Section 529 Qualified Tuition Plans

These plans come in two basic forms: **college-savings plans** (which allow people to invest after-tax dollars in a basket of mutual funds, with the assets growing tax free until those college bills start rolling in) and **prepaid tuition plans** (which allow people to lock in today's tuition prices for set schools, most often public schools in their home state).

In recent years, college-savings plans have been considerably more popular than prepaid tuition plans. The reasons for the difference are many. For starters, college-savings plans are easier to understand — they operate a bit like 401(k)s, with the notable exception that withdrawals are taken to cover college. College-savings plans can also be used to cover a wider range of college costs, like books and supplies, whereas most prepaid plans only cover the cost of tuition and fees.

And finally, there was a significant financial-aid issue: In the past, college-savings plans were treated more favorably under the federal financial-aid rules than prepaid tuition plans. Benefits paid out of prepaid plans were considered a resource of the child to pay for college. So withdrawals from a prepaid plan reduced federal financial-aid eligibility dollar for dollar. College-savings plans, on the other hand, are viewed as an asset of the account owner (most often, the parent), which means that, when it comes to determining financial aid, no more than 5.6% of the account value is considered available to pay the bills.

Recently, however, this financial-aid issue has been resolved. Thanks to the *Pension Protection Act,* a new law that went into effect in August 2006, federal financial-aid formulas now treat prepaid plans in the same manner as college-savings plans. In other words, distributions from both types of accounts are viewed as a parental asset. This is good news, as that no longer needs to influence your choices.

State-Sponsored College Savings 529 Plans

These are plans whose earnings grow tax-deferred and distributions are tax-free if used for qualified post-secondary education costs. These programs are sponsored by states, but most are open to people in and out of the state. In most states, the withdrawals are also state-tax-free. Some states also offer in-state residents a state-tax deduction or a credit on contributions. These plans, while not perfect, do offer some great advantages. www.savingforcollege.com offers some convenient comparisons of the different states' offerings.

Here's the basic deal. You contribute money to one of these plans, which is then invested in some sort of savings vehicle — typically mutual funds. Many of these plans offer stock funds when a child is quite young, which will then be transferred to more conservative investments, like bond funds, as the child gets closer to college age. Of course, unlike the prepaid tuition plans, there are no guarantees that your money will grow large enough to cover your tuition bills. But if you invest in a good plan, the returns (combined with the tax-free withdrawals) certainly give you a leg up. Also, these plans aren't strictly geared toward in-state schools, but are meant to be applied toward whichever school your child chooses to attend.

Withdrawals to pay the beneficiary's qualified college expenses are tax-free. If you can make substantial contributions to a 529 plan while your child is young, this can make a huge dent in the amount you will ultimately need for his/her education. You can usually make large lump-sum contributions (well over $250,000) and for gift-tax purposes you can spread a large gift over

5 years. (Gifts under $12,000 made under the tax-free gift rule won't result in federal gift taxes and won't reduce your federal gift or estate tax exemptions.) When contributing to a 529 plan, you can claim 5 years worth of $12,000 exclusions up front, which means a married couple can make a lump-sum payment of up to $120,000 (5 x $12,000 x 2 parents) without any negative gift tax consequences. And another plus: These tax benefits are available regardless of how high your income is as opposed to many of the other breaks. You can change your beneficiary easily, too, but you still pay tax and an IRS penalty (10%) if you withdraw your funds for something other than college-related expenses. The penalty may be waived if the account beneficiary (the college bound child) receives a scholarship, becomes disabled or dies.

Another thing to keep in mind is that investing in a college-savings plan could also affect your financial-aid eligibility. College-savings plans are typically viewed as a parental asset, rather than a child's. That's good news, and it means that a financial-aid officer would count a maximum of 5.6% of those assets toward your financial-aid eligibility. That's not a huge negative and, no matter what, don't let the fear of hurting your child's eligibility for financial aid paralyze you from developing a sound savings strategy.

Section 529 Prepaid College Tuition Plans

Don't confuse these with the 529 plans discussed in the previous paragraph. Both are allowed under Section 529 of the Tax Code, but prepaid tuition plans lock in the cost to attend certain in-state colleges. The basic premise of a prepaid plan is this: You can pay now for future college costs and by doing so lock in today's rates (or close to it — you may pay a slight premium). Considering that tuition and fees for public four-year colleges increased an average of 7.2% annually from 1990 through 2006, according to the College Board, this is a darn good deal. Withdrawals from these plans are federal-tax-free and, in most states, state-tax-free as well. The same basic withdrawal restrictions and penalties as the 529 savings plans.

Prepaid-tuition plans come in two forms. Until recently, prepaid plans were only offered by specific states and the plans centered on the major public universities in that state. In the fall of 2003, however, a private-school prepaid-tuition plan was introduced. This plan, known as the **Independent 529 Plan**, allows families in any state to pay today's tuition prices for future tuition bills at more than 257 participating private colleges.

Both types of prepaid plans come with some major drawbacks. First off, these plans obviously substantially restrict school selection. Granted, refunds are available, but if your child is attending a school not covered by the plan, there are no guarantees that the amount you have set aside in your prepaid plan will cover the school's costs. In many cases, it won't even come close.

Prepaid plans are tied to a specific group of schools, not the national average. In most cases, they're tied to in-state public schools. Of the 13 state-school-oriented prepaid plans currently open for enrollment, only two — Alabama and Massachusetts — allow nonresidents to invest. (as of this printing)

This, of course, begs the question of what happens when your child decides to head to a school *not* included in your prepaid plan. Folks who contributed to the Independent 529 plan, which currently has over $100 million under management, are out of luck: *The plan will not pay tuition at any nonparticipating school.* Instead, account owners can roll over their money to other beneficiaries or to a 529 college-savings plan. Refunds are also allowed, and you will not incur

taxes on the earnings and a 10% penalty if the money is used to pay for school. However, the account owner only gets back the principal plus or minus the portfolio's annual rate of return, which is capped at 2%. That's not a good deal. Right now, you could earn a higher return by investing your money in a high-yield savings account.

With the state-school plans, however, the results aren't as restrictive. Assets can be used to pay for any college, including in-state private schools and out-of-state public and private schools. However, if you bought into your state's prepaid plan, but your child was accepted to Yale, your plan will pay you based on the average public college tuition for the year. Suffice it to say, you'll have a large deficit to make up.

For parents who are wary of investment risk, the appeal of a prepaid plan's guaranteed return is obvious. In fact, if tuition rates continue going up at the current pace, parents may end up better off in prepaid plans than in college-savings plans. But because of high tuition inflation, many prepaid plans are having trouble proving they can meet their future obligations. Currently, five states — Colorado, Kentucky, Ohio, Texas and West Virginia — have closed their prepaid plans to new enrollment because of "unfunded liability," which basically means the plan's assets are less than its future liabilities.

Should parents be worried? As of this printing, no program has defaulted on current obligations. When looking at unfunded liabilities, they are typically 15 to 20 years in the future. There is still time for these plans to make up the gap or for the state to step in. Many prepaid plans do, in fact, carry some form of state guarantee, and probably at least half have unfunded future liabilities. So for the very wary, this is something to ponder.

Note: The financial information in this manual is of a general nature and may not apply to all situations. Contact a financial and/or tax advisor before making significant decisions.

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