

529 Plans

Named after the section of the federal tax code that governs them, 529 plans are tax-advantaged programs that help families save for college. Selecting a plan requires homework. The tax advantages, investment options, restrictions, and fees can vary a great deal.

Before buying a 529 plan, you should find out about the particular plan you are considering, and be sure you understand the plan's description of fees and expenses. Request an offering circular or official statement from the plan sponsor or your financial professional. Most 529 plans provide this document on their Web sites, where it may be called the "Disclosure Statement," the "Plan Disclosure Document," or something similar.

Two Types of 529 Plans

There are two types of 529 plans—prepaid tuition plans and college savings plans. Every state offers at least one of these types of plans. Some states offer both, and now a consortium of private colleges also offers a prepaid tuition plan.

Prepaid Tuition Plans

Prepaid tuition plans allow parents, grandparents and others to prepay tuition at today's tuition rates at eligible public and private colleges or universities so that they don't have to worry about future tuition increases.

- **Contribution Limits**
You pay for amounts of tuition (years, credits, or units) in one lump sum or through installment payments. There are a number of options. Some prepaid tuition plans offer contracts for a two-year community college or a four-year undergraduate program, or a combination of the two, and can cover one to five years of tuition. Some plans even allow the contract to be applied to graduate school tuition.
- **Covered Educational Expenses**
With only a few exceptions, however, most prepaid tuition plans do not cover other expenses, such as room and board. So you may want to consider other college savings options to cover these costs.
- **Guarantees and Safety Features**
Most states guarantee that the funds you put into a prepaid plan will keep pace with tuition. Some states back their prepaid tuition plans by the full faith and credit of the state, meaning that if the program should find itself in financial difficulty, the state will step in to provide the necessary funding. Other states do not have a formal guarantee, but do have a formal process by which the state's legislature will consider making an appropriation if necessary. Some states offer no guarantees that the plan will fund the future cost of tuition or that the state will step in should the plan falter.
- **Residency Requirements and Other Limitations**
Unlike college savings plans, most state prepaid tuition plans require either you or your child to be a resident of the state offering the plan when you apply. Some limit enrollment to a certain period each year. Many prepaid tuition plans also have age or grade limits for beneficiaries (i.e., future college students).
- **Investment Options**
Prepaid tuition plans have no investment options. Under prepaid plans, the price of the contract is determined prior to purchase and usually depends on the type of contract, the current grade of the beneficiary, the current and projected cost of tuition and the projected rate of return. These programs then pool the money and make long-range investments so that the earnings meet or exceed college tuition increases. When a child

is ready to go to college, the plan transfers funds to cover the tuition directly to the institution.

- **Portability**

If your child chooses not to attend a college covered by the prepaid tuition plan, all is not lost. Although you will not get the benefit of guaranteed tuition, all prepaid tuition plans allow you to use plan money to pay tuition at other colleges and universities. Many state prepaid tuition plans will pay out an amount equal to the weighted average tuition and mandatory fees at your state's public institutions, not to exceed the actual tuition and fees you incur. Most prepaid plans also let you transfer the plan to a child's brother or sister (although age restrictions may prevent transfers to an older sibling). Unfortunately, if your child chooses not to go to college and a sibling doesn't use the plan, or you need to cancel the prepaid plan, most plans will only give you back what you originally contributed with a reduction or elimination of any interest earned. Some plans also charge a cancellation fee.

College Savings Plans

With college savings plans, students of all ages can save for all college costs, including tuition, fees, room, board, textbooks and computers.

Not Just for Children. If you are considering going back to college or graduate school, you can open a college savings plan for yourself. You will save on taxes, and if you end up not going to school, you can always transfer the money, tax-free, to another 529 plan for your children or spouse.

- **Not Limited to In-State Public Colleges or State Residents**

Withdrawals from college savings plans can be used at most colleges and universities throughout the country, including graduate schools. Some foreign education institutions also may be eligible. Many states now offer at least one college savings plan that has no residency restrictions. You can live in Ohio, contribute to a plan in Maine, and send your child to college in California. However, if your state offers state tax advantages to residents who participate in the local plan, you'll miss out if you opt for another state's 529 plan.

- **Covered Education Expenses**

College savings plans typically cover all "qualified education expenses" at eligible colleges, universities, and other post-secondary institutions including:

- Tuition
- Fees
- Books and supplies
- Equipment
- Room and board

- **Contribution Limits**

When you invest in a college savings plan, you pay money into an investment account on behalf of a designated beneficiary. Contributions can vary and are only limited by the maximum and minimum contributions limits set by most plans. Although the maximum contribution amount differs from state to state, in the majority of states offering college savings plans, the maximum amount that you can contribute for one beneficiary exceeds \$200,000.

To further increase the amount of contributions you can make, you can open a second college savings plan in another state. Currently, the IRS only requires that contributions for one child cannot be more than the amount necessary for the qualified higher

education expenses of that child. So if you want your child to go to an expensive college and graduate school, one option you have is to open more than one college savings plan.

Most states also offer very flexible minimum contribution limits. Many require a \$250 initial contribution with subsequent contributions of as little as \$50. These minimum contribution amounts can be reduced even further in many states if you make contributions through payroll deductions or automatic transfers from a bank account.

- **Investment Options**

Typically, each plan gives you a number of investment options that allow you to invest in various mutual fund portfolios. Some college savings plans offer age-based mutual fund portfolios. When the child is younger, the portfolio typically invests mostly in stock funds, which carry a higher risk, but higher return potential. As your child grows older, the asset allocation becomes increasingly conservative as it gradually shifts to bond funds and other fixed-income funds.

Many states also offer non-age-based investment options, allowing you to select portfolios with conservative, moderate and aggressive asset allocations. Some states also offer investment options that allow you to invest in certificates of deposits whose interest rates are linked to an index that measures the average cost of college tuition.

Until recently, once you selected an investment option within a college savings plan, you could not change that option. Only new contributions could be invested in different investment options. Now, however, the IRS allows you to change your investment options once every calendar year in a college savings plan.

- **Investment Risk**

Investing in college savings plans does come with some risk. Unlike prepaid tuition plans, they don't lock in tuition prices. Nor does the state back or guarantee the investments. There also is the risk with most college savings plan investment options that you may lose money or your investment may not grow enough to pay for college. For example, if you choose a plan option that invests in stock mutual funds, chances are that your invested funds' annual performance will mirror the trends of the stock market. Thus, you may lose money during a declining market.

- **Fees, Charges and Expenses**

All 529 plans have fees and expenses. Not only do these charges vary *among* 529 plans, but also they can vary *within* a single 529 plan. Like mutual funds, a single college savings plan may offer more than one "class" of shares to investors. Often referred to as A, B or C classes, units or fee structures, each class has different fees and expenses. You can look at the offering document to see if a particular college savings plan offers more than one class.

It is very important to take fees and expenses into account when selecting a college savings plan. Slightly larger fees and expenses can make a big difference in the value of your investment over time. Let's say you invest \$10,000 in a college savings plan with a return of 8% before expenses. With a plan that had annual administration and operating expenses of 3.03%, after 18 years, you would end up with only \$22,966.81. If the college savings plan had expenses of 0.65%, you would end up with \$35,534—a **35% difference!**

Here's a list of some of the most common fees, charges and expenses found in college savings plans:

- **Enrollment Fee.** Many college savings plans do not charge an enrollment fee. Almost all enrollment fees are under \$50.

- **Annual Maintenance Fee.** Most college savings plans charge annual maintenance fees. These fees usually range from \$10 to \$50. Many plans reduce or eliminate this fee for residents, if you make automatic contributions, or if you maintain a certain balance, typically \$25,000.
- **Sales Charge (Front-end Sales Load).** Several college savings plans charge a sales charge when you buy certain investment options within a plan or purchase a plan through a broker or investment adviser instead of directly from the state. Generally, you can determine the sales load by looking at the fees and expenses section of the offering circular or prospectus. Not every plan has a sales load. In some plans, a sales charge may only be levied on certain share classes of the plan.

Get a Break on Front-end Sales Loads. Like mutual funds, Class A shares of college savings plans often offer discounts that reduce the front-end sales loads you pay. The investment levels at which the discounts become available are called **breakpoints**. The amount of the discount is based on the size of your investment, and the discount increases as the size of your investment increases.

- **Deferred Sales Charge.** A deferred sales charge or contingent deferred sales charge (CDSC) is a charge you pay when you withdraw money from an investment option or college savings plan. It is sometimes referred to as the back-end load. The charge may start out at 2.5% for the first year, and get smaller each year after that until it reaches zero. Generally, you can determine the deferred sales charge by looking at the fees and expenses section of the offering circular or prospectus. Not every college savings plan has a deferred sales charge. In some plans, a deferred sales charge may only be levied on certain classes of the plan.
- **Administration/Management Fee.** This is the total annual college savings plan operating expenses expressed as a percentage of the plan's assets. For example, an expense ratio of 1% represents an annual charge to the plan's assets—including your proportional interest in those assets—of 1% per year.
- **Underlying Fund Expenses.** Because college savings plan portfolios typically invest in a number of mutual funds, they bear part of the fees and expenses of these underlying funds. This expense is expressed as a percentage of a mutual fund's assets. Because college savings plan investment portfolios sometimes invest in a number of mutual funds, the offering circular or prospectus may contain fund expenses percentages for each of these funds.

Comparison of 529 Plans

Prepaid Tuition Plan	College Savings Plan
Most plans allow you to prepay tuition at eligible public and private colleges and universities at today's price.	No lock on college costs.
All plans cover tuition and mandatory fees. A few plans allow you to purchase a room & board option, use excess tuition credits for other qualified expenses or cover all qualified education expenses.	Covers all "qualified higher education expenses," including: <ul style="list-style-type: none"> • Tuition • Room & board • Mandatory fees • Books, computers (if required)

Most plans set lump sum and installment payments prior to purchase based on age of beneficiary and college tuition years purchased.	Many plans have contribution limits in excess of \$200,000.
Many state plans guaranteed or backed by state.	No state guarantee. Most investment options are subject to market risk. Your investment may make no profit or even decline in value.
Some state plans have age/grade limits for beneficiaries.	No age limit. Open to adults and children.
Most state plans require either plan owner or beneficiary to be a state resident at the enrollment time.	Most plans do not have a residency requirement. However, nonresidents may only be able to purchase some plans through financial advisers or brokers.
Most plans have limited enrollment period.	Enrollment open all year.

Common Features of Prepaid Tuition and College Savings Plans

Federal Tax Advantages

One of the biggest advantages of 529 plans over other college savings options are the tax advantages they offer. Earnings grow tax-free and withdrawals are tax-free when used for qualified education expenses.

Although the IRS typically allows you to give no more than \$12,000 a year to another person without a federal gift tax, you can contribute up to \$60,000 to a 529 plan in one year. A special tax law allows you to aggregate five years of the allowable \$12,000 annual gift-tax exclusion to jump-start a 529 plan. While you will be precluded from making any further gifts for five years, compounding will make your earnings grow faster than if you invested \$12,000 in each of the five years.

Also, anyone can contribute to a 529 plan. Unlike education savings accounts (ESAs) and saving bonds, which are discussed later, there are no income limitations. For most wealthy families, 529 plans are one of the few available tax-advantaged college savings options.

State Tax Advantages

State tax treatment of 529 plans varies from state to state. In over 5 states, contributions are tax deductible if you're a resident of the state sponsoring the 529 plan. For example, Colorado currently allows residents to deduct the entire amount of their contribution to their in-state plan for each beneficiary, up to the amount of their annual adjusted gross income. Rhode Island, on the other hand, allows only a \$1,000 deduction in total for joint filers and \$500 for single filers. Many states also follow the federal tax lead of allowing earnings to grow tax-free and imposing no state tax on qualified withdrawals from in-state and out-of-state plans.

A few states offer grants or matching contributions for low and moderate-income families. New Jersey offers a one-time scholarship to eligible beneficiaries their first semester at a New Jersey public university, and Maine offers a \$50 "first step" grant to all babies born in Maine in 2008 with an initial contribution of \$200, or if the account owner elects to fund the account through payroll deductions or automated contributions.

Control

Unlike custodial accounts and ESAs, 529 plans allow the account owner to maintain control over the assets in a 529 plan for the life of the account. You also can change beneficiaries to another "family member" of the original beneficiary. Thus, if your child gets a scholarship or decides not to go to college, you can name another beneficiary—even yourself. Some 529 plans, especially prepaid tuition plans, may limit or restrict your ability to change beneficiaries, so check the plan offering document.

Transfers

The assets of one 529 plan can be transferred tax-free to another 529 plan of another beneficiary, as long as the new beneficiary is a "family member" of the beneficiary of the 529 plan from which the transfer was made. "Family members" include, among others, the beneficiary's spouse, son, daughter, grandchild, niece, nephew and first cousin.

The assets of one 529 plan also can be transferred tax-free to another 529 plan for the same beneficiary. However, only one transfer of this type is allowed within any 12-month period. There also may be state tax implications when you transfer from one 529 plan to another. You may want to consult with your tax adviser before you make a transfer.

Withdrawals for Non-College Related Expenses

If your child decides not to go to college or you over-fund a 529 plan, you may pay a penalty in addition to any taxes you owe on any earnings. If you withdraw money from a 529 plan that is not used for qualified education expenses, you are generally required to pay income tax and an additional 10% penalty on earnings.

There are a number of exceptions to this penalty. The penalty may be waived if your child gets a scholarship or is disabled. You also can avoid the taxes and penalties by transferring the 529 plan to another beneficiary who will use the funds for qualified education expenses.