MSRB

Investment Performance Considerations for 529 Plan Account Owners

Investing in a 529 savings plan involves considerations about tax consequences, risk appetite, and gains and losses. This educational resource describes some of these considerations for 529 savings plan account owners. For additional information, see the MSRB's Investor's Guide to 529 Savings Plans.

Account owners are not subject to ordinary income or capital gains taxes as long as the funds withdrawn from the plan are used for qualified expenses.

Investing in a 529 Savings Plan[1]

A 529 savings plan is a tax-advantaged qualified tuition program designed to help investors save for certain K-12 tuition expenses[2] and higher education qualified expenses.[3]

A 529 savings plan may be sold one of two ways. It may be "direct sold," that is, interest in the 529 savings plan is purchased directly from the state that sponsors the plan, or from the plan's program manager. It may also be "advisor sold," that is, sold through a financial professional, such as a dealer or registered investment professional that has entered into a selling agreement with a 529 savings plan's primary distributor.

Evaluating Investment Options

When opening a 529 savings plan, account owners must select an investment option from the choices offered by the plan. Because those administering "direct sold" plans cannot provide advice to account owners regarding investment options, it is important that account owners evaluate the investment options and performance of their 529 savings plan on an ongoing basis. Three types of investment options are generally offered in a 529 savings plan: an age-based/target date option, a risk-based option and a capital preservation option.

Generally, with an age-based/target date investment option, the investments automatically become more conservative over time as the target date (*i.e.*, the beneficiary's expected enrollment date) gets closer. Risk-based investment options can vary greatly and are based on the investment risk profile (*i.e.*, aggressive, moderate or conservative) selected by the account owner. The underlying securities in a conservative investment option are expected to be less volatile than the securities in a moderate or more aggressive investment option.[4] Account

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1 This education piece is for educational purposes only and is not intended to recommend or describe any particular 529 savings plan. The MSRB does not provide legal, financial, investment, tax or benefits advice; therefore, investors should consult a legal, financial, investment, tax and/or benefits advisor for such assistance. This education piece is considered accurate as of June 2020 and does not address any proposed changes in applicable laws or regulations, nor will this education piece be updated to reflect any such changes.

2 State tax treatment of qualified withdrawals for K-12 tuition expenses varies state-to-state.

3 Examples of qualified expenses include tuition, fees, books, supplies and repayment of up to $10,000 on any qualified education loan of the designated beneficiary.

4 For investors with qualified expenses around the corner, an account owner may choose the capital preservation option, which generally guarantees the protection of principal and also provides for investment growth.

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owners are permitted to change their investment options twice each calendar year or when there is a change in beneficiary.

Making investment option changes could result in the realization of paper gains or losses.

Withdrawals and Tax Implications

With a 529 savings plan, the earnings grow tax-free and account owners are not subject to ordinary income or capital gains taxes as long as the funds withdrawn from the plan are used to pay for qualified expenses—certain K-12 tuition or higher education expenses—of the designated beneficiary (*i.e.*, a qualified withdrawal). Conversely, while an account owner can make a withdrawal at any time, a withdrawal that is not a qualified withdrawal will have tax consequences. More specifically, the earnings portion (capital gains) on an unqualified withdrawal is subject to federal income tax and, with limited exceptions,[5] an additional 10 percent penalty. The earnings portion also may be subject to state income tax.

Realized vs. Unrealized Gains or Losses

Market conditions can result in unrealized gains and losses (also known as paper gains and losses) in the account value under 529 savings plans. Account owners should be mindful that making investment option changes could result in the realization of paper gains or losses. At such time, the account owner locks in the last value of the account before reinvesting the amount in another investment option.[6] These realized gains or losses do not have tax consequences since the funds are reinvested into another investment option under the 529 savings plan. Additionally, while paper gains become realized capital gains at the time an account owner makes a withdrawal from the plan, such earnings remain tax free unless withdrawn for unqualified expenses. Conversely, while paper losses become capital losses upon an unqualified withdrawal, they do not result in additional taxes. Account owners should consult a tax advisor on treatment of capital loss.

[5] For example, if the beneficiary receives a scholarship for school, the account owner can take an unqualified withdrawal up to the amount of scholarship without a penalty, but the earnings portion will be taxed.

[6] An account owner only owns a unit of the 529 savings plan, which invests in a portfolio of funds. An account owner does not own the underlying securities comprising the portfolio.