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529 Plan Use Within Advisory Programs

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Introduction

Fund investors have numerous ways in which to receive and pay for investment advice from financial professionals.[1] Traditionally, many investors have participated in a commission-based model through a broker-dealer, where the fee for advice is tied to and included with the transaction to acquire or sell shares. In recent years, some investors seeking advice have migrated toward an asset-based fee model offered by a registered investment adviser (RIA) or within a fee-based advisory program at a broker-dealer. The RIA, acting in the best interest of the investor, creates an asset allocation among recommended securities and periodically rebalances the investor's accounts to maintain an optimal asset allocation over time. The investor is charged an asset-based fee for advice that is based on a percentage of the investor's assets under management in the advisory program. The fee is often withdrawn from one or more account positions held within the advisory program.

While advisory programs have included mutual fund shares for quite some time, their use has been far less common for qualified tuition plans created under Section 529 of the Internal Revenue Code.[2] A 529 plan is a tax-advantaged investment vehicle that encourages saving for the education expenses of a designated beneficiary and is sponsored by a state, state agency, or educational institution.

Recently, members of the Investment Company Institute's Broker-Dealer Advisory Committee's 529 Plan Task Force began exploring how 529 plans could be offered in advisory programs. Task force members noted that some 529 plan attributes may present unique challenges when offered in an advisory program, especially the treatment of advisory fees and investment option changes. To date, there is only one advisory model 529 plan available, although some 529 plans offer advisory or institutional share classes for use by intermediaries in fee-based advisory programs. In response, a working group of the task force prepared this white paper to explore the use of 529 plans by intermediaries within advisory programs, highlighting key considerations for 529 plan program managers[3] and intermediaries.

Regulation Best Interest

Effective June 30, 2020, the Securities and Exchange Commission adopted Regulation Best Interest (Reg BI) regarding standards of conduct for broker-dealers when making a recommendation on any securities transaction or investment strategy to a retail customer, such as investing through a commission-based versus advisory arrangement.[4] For organizations offering 529 plans in both arrangements, factors such as investment time horizon, available age- or target-based options, and investment change limits may lead to different recommendations on the appropriate arrangement for different retail customer situations.

1 In addition to seeking investment advice from intermediaries such as broker-dealers and RIAs, investors may also pursue "self-directed" investment, where they do not seek the advice of an investment professional.

2 Qualified tuition plans are also known as 529 plans. The focus of this paper is on 529 education savings plans sold through intermediaries. A second type of qualified tuition plan is the prepaid tuition plan.

3 A 529 plan program manager is defined by the Securities and Exchange Commission as "a financial services firm—a mutual fund company, a brokerage firm, an investment adviser, or an insurance company—that handles all of the transactions and investments within the plan." (www.investor.gov/introduction-investing/investing-basics/glossary/529-plan-or-program-manager)

4 The final rule for Reg BI may be found at www.sec.gov/rules/final/2019/34-86031.pdf.

Background

Enacted into law in 1996 and named after Section 529 of the Internal Revenue Code, 529 plans have experienced continual growth in assets and accounts, as well as expanded potential use as a tax-advantaged investment supporting education.[5] While originally created to support the pursuit of higher education, changes in the past decade have expanded 529 plan use to cover K–12 education, apprenticeships, and some student loan payments. Assets held by 529 plans reached an all-time high in the fourth quarter of 2020, with $425.2 billion in assets and 14.8 million accounts.[6]

Types of 529 Plans

There are two types of plans: prepaid tuition plans and 529 education savings plans. Education savings plans are the most popular choice: they made up 94 percent of all 529 plan assets and 93 percent of accounts at year-end 2020.

Prepaid Tuition Plans

Prepaid plans offer "tuition units" or "contracts" by a state administrator or private entity at today's rates to prepay the future cost of college tuition. Plans often limit what is covered (e.g., excluding books or room and board) and are restricted to the state or institution of issuance. By their very nature of prepaying today to cover tuition "tomorrow," plan performance is based upon tuition inflation. Many prepaid plans have not been able to keep up with the rate of tuition inflation and have ceased operations, either rolling client assets into 529 education savings plans or providing refunds to contributors. Ten states provide prepaid tuition plans that are accepting new applicants.[7]

529 Education Savings Plans

State administrators offer 529 education savings plans that are either sold directly to investors (direct-sold plans) or through financial professionals at broker-dealers and RIA firms (commonly referred to as adviser-sold plans). The latter are the focus of this paper. Most 529 plans offer a variety of age-based asset allocation investment options held in mutual funds, exchange-traded funds (ETFs), and stable value products (e.g., constant net asset value [CNAV] money market funds, bank CDs) that become more conservatively invested as the beneficiary gets closer to age of matriculation. Proceeds may be used at US-accredited higher educational institutions and are also accepted at many international colleges and universities. Although states administer 529 plans, recordkeeping and administrative services often are delegated to a program manager.

5 The Achieving a Better Life Experience (ABLE) Act of 2014 permitted program managers to offer tax-advantaged accounts to Americans with disabilities to cover disability-related expenses. The information included in this paper would also pertain to 529 ABLE accounts.

6 Data for 2020 are from the Investment Company Institute and College Savings Plan Network. Historical information on industry assets and accounts can be found at www.ici.org/research/stats/529s.

7 These states are Florida, Illinois, Maryland, Massachusetts, Michigan, Nevada, Pennsylvania, Texas, Virginia, and Washington.

Important Attributes and Tax Features of 529 Education Savings Plans

Any US resident can be a 529 plan account owner or beneficiary. All contributions to a 529 plan are made on an after-tax basis.[8] Contributed amounts and earnings grow tax-deferred, and all earnings are considered free of federal income tax when used at an accredited higher educational institution for qualified educational expenses such as tuition, room and board, fees, books, and computer equipment. Additional uses include covering tuition at K–12 public, private, and religious schools; accredited apprenticeship programs; and payments toward the qualified education loans of beneficiary, sibling(s), or other eligible family members.

Flexibility

Unlike other education-oriented savings vehicles—such as Coverdell education savings accounts or Uniform Gifts/Transfers to Minors Act (UGMA/UTMA) accounts—529 plans do not limit accounts based on the age of the beneficiary or income of the account holder. Account owners maintain control over the 529 plan account and can withdraw money at any time (subject to ordinary income taxes and 10 percent federal income tax penalty on the earnings portion of any nonqualified withdrawals). The account owner may change the beneficiary to themselves or another family member at any time, as defined by the Internal Revenue Code, as well as name a successor owner in the event of the account owner's death. Account owners may change investment options up to twice per calendar year or when changing beneficiaries, and they may roll over assets to another 529 plan once every 12 months.

Professional Money Management

Like a 401(k) retirement plan, 529 plan assets are made up of professionally managed investments. Various 529 plan portfolio allocations include age-based, years to enrollment, static, and individual fund portfolios, and typically use a combination of indexed and actively managed mutual funds, ETFs, and stable value products in their portfolio construction.

Federal and State Benefits

529 plans offer extensive federal and, in many cases, state tax benefits. In addition to federal tax-deferred growth and tax-free use for qualified educational expenses, certain 529 plan assets may be gifted to another individual without paying federal gift taxes.[9] In-state investors may receive state tax deductions and credits for contributions,[10] matching grant and scholarship opportunities at in-state schools, and exemption from state financial aid calculations.

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8 Some states may offer a full- or partial tax deduction or tax credit for 529 plan contributions.

9 In 2021, a 529 plan account holder may make gifts to an individual (related or unrelated to the account holder) that are excluded from gift tax of up to $15,000 per year, or up to a $75,000 lump sum gifted in one year under the "five-year forward gifting provision." Married couples are each permitted to gift up to the maximum benefit. Refer to www.irs.gov for specific gift tax exemption details.

10 More than half of states and the District of Columbia offer in-state tax deduction or credit for contributions into the state's 529 plan, while seven states offer the same benefits for contributions made into any state's 529 plan. The remaining states either do not offer a tax deduction or tax credit or do not have a state income tax.

Supporting 529 Plans In Advisory Arrangements

Successfully launching and supporting a 529 plan for use by RIAs and within broker-dealer advisory programs requires program managers to consider numerous factors and may be achieved through different strategies. Working group members identified two potential strategies[11] to illustrate the factors that must be considered:

- Existing program managers may consider **offering an advisory or institutional share class as part of an existing 529 plan**.
- New or existing program managers may consider **building an advisory model 529 plan**.

Offering an Advisory or Institutional Share Class as Part of an Existing 529 Plan

Some program managers have launched advisory or institutional share classes within 529 plans for use by intermediaries within a fee-based advisory program. These share classes typically are constructed without sales charges, service fees, or financial professional compensation, ideally suiting intermediaries that charge an asset-based fee for advice based on the client's assets under management. These additional share classes are typically offered within all investment options currently available in the 529 plan. Intermediaries that want to pursue this strategy would execute updated selling agreements with the asset managers and/or 529 program managers, as appropriate, and update systems to include these share classes within their advisory programs.

Working group members noted competing interpretations when considering how to collect an asset-based fee for 529 plan accounts held in advisory arrangements.[12] Some working group members have interpreted that any asset-based fee for advice collected directly from a 529 plan account would be considered a nonqualified withdrawal for tax purposes. This interpretation subjects earnings to a 10 percent penalty and requires the account holder to report earnings as taxable income. Other working group members consider the asset-based fee for advice as akin to an account maintenance fee that may be collected directly from 529 plan accounts. The lack of consensus regarding fee collection underscores the importance of reviewing options and consulting with appropriate legal counsel to discern how to best administer fees within the advisory arrangement, without creating adverse tax consequences for shareholders. For example, some working group members suggested that intermediaries could consider alternative billing methods to collect the fee outside the 529 plan account. Examples include direct invoicing of the asset-based fee for advice to the account holder or charging the fee to another eligible account type within the account holder's brokerage account.

[11] This list may not include all potential strategies that could be employed. In addition, program managers and intermediaries may have unique factors that may lead to different strategies and potential outcomes.

[12] Organizations should rely on their assessment of the legal, tax, and compliance considerations of assessing fees for advice on 529 plan positions.

If an advisory or institutional share class is added to an existing 529 plan, it is possible that existing 529 plan account holders and their intermediaries may want to convert into the advisory platform structure. Program managers and intermediaries may want to consider policies and procedures to allow for conversions of existing 529 plan share classes to the advisory or institutional share class upon request by intermediaries. Conversion may require operational accommodations across the unlike share classes.[13]

Policies, procedures, and regulatory rules surrounding 529 plans will still apply even though the advisory share class is held within an advisory program at the intermediary. This includes frequency of investment option changes, maximum account balance limits, and any state tax considerations.

Building an Advisory Model 529 Plan

A driving force to offer advisory model 529 plans is for intermediaries to harmonize options for distributing 529 plans with long-standing options available to their mutual fund counterparts. The advisory model 529 plans currently available are supported and managed by intermediaries only and operate on the intermediary's advisory platform.[14] Therefore, it is reasonable to expect future advisory model 529 plans to merge key 529 plan product attributes with the operational characteristics and asset-based fee for advice approach of existing mutual fund advisory programs.

Like its traditional 529 plan counterpart, an advisory model 529 plan would require several asset allocation portfolio models to align with account holders' future educational funding needs and overall wealth strategy. Advisory model 529 plan asset allocation portfolio models include investment options (e.g., mutual funds, ETFs) that will require periodic rebalancing to ensure account holders are appropriately allocated in accordance with their selected strategies. This rebalancing does not count toward the client's annual limit on investment option changes, currently twice per calendar year. This is an important operational consideration for the recordkeeping system that may use similar mechanisms (e.g., exchange transaction) to complete rebalancing and investment option changes.

Advisory programs often assess an asset-based fee for advice against one or more of the various positions held within the program. In addition, programs may also apply tiered pricing based on overall advisory platform holdings within a household. There are important tax, legal, and compliance considerations regarding how fees for advice are charged within advisory programs that should be fully vetted to ensure clients are not adversely affected, such as by being assessed with a nonqualified withdrawal for such distributions from the 529 account.

[13] In May 2020, ICI published *Mutual Fund Share Class Conversions: A Matrix of Possibilities*, a white paper about operational considerations of various share class conversion approaches. As noted on page 2 of the paper, "529 share class conversions follow the event types as depicted…for mutual funds."

[14] Program managers that introduce an advisory model 529 plan should consider how the plan can be administered/managed by broker-dealer firms on their advisory platforms.

Additional Considerations

Regardless of the method used to pursue offering 529 plans in advisory arrangements, there are additional considerations for interested parties before any strategy may be advanced.

- **Aggregate asset tracking**: An important consideration for 529 plan administration and control is the ability to provide and track aggregate assets across different plans within a given state, specifically maximum aggregate account balance limit and investment option change monitoring. This is especially challenging for plans sold and serviced both by the program manager (as direct-sold plans) and by an intermediary (as adviser-sold plans, often in an omnibus[15] arrangement). Aggregate asset tracking becomes more complicated because parties may need to accommodate for and monitor multiple sources for rule enforcement (e.g., investment option changes) and proper tracking/reporting of principal and earnings. Since advisory model 529 plans supported on a broker-dealer's advisory platform rely on omnibus arrangements, aggregation is an important consideration to address.
- **Controls, processes, system capabilities, and oversight**: Program managers must ensure that the policies, procedures, and intermediary system capabilities supporting 529 plans, either through advisory or institutional share classes or an advisory model 529 plan, are able to accommodate all 529 plan requirements (e.g., share class suitability, investment option change limits, tax reporting). This includes the advisory platform itself, the omnibus subaccounting recordkeeping system, the brokerage platform, and any other systems necessary to successfully make the chosen 529 plan advisory arrangement available. Program managers may need to update their operational and compliance practices to ensure proper oversight of intermediary activities related to the 529 plans, especially in the omnibus model.
- **Financial professional compensation shift**: Financial professionals, especially those who work at broker-dealers, may be accustomed to receiving compensation for 529 plan advice through the commission-based model. Intermediaries moving to an advisory model, either by share class or an advisory model 529 plan, will want to carefully set expectations with financial professionals on the differences in providing advice within advisory models and receiving fee-based compensation. Intermediaries that operate in a direct-at-fund arrangement, meaning the program manager maintains the books and records for the intermediary customer's positions, will need to explore any changes necessary to compensation models for assets held in 529 plan advisory share classes. As previously discussed, investments in those share classes (e.g., advisory or institutional) do not provide direct or indirect compensation for advice to the intermediary.

[15] Omnibus accounts hold shares that are registered with the program manager in the name of the financial intermediary. The intermediary maintains the underlying account holder information on its own recordkeeping systems—a process known as subaccounting—and reports share transactions to the program manager on an aggregate basis. The intermediary or its agent handles all communications and servicing of its customer accounts.

Conclusion

Certain attributes of 529 plan products present unique operational challenges to offering them in an advisory arrangement, especially regarding share class selection, treatment of advisory fees, and investment option changes. However, each of the operational challenges posed has potential solutions, and for many financial intermediaries, these challenges are not insurmountable. It will be important to develop controls and processes on the omnibus platform to uphold the unique policies, procedures, and regulatory rules surrounding 529 plans supported through advisory arrangements.

To continue to be relevant to fee-based financial professionals and investment advisers and to meet potential future regulatory requirements, it is imperative that the 529 industry continue to adapt and evolve to meet client needs. This includes considering an advisory 529 option on intermediary platforms. Most importantly, by offering more choice to clients and improving the ability to support 529 plan activities, financial professionals and investment advisers are more likely to initiate educational planning conversations and help perpetuate growth in education savings, one of the largest and most important financial goals for families in the United States.