The ABC's of 529 Plans

If you're already saving for college, you've probably heard about 529 plans. 529 plans are revolutionizing the way parents and grandparents save for college, similar to the way 401(k) plans revolutionized retirement savings. Americans are pouring billions of dollars into 529 plans, and contributions are expected to increase dramatically in the coming decade. Where did these plans come from, and what makes them so attractive?

The history of 529 plans

Congress created Section 529 plans in 1996 in a piece of legislation that had little to do with saving for college--the Small Business Job Protection Act. The law on 529 plans was later refined in 1997 by the Taxpayer Relief Act, and again in 2001 by the Economic Growth and Tax Relief Reconciliation Act. In this short period, 529 plans have emerged as one of the top ways to save for college.

Section 529 plans are officially known as qualified tuition programs under federal law. The reason "529 plan" is commonly used is because 529 is the section of the Internal Revenue Code that governs their operation.

What exactly is a 529 plan?

A 529 plan is a college savings vehicle that has federal tax advantages. There are two types of 529 plans: state savings plans and prepaid tuition plans. Though state savings plans and prepaid tuition plans share the same federal tax advantages, there are important differences between them.

State savings plans

State savings plans let you save money for college in an individual investment account. These plans are run by the states, which typically designate an experienced financial institution to manage their plan. To open an account, you fill out an application, choose a beneficiary, and start contributing money. However, you can't hand pick your own investments as you would with a Coverdell ESA, custodial account, or trust. Instead, you typically choose one or more portfolios offered by the plan--the underlying investments of which are exclusively chosen and managed by the plan's professional money manager. After this, you simply decide when, and how much, to contribute.

With early state savings plans, plan managers commonly invested your money based only on the age of your beneficiary (known as an age-based portfolio). Under this model, when a child is young, most of the portfolio's assets are allocated to aggressive investments (e.g., stock mutual funds). Then, as a child grows, the portfolio's assets are gradually and automatically shifted to less volatile investments (e.g., bond funds and money market funds) to preserve principal. The idea is to take advantage of the stock market's potential for high returns when a child is still many years away from college, while recognizing the need to lessen the risk of these investments in later years.

Though the age-based portfolio model is certainly logical (indeed, many parents were already trying to invest this way on their own), offering only this type of portfolio made state savings plans seem a bit inflexible. After all, with other college savings options like Coverdell ESAs, custodial accounts, mutual

funds, and trusts, you can invest in practically anything (thereby taking into account your risk tolerance), and you have complete freedom to sell an investment that's performing poorly (though in some cases the proceeds must still be used for education purposes, or for the child's benefit in general).

Now, state savings plans are older and wiser. Today, more plans offer a wide array of portfolio choices. So, in addition to choosing an age-based portfolio, you may also be able to direct your 529 plan contributions to one or more "static portfolios," where the asset allocation in each portfolio remains the same over time. These static portfolios usually range from aggressive to conservative, so you can match your risk tolerance. But keep in mind that state savings plans don't guarantee your return. If the portfolio doesn't perform as well as you expected, you may lose money.

When it's time for college, the beneficiary of your account can use the funds at any college in this country and abroad (as long as the school is accredited by the U.S. Department of Education).

Prepaid tuition plans

Prepaid tuition plans let you save money for college, too. But prepaid tuition plans work differently than state savings plans. Prepaid tuition plans may be sponsored by states (on behalf of public colleges) or by private colleges.

A prepaid tuition plan lets you prepay tuition expenses now for use in the future. The plan's money manager pools your contributions with those from other investors into one general fund. The fund assets are then invested to meet the plan's future obligations (some plans may guarantee you a minimum rate of return). At a minimum, the plan hopes to earn an annual return at least equal to the annual rate of college inflation for the most expensive college in the plan.

The most common type of prepaid tuition plan is a contract plan. With a contract plan, in exchange for your up-front cash payment (or series of payments), the plan promises to cover a predetermined amount of future tuition expenses at a particular college in the plan. For example, if your up-front cash payment buys you three years' worth of tuition expenses at College ABC today, the plan might promise to cover two and a half years of tuition expenses in the future when your beneficiary goes to college. Plans have different criteria for determining how much they'll pay out in the future. And if your beneficiary attends a school that isn't in the prepaid plan, you'll typically receive a lesser amount according to a predetermined formula.

The other type of prepaid tuition plan is a unit plan. Here, you purchase units or credits that represent a percentage (typically 1 percent) of the average yearly tuition costs at the plan's participating colleges. Instead of having a predetermined value, these units or credits fluctuate in value each year according to the average tuition increases for that year. You then redeem your units or credits in the future to pay tuition costs; many plans also let you use them for room and board, books, and other supplies.

A final note to keep in mind: Make sure you understand what will happen if a plan's investment returns can't keep pace with tuition increases at the colleges participating in the plan. Will your tuition guarantee be in jeopardy? Will your future purchases be limited or more expensive?

What's so special about 529 plans?

Section 529 plans--both state savings plans and prepaid tuition plans--offer a unique combination of features that have made them attractive to college investors:

- Federal and state tax-deferred growth: The money you contribute to a 529 plan grows tax deferred each year. This means that instead of paying income tax on your earnings every year, as you would with a mutual fund or with investments held inside a custodial account, you don't owe any tax until you make a withdrawal from the plan.
- Federal tax-free earnings if the money is used for college: If you withdraw money to pay for college (known under federal law as a qualified withdrawal), the earnings are not subject to federal income tax, similar to the treatment of Coverdell ESA earnings.
- Favorable federal gift tax treatment: Contributions to a 529 plan are considered completed, present-interest gifts for gift tax purposes. This means that contributions qualify for the $11,000 annual gift tax exclusion. And with a special election, you can contribute a lump sum of $55,000 to a 529 plan, treat the gift as if it were made over a five-year period, and completely avoid gift tax.
- Favorable federal estate tax treatment: Your plan contributions aren't considered part of your estate for federal tax purposes. You still retain control of the account as the account owner but you don't pay a federal estate tax on the value of the account. But if you spread today's gift over five years and you die within the five years, a portion of the gift will be included in your estate.
- State tax advantages: States can also add their own tax advantages to 529 plans. For example, some states exempt qualified withdrawals from income tax or offer an annual tax deduction for your contributions. A few states even provide matching scholarships or matching contributions.
- Availability: Section 529 plans are open to anyone, regardless of income level. And you don't need to be a parent to set up an account. By contrast, your income must be below a certain level if you want to contribute to a Coverdell ESA or qualify for tax-exempt interest on U.S. education savings bonds (Series EE bonds, which may also be called Patriot bonds, and Series I bonds).
- High contribution limits: The total amount you can contribute to a 529 plan is generally high. Most plans have limits of $250,000 and up. Coupled with the tax-deferred growth of your principal and the income tax-free treatment of qualified withdrawals, it's easy to see how valuable your money can be in a 529 plan.
- Professional money management: For college investors who are too busy, too inexperienced, or too reluctant to choose their own investments, 529 plans offer professional money management.
- State savings plan variety: In many cases, you're not limited to the state savings plan in your own state. You can shop around for the plan with the best money manager, performance record, investment options, fees, and customer service. (You can't generally shop around with prepaid tuition plans, though.)
- Rollovers: You can take an existing 529 plan account (state savings plan or prepaid tuition plan) and roll it over to a new 529 plan once every 12 months without paying a penalty. This lets you leave a plan that's performing poorly and join a plan with a better track record or more investment options (assuming the new plan allows nonresidents to join).
- Simplicity: It's relatively easy to open a 529 account, and most plans offer automatic payroll deduction or electronic funds transfer from your bank account to make saving for college even easier.
- Innovation: Section 529 plans are a creature of federal law, but the states are the ones that interpret and execute them. As Congress periodically revises the law on 529 plans, states will continue to refine and enhance their plans (and their tax laws) in order to make them as attractive as possible to college investors from all over the country.

Note: The provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 that made qualified withdrawals from a 529 plan tax free at the federal level will expire on December 31, 2010. Unless Congress extends the law, after December 31, 2010 the federal tax treatment of 529 plans will revert to the law in effect prior to January 1, 2002 (qualified withdrawals taxed at beneficiary's rate). By contrast, qualified withdrawals from a Coverdell ESA will continue to be tax free at the federal level after 2010 because their tax treatment is not dependent on the 2001 Tax Act.

What are the drawbacks of 529 plans?

No college savings option is perfect, and 529 plans aren't, either. Here are some of the drawbacks:

- Investment options: 529 plans offer little control over your specific investments. With a state savings plan, you may be able to choose among a variety of investment portfolios when you open your account, but you can't direct the portfolio's underlying investments. With a prepaid tuition plan, you don't pick anything--the plan's money manager is responsible for investing your contributions.
- Investment guarantees: State savings plans don't guarantee your investment return. And even though prepaid tuition plans typically guarantee your investment return, some plans have recently announced modifications to the benefits they'll pay out due to projected actuarial deficits.
- Investment flexibility: If you're unhappy with your portfolio's investment performance in your state savings plan, you typically can direct future contributions to a new portfolio (assuming your plan allows it), but it may be more difficult to redirect your existing contributions. Some plans may allow you to make changes to your existing investment portfolio once per calendar year or upon a change in the beneficiary. But in either case, it depends on the rules of the plan. However, you do have one option that's allowed by federal law and not subject to plan rules. You can do a "same beneficiary" rollover (a rollover without a change of beneficiary) to another 529 plan (a state savings plan or a prepaid tuition plan) once every 12 months, without penalty. This gives you the opportunity to shop around for the investment options you prefer.
- Nonqualified withdrawals: If you want to use the money in your 529 plan for something other than college, it'll cost you. With a state savings plan, you'll pay a 10 percent federal penalty on the earnings part of any withdrawal that is not used for college expenses (a state penalty may also apply). You'll pay income taxes on the earnings, too. With a prepaid tuition plan, you must either cancel your contract to get a refund or take whatever predetermined amount the plan will give you for a nonqualified withdrawal (some plans may make you forfeit your earnings entirely; others may give you a nominal amount of interest).
- Fees and expenses: There are typically fees and expenses associated with 529 plans. State savings plans may charge an annual maintenance fee, administrative fees, and an investment fee based on a percentage of your account's total value. Prepaid tuition plans may charge an enrollment fee and various administrative fees.