TITLE: MISSOURI TAX SAVINGS ARE THE “MOST”

According to the 2011 Fact Book published by the [U.S.] Investment Company Institute (ICI), “The demand for [college] education savings vehicles has been historically modest partly because of investors’ lack of familiarity with them.” Distributions were taken out of only 1.1 million 529 accounts in 2010 while more than 20 million individuals attended college that year. These plans are especially tax advantageous for Missouri taxpayers – a point that CPAs should emphasize to their clients.

BACKGROUND ON STATE 529 COLLEGE SAVINGS PLANS

A college savings plan sponsored by a state receives tax advantages under IRC §529. It is more appropriate to call them “higher education” savings plans as two- and four-year colleges, universities, and vocational/technical/trade schools qualify. A state 529 account has one owner and the owner names a beneficiary. The beneficiary does not have to be the owner’s dependent. Thus, a grandparent or other relative can set one up and the same individual can be a beneficiary of more than one 529 account. The owner of the 529 account can change the beneficiary. The owner can also be the beneficiary.

The tax advantages of a 529 account are similar to those of a Roth retirement account. Like a Roth, interest, dividends, and gains on the investments in a 529 account are exempt from all income taxes. Like a Roth, withdrawals are tax-free if used for the beneficiary’s tuition and fees, required books and supplies, and room and board at any higher education institution in the U.S. where students are eligible to receive federal financial aid. There are over 7,000 such institutions (over 4,000 colleges/universities and over 2,000 vocational/technical/trade schools). A 529 account, thus, does not constrain the beneficiary’s choice of a higher education institution.

TOTAL ASSETS IN 529 PLANS

There are currently about 10 million 529 accounts that contain approximately $150 billion. Slightly less than half of this total is in direct-sold (i.e., opened directly by investors) accounts and slightly more than half is in advisor-sold (i.e., opened through a financial advisor) accounts. A typical state has one direct-sold 529 plan and one advisor-sold 529 plan. Virginia’s CollegeAmerica 529 plan is advisor-sold and has total assets of approximately $30 billion—about one-fifth of total assets in all 529 plans. This is the only advisor-sold plan that received Morningstar’s top rating in a November, 2010 analysis. Direct-sold 529 plans receiving the top rating include Alaska’s T. Rowe Price College Savings Plan and Maryland’s College Investment Plan. The performance of both was in the top 10 for the one-, three-, and five-year periods ending March 31, 2011 (source: savingforcollege.com).

INVESTING IN MISSOURI’S MOST 529 PLANS

Missouri has one direct-sold 529 plan and one advisor-sold 529 plan. The websites for the two plans are *missourimost.com* and *most529advisor.com.* Total assets in the two MOST plans are approximately $1.5 billion, which is about 1.0% of total assets in 529 accounts in the U.S. (Missouri’s population is about 2.0% of the total population in the U.S.) More than 90% of funds in MOST plans are in direct-sold MOST accounts. Direct-sold MOST accounts have no fees and allow initial and subsequent contributions to be as little as $25. The investment manager for the direct-sold MOST accounts is Vanguard - the largest mutual fund family in the U.S. by total assets. Vanguard is well known for offering mutual funds that have relatively low annual expenses.

After a 2010 law change, there is no longer a minimum amount of time the funds contributed to the MOST account must be invested before being withdrawn to pay for higher education costs of the beneficiary. Thus, it is never “too late” for a Missouri income taxpayer who will be paying higher education costs to save state income tax by contributing to a MOST account. Once the funds are credited to the account, they can be withdrawn to pay the beneficiary’s qualified higher education costs.

When contributing to a 529 account, the owner must choose among the mutual funds offered by the state’s plan. In the direct-sold MOST, the mutual fund with the lowest risk is the *Vanguard Interest Accumulation Portfolio* which invests in “high-quality, short-term money market instruments.” Using the lowest risk fund is a wise choice for an individual contributing to a MOST then withdrawing the money shortly thereafter to pay higher education costs of the beneficiary. If the beneficiary will not be going to college for several years, MOST offers more risky investment options that offer higher return potential over longer periods of time.

TAX TREATMENT OF A MISSOURI INCOME TAXPAYER’S 529 ACCOUNT IS BETTER THAN A ROTH IRA

Contributions to a 529 account by a Missouri income taxpayer receive tax treatment that is better than a Roth IRA. First, an unmarried individual with adjusted gross income (AGI) of $122,000 or higher is not allowed to contribute any money into a Roth IRA for the year whereas such an individual can contribute to a MOST account. Even if an individual’s AGI is low enough that the maximum contribution to a Roth IRA is allowed ($5,000 if under age 50 and $6,000 if age 50 or over), a larger amount can be contributed to a MOST account. The greatest advantage though is that Roth contributions do not generate any tax deductions whereas the first $8,000 contributed to a 529 account by a Missouri income taxpayer is an “above-the-line” Missouri income tax deduction. If married filing a combined MO-1040 tax return and both spouses contribute $8,000 to 529 accounts that each one owns, the total deduction on their MO-1040 will be $16,000.

STATE INCOME TAX SAVINGS AND CHOICE AMONG STATE 529 PLANS

Under the tax law in most states, the only way to save state income tax on a contribution to a 529 plan is if an income taxpayer in a particular state contributes to a 529 plan in that same state. A Missouri income taxpayer saves tax on contributions made to *any* state 529 account. Missouri is one of only a few states that offer this option. To receive the maximum Missouri income tax savings of $480 the Missouri taxpayer must contribute $8,000 to state 529 accounts and be subject to Missouri’s highest individual income tax rate of 6%, which occurs when Missouri taxable income exceeds $9,000. Such a taxpayer receives more state tax savings than a resident of almost every other state contributing the same amount to a 529 account in his or her state.

TAX SAVINGS ARE INDIRECT ASSISTANCE WITH HIGHER EDUCATION COSTS

The traditional types of assistance in paying higher education costs that one thinks of are grants, scholarships, and loans. Students and financial advisors should broaden their view to include tax savings. Contributing to a MOST account to generate tax savings then withdrawing the money shortly thereafter strikes many people as “odd” and “too good to be true,” but it is not. The tax savings represent assistance provided by the state of Missouri to its individual income taxpayers that will be paying higher education costs.

IMPACT ON FEDERAL TAXES AND FINANCIAL AID

Since a Missouri income taxpayer contributing to a 529 account reduces Missouri income tax, and federal itemized deductions include state income tax, if such taxpayer itemizes deductions on Form 1040 instead of taking the standard deduction then federal income tax effectively increases due to contributing to a 529 account. However, the increase in federal income tax is significantly less than the reduction in Missouri income tax. If a taxpayer pays higher education costs that qualify for federal tax credits, paying such costs out of a 529 account does not negatively impact the federal tax savings from the credits. Further, contributing to a 529 account in the same year does not negatively impact those federal tax credits.

Regarding qualification for federal financial aid, if a grandparent or other relative owns the 529 account, it has no negative impact. If a student qualifies as a dependent and a parent owns the 529 account, there is a small, negative impact. If a student owns the 529 account, benefits from it, and is not a dependent - the impact on federal financial aid is that 20% of the amount in the 529 account is considered to be available to pay for higher education costs so the account can reduce the amount of federal student loans and/or grants the student is eligible to receive.

CONCLUSION

Whether a Missouri income taxpayer is a parent contributing to a 529 account for a dependent, or a grandparent contributing to a 529 account for a grandchild, or an adult working full time and going to college part-time while paying for it them self, contributing to a 529 account is the most tax-efficient way to both save for higher education costs and pay for such costs currently. This is because of the Missouri state tax deduction for contributions to the 529 account. It is possible for many Missouri income taxpayers to save this much tax, and savings from contributing to a 529 account outweigh any negative impact on federal tax and/or qualification for federal financial aid.

CPAs should especially focus their informational efforts on clients in Missouri’s 6% tax rate bracket that are either currently paying higher education costs or will be doing so in the future. Let clients know that Missouri’s direct-sold MOST account is easy to set up and contribute to, has a very low risk option to invest in (the *Vanguard Interest Accumulation Portfolio*), has more tax advantages than a Roth IRA, and allows withdrawals shortly after contribution.

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