Choosing a 529 Plan

Introduction

Choosing a 529 plan means first deciding whether a college savings plan or a prepaid tuition plan appeals to you. If you decide on a prepaid tuition plan, you're generally limited to the plan offered by your state. But if you choose a college savings plan, you'll need to decide on the specific plan you want to join, because most college savings plans are open to residents of any state. You'll want to consider a variety of things like account ownership and beneficiary designation rules, state tax advantages, investment portfolios offered and flexibility in changing the portfolio, contribution rules, and costs and fees.

Any state that offers a 529 plan can provide you with a free packet of information that describes the program and its rules. You can also check out a plan's website.

Note: Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits. As with other investments, there are generally fees and expenses associated with participation in a 529 savings plan. There is also the risk that the investments may lose money or not perform well enough to cover college costs as anticipated.

College savings plan or prepaid tuition plan?

Both college savings plans and prepaid tuition plans are 529 plans, but they're not the same. With a college savings plan, the focus is on saving for college costs in the future, whatever those costs may be. You typically choose one or more investment portfolios at the time you open an account, and all of your contributions are directed into the portfolio you choose. Each portfolio generally consists of a number of mutual funds. The rate of return you earn each year depends on how your portfolio performs in the market. Your return is not guaranteed; in fact, you may lose money.

With a prepaid tuition plan, the focus is on prepaying some or all of college tuition today for use in the future. You typically either purchase tuition credits or make a contribution (periodic or lump sum) to an account. In return, the plan guarantees either that it will cover a predetermined amount of college tuition at the time your child is ready to attend, or a minimum rate of return that is tied to the rate of college inflation in that state. As mentioned, most states limit participation in their prepaid tuition plans to state residents.

In addition to these basic investment differences, prepaid tuition plans generally have more restrictions than college savings plans. Here are some questions you should ask about any prepaid tuition plan:

- Can the beneficiary be any age when the account is opened?
- Are there specific enrollment periods during which the account must be opened?
- Are other college expenses covered besides tuition?
- Must the account be used by the time the beneficiary reaches a certain age?
- What happens if the beneficiary doesn't attend an in-state public college?
- What are the fees associated with opening and maintaining the account?

And for college savings plans, along with comparing costs and fees among plans, you should find out whether your state limits 529 plan state tax benefits to individuals who join the in-state college savings plan only.

Account ownership and beneficiary designation rules

Note: The remainder of this discussion applies only to college savings plans.

When comparing college savings plans, keep plan flexibility in mind, particularly with respect to account ownership and beneficiary designation rules. These rules may vary from state to state. As an account owner, you'll want to make sure the account works the way you want it to work. Generally, the account owner retains ownership and a certain amount of control over the college savings plan account. For example, he or she can terminate the account and receive a refund of contributions, and can also change the beneficiary of the account. Here are some questions to ask when researching various college savings plans:

- Can I own the account jointly with my spouse or another person?
- Can a trust or other entity be an account owner?
- Can I name a successor owner when I open the account? If not, what happens to the account when I die?

- Must the account owner be a state resident? Must the beneficiary be a state resident?
- What happens if the account owner or beneficiary later moves out of state?
- Are account statements issued only to the account owner or also to the beneficiary?
- Can I view the account on-line?

Tax considerations

No matter which college savings plan you join, withdrawals used for the beneficiary's qualified education expenses will be tax free at the federal level. But states differ in their tax treatment of college savings plans.

Some states may exempt a plan's earnings from income tax if used to pay qualified higher education expenses. Some states may also let you deduct some or all of your plan contributions, or give you a tax credit. Other states offer no such income tax benefits. Research the tax benefits (if any) available in your own state. And remember--you're entitled only to the state tax benefits offered by the state in which you reside, and some states may limit their 529 plan tax benefits to individuals who join the in-state college savings plan only.

Also, consider any state gift tax issues regarding contributions, and see if there are state penalties for withdrawals that are not used for education expenses. The following questions can help you determine what tax advantages each state offers:

- Can I claim a deduction on my state income tax return for my contributions to the college savings plan?
- Is there a limitation (cap) placed on the amount of my state income tax deduction? If so, what is it?
- Is my deduction recaptured into income if later withdrawals are not used for the beneficiary's qualified education expenses?
- If a withdrawal from the college savings plan is used to pay qualified education expenses, are the plan's earnings exempt from state income tax?
- Does the state offer any tax credits or matching contributions? Must I join the in-state college savings plan to get my state's tax benefits?

Investment options and flexibility

When comparing college savings plans, you should consider the number and type of investment vehicles that each plan offers. Since some investors are more comfortable with risk than others, investment choice is important. For example, if you're a conservative investor with limited funds, you might not want to open an account in a state that offers you only one type of investment option--an aggressive, high-risk portfolio. Investment choice may also be important if you're a sophisticated investor who wants to maximize return. However, keep in mind that all investing involves risk, including the possible loss of principal, and there can be no assurance that any investment strategy will be successful.

Some college savings plans may restrict you to a certain investment portfolio based on the beneficiary's age (known as an age-based portfolio), while others may let you choose a portfolio that's not tied to the beneficiary's age. Some plans provide you with an extensive menu of investment options, while others offer only a few portfolios. Some plans also allow you to change your investment portfolio twice per calendar year or when you change the beneficiary.

You may want to look at the past investment performance of a particular portfolio and compare it with other portfolios in different plans (but keep in mind that past performance does not guarantee future results). You should also think about the reputation of the plan manager. Here are some investment-related questions to ask:

- How many investment options does the college savings plan provide?
- Is an age-based asset allocation approach offered? If so, can I select a portfolio other than one designed to match the age of my designated beneficiary?
- If the college savings plan offers more than one investment option, can I spread a contribution among the options without opening multiple accounts?
- Who manages the plan's investments, and how solid is that company's reputation?
- Can I choose one investment portfolio with today's contribution, and a different portfolio with future contributions?
- Will the plan let me switch my account from one portfolio to another portfolio?

- When does the investment manager's contract with the plan end? What happens to my account if the state changes investment managers?

Contribution rules

Another area to research is the contribution rules of each plan. For example, if you have plenty of funds to invest, you might be interested in a college savings plan that allows you to accumulate the most funds. Most plans have contribution limits over

$300,000. If money is tight for you, you might want to avoid plans that require a minimum annual contribution. Find out the answers to the following questions:

- What's the maximum contribution limit for the plan?
- What's the minimum amount I must contribute to establish the college savings plan?
- Are annual contributions required? If so, how much?
- Can someone other than the account owner make plan contributions?
- Are the contribution limits different if I am a resident of the state or a nonresident?

Costs and fees

Since college savings plan costs and fees can really add up and take a sizable bite out of your funds, you should consider the expenses associated with each plan. Sometimes, nonresidents joining a plan must pay higher broker's fees or higher annual account fees. Investigate whether a break is given to state residents, and compare the overall costs of different plans. Consider the following questions:

- Are residents and nonresidents treated differently in terms of plan costs and fees?
- Is there an application fee, beneficiary substitution fee, or account owner substitution fee?
- What other fees and costs are charged, and what are the amounts?
- Will my fees be less if I contribute through payroll deduction or automatic deduction from my checking account?

- Is there a fee to do a rollover to another state's plan?
- Will I be penalized if I move my account out of the plan within a short time after I open the account? How short a time?
- Is there a fee if I terminate the account?
- Do I pay the fees separately, or is the fee deducted from my account?

Questions & Answers

How do you know whether to choose a college savings plan or a prepaid tuition plan?

Your investment preferences and the college you think the beneficiary (let's assume it's your child) might attend will affect your choice.

A prepaid tuition plan generally guarantees you a minimum rate of return to ensure that you keep up with college inflation. Essentially, by contributing to such a plan, you lock in tomorrow's tuition at today's prices. This can certainly bring you peace of mind. However, if the stock market enjoys an extended period of high returns, you'll generally still be limited to the return that your plan promises. Also, to receive the maximum benefits under a prepaid tuition plan, your child must attend a participating college. If your child chooses a different school, you may pay a penalty.

By contrast, a college savings plan doesn't guarantee you any minimum rate of return. When you invest your money in a plan's portfolio (whether it's an age-based portfolio geared to your child's age or another portfolio), you take your chances. If your portfolio earns a high rate of return, you're entitled to all of it. But if it earns little or nothing (or even loses money), you may end up with less than you need to pay for your child's education. The good news is that your child can use the funds in a college savings plan at any college that is accredited by the U.S. Department of Education.

If you're a fairly conservative investor and believe that your child will attend a specific college, then a prepaid tuition plan may be the appropriate choice. But if you don't want to restrict your child's college options or you believe that you can earn a better rate of return than what is promised by a prepaid tuition plan, then a college savings plan that offers a range of investment options may be the right choice.

Can you invest in any state's 529 plan, or are you limited to your own state's plan?

It depends. Prepaid tuition plans are typically limited to state residents, while college savings plans are typically open to residents of any state.

If you open a 529 account, will your child's choice of college be restricted?

It depends. With a college savings plan, your child can use the money at any college in the country and abroad that is accredited by the U.S. Department of Education. By contrast, with a prepaid tuition plan, your child will receive the maximum benefits under the plan only if he or she attends one of the colleges in the plan. If your child chooses a different school, you may pay a penalty.

What expenses and fees are generally associated with 529 plans?

Many 529 plans pass along their costs of administration to account owners through fees and other expenses. These fees vary from state to state. Typical charges include an enrollment or application fee when you set up most prepaid tuition contracts. College savings plans charge account owners for fund expenses and investment management fees imposed by the program's investment manager, as well as other fees. Charges by the investment manager are in the form of a preset percentage of your account's accumulated value. Many college savings plans also impose a flat account maintenance fee unless you maintain a substantial balance or make automatic payments to your account.

You may also be charged a fee for changing your 529 account's beneficiary, owner, or payment schedule. Keep in mind, however, that the program administrator can waive fees, particularly if you're a resident of the state running the plan.

Make sure you have a full understanding of the fees that apply to a 529 plan you're considering. Such charges could have a significant impact on your account's return. But the plan with the lowest fees is not necessarily the best. Weigh fees and expenses with other factors, such as investment history, program flexibility, and state tax issues.

How do you enroll in a state's 529 plan?

Contact the plan administrator that runs the 529 plan that you want to join. All plans have websites and toll-free numbers to help you get the information you need. Plan administrators may be state agencies or companies established solely for the purpose of running a 529 plan, or they may be investment firms. In any case, the plan administrator operates under the authority of each state government, such as the state treasury department. The plan administrator will send you a packet of information that includes enrollment materials, along with a program description. Read the information thoroughly and make sure you understand the plan's rules before you enroll.

In addition, be sure to check the enrollment period for the plan. Many states offer open enrollment, meaning you can join the plan at any time. Other states have shortened enrollment periods, such as October to January.