year created a truly progressive charitable system: it provides annual deductions up to $2,400 per year per beneficiary (or $4,800 for married couples) for families saving for their own children; but allows double deductions (up to $4,800 for singles and $9,600 per couple) for 529 account contributions for eligible needy, non-related beneficiaries. Such deductions are almost certain to save the state money, because they benefit children who likely would qualify for college assistance. And they will make college accessible for children who might not otherwise be able to afford it. Providing tax benefits to relatives, rather than account owners only, also would promote college savings.

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- ***In-state versus out-of-state savings plans.*** Until recently, states provided deductions only for contributions to their own approved college savings plans. But as of this year, three states—Kansas, Maine, and Pennsylvania—allow deductions for contributions to plans sponsored by any state. Such flexibility promotes healthy competition for contributions, encouraging even better deals for families. Arizona's approved 529 plans no longer rank in the bottom among the plans offered in the 50 states, but they still are not at the top.[8]

- ***Rollovers and carryovers.*** Many states that provide deductions only for in-state 529 plans allow deductions for amounts rolled over from plans from other states. Several states that cap the amount of deductions allow carryovers of excess contributions from prior years.

Making Arizona First for College Self-Sufficiency

Arizona would benefit greatly by providing tax benefits for college savings. Because all of Arizona's main postsecondary institutions are public, the student aid provided by such institutions is largely taxpayer-funded. To the extent that students who attend Arizona public colleges and universities are self-sufficient, it would reduce the burden on taxpayers and allow scholarships to be focused on students with the greatest need.

Arizona can take the lead by providing uncapped tax benefits for families saving for college by providing benefits for taxpayers contributing to college savings for other people's children (particularly the needy) and by allowing families to choose the best 529 plans for their children. If Arizona takes these steps, it will go from worst to first in providing opportunities for financial self-sufficiency in postsecondary education.

Notes

The author thanks Goldwater Institute Ronald Reagan Fellow Barbara Smith for her research assistance.

1. See Nicole Bullock, "A Fresh Look," *SmartMoney*, March 2007, p. 96.

2. Jane J. Kim, "The Best and Worst 529 College Savings Plans," *Wall Street Journal*, March 1, 2007, p. D1.

3. See Bullock, 94-97; Kim, D-1-D-2.

4. Bullock, 96-97; see also "College Just Got Cheaper," *Kiplinger's*, April 2007, p. 17.

5. Bullock, 94 and 96.

6. The states that have an income tax but do not provide deductions for 529 contributions are Alabama, Arizona, California, Hawaii, Kentucky, Massachusetts, Minnesota, New Jersey, and North Dakota. Those states that have no income taxes and do not provided deductions for 529 contributions are Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington, and Wyoming. All others have income taxes and provide deductions or credits for 529 contributions.

7. Data from states was gathered from www.savingforcollege.com, which provides comprehensive information about state policies and various 529 plans.

8. See Russ Wiles, "College Investment Funds in Ariz. No Longer Losers," *Arizona Republic*, March 2, 2007, p. D1.

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