

529 PLANS – AN OVERVIEW

Before 2001 529 plans were relatively unknown. Today every state offers at least one plan, and there are altogether 126 plans to choose from. What are they? They are college savings programs with tax advantages; they are offered by and administered by the states; and the name comes from the federal tax code that created them. The plan options vary considerably, making it a huge task to identify your best choice.

The common basics are: you commit funds to the plan for a named beneficiary's college expenses, and any gains and/or earnings in the plan are tax-free, at least until distributions are made. The ingredients that vary widely and that you will need to know in order to choose appropriately are discussed below:

Savings Plans and Prepaid Tuition Plans

The savings plan is offered by all states and has the most varieties. The most popular is the age-based plan, which also has more than one variety. Most of these age-based plans invest in a collection of mutual funds, usually ranging in risk from an aggressive growth fund to a bond fund, and sometimes a money market fund. As the child's age approaches college age, the allocation among the funds in the age-based plan becomes more conservative. The plans can be managed by the contributor only to the extent that he/she may switch between options or plans periodically.

In the static prepaid tuition plan, future tuition is purchased at current prices, either in a lump sum or through a series of payments. The state invests the contributions received to keep up with the rate of inflation, and you are guaranteed the amount needed to cover tuition and fees. If you buy three years' worth of tuition, you are guaranteed three years' tuition at a state college when the time comes, regardless of the increase in cost of tuition.

The Independent 529 Plan is a prepaid tuition plan offered by a widely diversified consortium of well over 200 colleges and universities in 39 states. The schools in this plan offer an additional discount (at least 0.5%) on current tuition costs. You purchase a certificate at today's tuition rate for a percentage of future tuition, and this certificate is honored by all member schools, regardless of how much tuition costs have risen. See details later in article.

Bottom line: Savings plans fluctuate in value, as their underlying investments are mostly mutual funds invested in the stock market. There is no guarantee that these plans will increase as much as the tuition rate. With the prepaid plan there is no risk of principal, but there is not the opportunity of increasing the value of the plan as in a savings plan.

Costs Involved

Contribution Limits: Most savings plans have maximum contribution limits based on seven years' average costs for post-secondary education. The median limit is \$235,000. Prepaid tuition plans typically limit the contribution amount to \$50,000 to \$100,000. Minimum contributions are usually very flexible, often as little as \$50 payments, especially if enrolled in an automatic payroll deduction program. Any gift over \$11,000 to one person in one year would be subject to the federal gift tax. However, a special tax law allows aggregating five years for a one-time contribution of \$55,000 to a 529 plan. No other contributions can be made for five years, but you should benefit from the compounding of earnings. There is no limit to the number of contributors to one plan.

Fees and Expenses of the Plan: Some plans have an enrollment fee (usually less than \$50); most have an account maintenance fee, which is charged annually, usually not more than \$50; an administration or management fee, representing operating expenses, is charged annually as a percentage of assets in the plan, typically around 1%, but can be as high as 2%. Other charges to look for when shopping for a 529 plan are: a) front-end loads or sales charges when buying certain mutual funds in the plan, sometimes as much as 5% or 6%; b) deferred or back-end loads that are charged when making withdrawals from the plan; and c) additional fees and expenses of the underlying mutual funds that get passed on to the 529 plan investor. Fees and expenses can be so great with some plans that they obliterate the growth and earnings of your plan's investments.

Education Costs that Qualify for Withdrawals: Qualified withdrawals from the plans almost always include tuition, books, and room and board at eligible post-secondary institutions. Most plans now allow withdrawals for schools in states other than the plan's state and other than where the contributor lives. Some have even more liberal qualifying criteria.

Taxation Issues

The number one reason to use a 529 plan to save for college education is that earnings on your investment are not taxed, not even when the funds are withdrawn, as long as they are used for qualified education expenses. This could turn out to be no benefit, if a) the investments have not earned more than the increase in tuition and education expenses over the life of the plan; and/or b) the law exempting withdrawals expires in 2010 without being extended, and you have more withdrawals to make. However, according to [FinAid.org's](http://FinAid.org) web site, "by 2010 there will be at least \$300 billion to \$400 billion invested in the 529 plans, putting considerable pressure on Congress to make the tax act provisions permanent."

Some states offer additional tax advantages, such as deductions for the contributions, so it is necessary to check these out before choosing a fund.

The Beneficiary

The beneficiary you name does not have to be your child or even related to you. In fact, it can be you. Most plans will allow you to change the beneficiary.

Another reason besides the potential tax advantages that people sometime prefer a 529 plan over a custodial (uniform gift to minors) account is the fact that the contributor continues to be the "owner" of the account. Control over the account is not relinquished to the beneficiary at any time.

Financial Aid Eligibility

Section 529 college savings plans are considered an asset of the account owner, not the beneficiary, and therefore have little impact on financial aid eligibility. Withdrawals from prepaid tuition plans, however, reduce dollar for dollar the need-based aid package. [FinAid.org's](http://FinAid.org) site asserts that, "The states and the American Council on Education are lobbying Congress to have the plans accorded the same financial aid treatment as section 529 college savings plans."

Investment Choices

There are no investment choices in the prepaid tuition plans. The savings plans mostly offer mutual funds. The age-based plans are formulated to adjust risk allocation among a limited number of mutual funds based on the beneficiary's age, becoming more conservative as the beneficiary approaches college age. These allocation changes are not actively managed to take into consideration macroeconomics, but rather are determined by age ranges. Many of the plans use index funds as their investments, so often the underlying funds are also not actively managed. Occasionally there are offerings of guaranteed investment contracts and other customized investment strategies.

In my examination of 529 plans and documents about them, the investment choices do not seem to be highlighted as very important features of these plans. Descriptions of plans focus on tax advantages and contribution limits. I don't understand this. If the investments don't grow, there is no income tax advantage on earnings. Even if your state allows a tax deduction for contributions, is it still a good deal if your account is worth less at college time than the amount you invested?

529 Plan Examples:

INDEPENDENT 529 PLAN

This plan could easily be considered the best choice of all the 529 plans. (Suze Orman of CNBC agrees.) Based on the historical 6% per year increase in tuition costs, paying college tuition at today's rate, to be used five, ten, or fifteen years in the future, will likely save at least 6% per year in the plan, plus tax advantages. Estimates indicate that buying a certificate for one year's tuition at \$20,000 will save nearly \$16,000 by the time the certificate is redeemed.

There are no entry, maintenance, or exit fees. Maximum contribution limits are high, but can also be paid in as little as \$25 per purchase. The gains on the value of each certificate are federally tax-free, and most states also exempt these gains. The certificate(s) can be used at any of the more than 200 participating colleges.

There are no investment options to choose from. The assets in the plan are held in a qualified trust, and the financial institutions involved take all the investment risk.

CALIFORNIA: GOLDEN STATE SCHOLARSHARE COLLEGE SAVINGS TRUST

This is the only plan that California offers. Tax benefits and contribution limits are favorable, and I didn't find any bombs hidden in the plan. I chose this one because it has fairly low fees:

- No enrollment fee
- No account maintenance fee
- An asset-based management fee of .7 - .8%
- Qualified withdrawals are exempt from state income tax

The plan manager is TIAA-CREF, and the plan's mutual fund offerings are TIAA-CREF funds. There are two age-based plans and three static plans, one of which is a guaranteed plan that guarantees principal and a minimum 3% annual rate of interest.

COLLEGE SAVINGS IOWA

This is Iowa's only plan, and it is one of the highest-rated plans according to www.savingforcollege.com. Like California's plan its tax benefits and contribution limits are good—even better since contributions are state tax-deductible for an owner residing in Iowa. Fees and expenses are low:

- No enrollment fee
- No account maintenance fee
- An asset-based management fee of .65%
- Qualified withdrawals are exempt from state income tax

The plan manager is The Vanguard Group, and the underlying mutual funds are Vanguard funds.

They offer four age-based programs and eight static options to choose from.

ILLINOIS: BRIGHT START SAVINGS

Illinois has two plans, but this one is among the top-rated plans according to savingforcollege.com. It is managed by Citigroup Asset Management and compares to the above two plans with respect to contribution limits, tax benefits, and fees:

- No enrollment fee
- No account maintenance fee
- An asset-based management fee of .99%
- Qualified withdrawals are exempt from state income tax

The plan offers an age-based option and three static options. This plan's mutual fund investment offerings are from a variety of mutual fund companies.

Conclusion

The above examples give you an idea of how many considerations there are to review when shopping for a 529 plan. Keep in mind while shopping that the above plans are considered to be among the better choices.

The Independent 529 Plan is hands-down the best choice among the 529 plans, especially if you can make a sizable first purchase in the plan. The sooner and more you purchase, the greater the savings.

The investment choices currently offered by the other plans, and in some cases the high fees and expenses, make those 529 plans not that attractive as college saving options.

Another 529 plan could be a good college savings choice under these circumstances:

- You don't mind having little control over the investments or prefer a professional make those choices anyway.
- You get a state tax deduction for your contributions, and your contributions are sizable enough for the deduction to benefit you.

- Your qualified withdrawals are state income tax-free.
- You are able to take advantage of the one-time \$55,000 contribution to jump start earnings and growth in the investment portfolio.
- You choose a plan that achieves adequate earnings gains, i.e. more than tuition inflation and preferably more than that; or you choose the “peace of mind” guaranteed option.
- You choose a plan that has minimal fees and expenses.
- The tax laws governing 529 plans do not change before your beneficiary finishes college.

I would suggest looking into other college savings options before committing to a 529 plan. Start by reading the overviews on [Custodial](#) accounts and [Coverdell Education Savings](#) accounts on this site. Other online resources include: www.independent529plan.org, www.savingforcollege.com, and www.finaid.org.

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February 2005