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In this report,[1] we examine how a broker-dealer and its financial professionals can meet the best interest care obligation under the US Securities and Exchange Commission (SEC) Regulation Best Interest (Reg. BI) when recommending an education savings plan (529 Plan) to a retail customer, with a particular focus on the relevance of potential state tax benefits to such recommendations.

FEATURES AND BENEFITS OF 529 PLANS

Purpose

529 Plans are state-sponsored investment programs that facilitate savings for qualified education expenses, including tuition, fees, room and board, and other education-related expenses. Unlike retirement accounts that penalize withdrawals prior to retirement age, 529 Plan funds are available for withdrawal without penalty as soon as the qualified expense is incurred, making them a potentially attractive way to save for college and other eligible education expenses.

Tax Preferred

Saving and investing through a 529 Plan can provide federal and state tax benefits.

- **Federal tax benefits:** Withdrawals used to pay for qualified expenses are free from federal income tax. Thus, 529 Plan savings grow tax-free.
- **State tax benefits:** State income tax benefits vary from state to state and can depend on whether the owner's 529 Plan is sponsored by the state in which they reside (an in-state 529 Plan) or by another state (an out-of-state 529 Plan). Most states exclude withdrawals from state tax, regardless of in-state or out-of-state status. Many states allow for tax credits or deductions on state income tax returns for contributions to in-state 529 Plans. Some states provide for tax deductions and credits for out-of-state 529 Plan contributions as well. In certain states, state tax deductions will not be available for high-income individuals.

  Observation: Ultimately, state tax benefits will depend not just on state law, but also on the retail customer's tax status and liabilities. A deduction for contributions to an in-state plan will typically be more meaningful to retail customers at higher income levels and tax brackets. These potential benefits should be balanced against other features of the available 529 Plans, including costs and available investments, when deciding whether a particular plan is in the retail customer's best interest. Moreover, as specific individual tax advice is beyond the scope of services offered by broker-dealer representatives, customers are generally instructed to consult with their personal tax advisors before committing to a specific tax strategy.

Types of 529 Plans

There are two basic types of 529 Plans: prepaid tuition plans and education savings plans. Prepaid tuition plans are sponsored by a state and can only be used to fund tuition at particular in-state colleges and universities. Education savings plans provide broader benefits, as amounts held in these plans can be used at any college or university to cover qualified expenses, and can also be used for certain expenses incurred at private or religious elementary or secondary schools.

[1] PFS Investments, Inc. engaged Morgan Lewis to research and prepare this analysis, which is available for general distribution.

Significant Variation Among 529 Plans

529 Plans vary significantly in their features.

- **Investment Options:** Investment options (including investment objectives, managers, and fees) are different in each 529 Plan and are generally chosen by the state sponsor. Investment options can include various mutual funds and exchange-traded funds, including target date funds with asset allocations that become more conservative over time as the target withdrawal date approaches. Thus, depending on the particular retail customer's investment goals and financial circumstances (including their other assets and investment accounts), one state's 529 Plan may have higher risk-adjusted potential investment returns (net of fees and tax benefits) than another state's 529 Plan (regardless of whether the plan is an in-state or out-of-state plan).
- **Fees and Expenses:** Costs vary from plan to plan and can include account maintenance fees (typically a fixed charge of $10–25 per quarter or per year), program and asset management fees, and other transaction and administrative fees. Additionally, 529 Plan investors incur investment costs, including investment expenses that vary depending on the investment option selected, share classes, waivers, and discounts. In making a recommendation, it is important to review the fees and expenses associated with available 529 Plans to determine which 529 Plan(s) may be in the retail customer's best interest. Specifically, an out-of-state plan may be more cost effective on an after-tax basis or otherwise have features that are more advantageous to the customer than an in-state plan.
- **Minimum Investments and Maximum Balances:** Plans may have differing minimum investment amounts for contributions that also vary depending on whether the customer is making a lump sum investment or investing through a periodic investment plan. Plans also have different maximum balances; when such balances are reached they will not accept additional contributions.
- **Plan-Specific Features:** Some plans may provide access to online gifting platforms to allow relatives to contribute on behalf of the beneficiary. Plans may have different policies that impose restrictions on account ownership changes or distributions. Plans may also vary in eligibility for contribution matching programs.

APPLYING REG. BI TO 529 PLANS

The SEC applies Reg. BI to a broker-dealer's recommendation of a 529 Plan provided to a retail customer as an account-type recommendation.[2] Like other account-type recommendations, the broker-dealer must determine whether the particular 529 Plan recommendation is in the retail customer's best interest given the retail customer's investment profile, needs, and objectives and after considering the 529 Plan's investment options, services, fees and costs, other features, and, where applicable, how the 529 Plan investments ultimately fit into the customer's holistic or goals-based financial plan.

[2] "In addition to brokerage versus investment advisory accounts, there are also many options or account types within brokerage accounts. For example, brokerage accounts can include: Education accounts (e.g., 529 Plans and tax-free Coverdell accounts) . . . ." *Regulation Best Interest: The Broker-Dealer Standard of Conduct*, 84 Fed. Reg. 33,318, 33,337 n. 174 (July 12, 2019). In a discussion of the definition of a retail customer, the Reg. BI Adopting Release also indicated that "the definition of retail investor includes natural persons seeking brokerage or advisory services for other tax-favored savings arrangements such as . . . a qualified tuition program or '529 plan' established pursuant to Code section 529." *Id.* at 33,343 n. 250.

- 529 Plans are unique in that they may provide access to state tax benefits that vary from state to state and in-state 529 Plans can be (but are not always) more advantageous from a tax perspective.

A best interest analysis should of course consider state tax benefits generally, but state tax benefits are only one of several benefits and attributes that should be considered in determining whether a particular 529 Plan is in the retail customer's best interest. Specifically, costs and available investment offerings and options may be more important in analyzing the customer's potential outcome than the state tax benefits inherent to any particular plan.

Whether a recommendation meets Reg. BI's best interest standard depends on the investor's personal facts and circumstances. As a broker-dealer is required to consider all relevant factors when providing a recommendation, focusing on the state tax benefit alone would fall short of this standard.

MEETING THE REG. BI CARE OBLIGATION WHEN RECOMMENDING 529 PLANS

Reg. BI requires that a broker-dealer must "act in the best interest of the retail customer at the time the recommendation is made, without placing the financial or other interest of the broker, dealer, or natural person who is an associated person of a broker or dealer making the recommendation ahead of the interest of the retail customer."[3] In addition to meeting the disclosure, conflict of interest, and compliance obligations, for a recommendation to be in a retail customer's best interest, a broker-dealer must satisfy Reg. BI's care obligation.[4]

Specifically, the broker-dealer must exercise reasonable diligence, care, and skill to

- understand the potential risks, rewards, and costs associated with the recommendation; and
- have a reasonable basis to believe that the recommendation is in the best interest of the retail customer based on that retail customer's investment profile and the potential risks, rewards, and costs associated with the recommendation and that the recommendation does not place the broker-dealer's financial interests ahead of the retail customer's interests.[5]

In its release adopting Reg. BI, the SEC staff noted that "the factors a broker-dealer should understand and consider when making a recommendation may vary depending upon the particular product or strategy recommended."[6] The SEC staff further noted that "cost—along with potential risks and rewards—will always be a relevant factor that . . . a broker-dealer must consider in making a recommendation," but that cost "is not a dispositive factor," and that making a recommendation solely on the basis of cost (i.e., recommending the lowest cost option) without considering other relevant factors would not meet the best interest standard.[7] Given the significant impact costs can have on investment

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[3] 17 C.F.R. § 240.15l-1(a)(1).

[4] 17 C.F.R. § 240.15l-1(a)(2)(ii).

[5] Reg. BI also requires that a series of recommended transactions is not excessive and is in the retail customer's best interest when taken together. 17 C.F.R. § 240.15l-1(a)(2)(ii)(C).

[6] 84 Fed. Reg. at 33,373.

[7] "[W]e emphasize that while cost must be considered, it should never be the only consideration." *Id.* at 33,326.

returns, the SEC's views here indicate the importance of considering all of the relevant factors in making an investment recommendation under Reg. BI.

Recommending a 529 Plan solely on the basis of potential state tax benefits would seem to frustrate Reg. BI's care obligation, as doing so would ignore many other factors relevant to determining whether the plan is in the retail customer's best interest based on the customer's personal investor profile. As noted above, the amount of the tax benefit/offset will depend on various factors, including the specific state law providing for the tax benefit, the retail customer's tax bracket and income tax liability, and the amounts (and timing) of the customer's anticipated contributions. Depending on state law, retail customers in lower tax brackets with lower tax liabilities and low contributions (i.e., low to mid-income investors) will generally get less of a tax benefit than those customers with higher brackets and liabilities (i.e., mass affluent/high-income investors).

This dichotomy emphasizes not just the need to look at the tax benefits associated with the available 529 Plans when evaluating different options that can be recommended, but also the need to focus more on the ultimate after-tax investment returns of such plans, which includes considering the plans' overall costs, fees and expenses, timing of anticipated contributions, and investment options and services. In some cases, an out-of-state 529 Plan could be a better choice than an in-state plan. In other cases, recommending an out-of-state plan could be better than having access to no plan at all.

In the Reg. BI Adopting Release, the SEC indicated that the use of a single factor in making a recommendation—even if that factor was important—was not consistent with the best interest standard. "[W]hile cost is an important factor that always needs to be taken into consideration in making a recommendation, it is not the only one."[8] If cost were the sole factor, only the lowest cost investment would be recommended. Similarly, if access to the nominal state tax benefit alone were the sole factor, in any state offering such a benefit, only that state's plan could be recommended and generally made available to that state's residents. This practice would ignore the consideration of costs, risks, and rewards. It would also inhibit competition (including pricing competition) in the 529 Plan market.

CONSIDERATION OF REASONABLY AVAILABLE ALTERNATIVES

The SEC staff indicated that a broker-dealer must consider "reasonably available alternatives" in satisfying the care obligation.[9] In particular, the SEC staff stated that the broker-dealer "should consider reasonably available alternatives offered by the broker-dealer."[10] However, the SEC staff emphasized that this standard does not require the broker-dealer "to conduct an evaluation of every possible alternative, either offered outside of the firm (such as where the firm offers only proprietary or other limited ranges of products) or available on the firm's platform."[11]

The SEC recognized that "different products are rarely perfectly equal, and that differences will be both quantitative and qualitative in nature . . . [and a] broker-dealer will not be required to recommend the single 'best' of all possible alternatives that might exist, in part because many different options may in fact be in the retail customer's best interest."[12] While the SEC indicated that a broker-dealer is not

[8] *Id.* at 33,373.

[9] *Id.* at 33,380.

[10] *Id.* at 33,381.

[11] *Id.*

[12] *Id.*

required to consider investment alternatives it does not offer on its platform, it does require firms that materially limit their platforms to identify and disclose such limitations and ensure that the limitations do not cause the broker-dealer to make recommendations that put the broker-dealer's or financial professional's interests ahead of the retail customer's interests.[13]

Consistent with this guidance, it seems reasonable to take the position that a broker-dealer operating nationally does not need to offer to its customers every 529 Plan available in the United States (almost every state offers one), and that a broker-dealer need not consider 529 Plans that are not available on its platform. However, the broker-dealer must still be able to conclude that the recommended 529 Plan is in the retail customer's best interest and that limitations on the 529 Plans offered are disclosed and do not cause the broker-dealer or financial professional to put their interests ahead of the retail customer's interests.

Thus, the broker-dealer should be able to recommend an out-of-state plan if the plan reasonably meets the retail customer's financial needs based on the customer's investor profile (including whether the customer will actually save for the educational expense without access to a 529 Plan).

It is important to note that the SEC did not intend Reg. BI to result in a single "best" option. Under Reg. BI, investment alternatives are to be considered and evaluated under a variety of qualitative and quantitative factors and result in a spectrum of reasonable products or alternatives. For example, and in particular, some retail customers, particularly low to mid-income investors with little investment experience, may benefit from access to a 529 Plan and a financial professional who will help them maintain savings discipline—even if the available 529 Plan is not state tax optimized, especially where potential state tax benefits may be minimal, or if the alternative is for the customer to not save at all.

GUIDANCE FROM OTHER REGULATORS

This subjective and qualitative view is supported and supplemented by Municipal Securities Rulemaking Board (MSRB) guidance. Specifically, the MSRB has indicated that selection of a 529 Plan should be based on a holistic review of 529 Plan features and not simply the presence of a state tax benefit. As it stated in its educational material for investors in 529 Plans, an investor should consider a variety of 529 Plans, "including those beyond your home state, to determine which 529 savings plan is right for you based on the different features and costs."[14]

The MSRB further noted that state-based benefits are just one of many factors to be considered in choosing a 529 Plan. Other factors to consider include, for example, state contribution limits, available investment options, a state's 529 Plan performance, and the cost of investing in the particular 529 Plan.

According to the MSRB, in addition to states that offer favorable tax treatment for residents investing in an in-state 529 Plan, some states offer a tax deduction for contribution to any 529 Plan, regardless of its location. While an investor's in-state 529 Plan may provide access to a favorable tax benefit, the MSRB stated that this "does not mean that an in-state 529 savings plan is superior to an out-of-state 529 savings plan."[15] Thus, the balancing of all of the relevant attributes needs to be done before making an investment decision.

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[13] *Id.* at 33,382.

[14] Municipal Securities Rulemaking Board, Investor's Guide to 529 Savings Plans 31 (2022).

[15] Municipal Securities Rulemaking Board, Tax and Legal Considerations for 529 Plans (2020).

Further support for the position that tax benefits alone are not determinative for an investment recommendation can be found in the US Department of Labor's (DOL's) Prohibited Transaction Exemption 2020-02 (PTE 2020-02) Adopting Release. Specifically, in considering whether tax-exempt municipal bonds could be recommended for a tax-qualified individual retirement account, the DOL noted that an investment recommendation could be made that is contrary to a retail customer's optimal tax result due to the importance of other factors as part of a best interest recommendation.[16] Here, the DOL recognized that the potential performance of the municipal bond on an after-tax basis could make it an appropriate investment for an individual retirement account (IRA), notwithstanding that the tax benefits associated with the bond for a taxable account would not be realized due to the qualified status of the IRA.

Again, a best interest analysis is a process of considering and balancing the attributes of a specific financial product in light of the customer's personal needs, and not a formulaic process.

EXAMPLE: 529 PLAN STATE TAX BENEFITS OVER TIME

This hypothetical illustration shows how a 529 Plan state tax benefit, while important, can be subsumed by other factors over the life of the account.

In this example, assume two taxpayers each with $100,000 in annual income live in a state with a state income tax rate of 5%. Each makes a $5,000 contribution to a 529 Plan. The chart below shows potential outcomes where Taxpayer 1 receives a tax deduction for a $5,000 contribution to an in-state plan with lower returns than the out-of-state plan that Taxpayer 2 contributes to and does not receive a state tax deduction:

	In-State Plan (Taxpayer 1)	**Out-of-State Plan (Taxpayer 2)**
Initial contribution	$5,000	$5,000
Value of tax deduction	$250 ($5,000 x 5%)	$0.00 ($0.00 x 5%)
Annual rate of return, net of expenses	6.0%	7.0%
Value of plan account after 10 years	$8,954	$9,836
Value of tax deduction (assuming same return, net of expenses)	$448	$0.00
Total value of assets after 10 years	$9,402	$9,836

In all, 10 years after their contributions, Taxpayer 1 would have a total of $434 less in after-tax investment returns than Taxpayer 2. Each year thereafter, the monetary advantage to Taxpayer 2 would grow because of the ongoing effect of the plans' relative investment performance. This shows that the one-time nature of the state tax benefit must be weighed against other factors relevant to the 529 Plan account's total after-tax return, net of cost.

[16] *See* DOL, Prohibited Transaction Exemption 2020-02, Improving Investment Advice for Workers & Retirees, 85 Fed. Reg. 82,798, 82,816 (Dec. 18, 2020).

Of course, the annual rate of return for the next 10 years is unknown at the time of the recommendation, which is made based on the financial professional's subjective evaluation of the likely potential return from different investment options and managers.

CONCLUSION

In summary, to meet the Reg. BI care obligation when making a 529 Plan account-type recommendation to a retail customer, a broker-dealer should consider the totality of relevant factors for that customer, including the following:

- The services available through the plan account (including the customer's desire for ongoing assistance and recommendations from their preferred financial professional)
- The investment products available in the plan account (and their risk and return potential)
- The total costs associated with investing in the plan
- Any potential tax benefits to the customer
- The account's features

Making a recommendation solely based on whether the 529 Plan is an in-state plan would be inconsistent with the best interest standard.

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