

## 529 Plans vs. Other College Savings Options

Section 529 plans can be a great way to save for college--in many cases, the best way--but they're not the only way. When you're investing for a major goal like education, it makes sense to be familiar with all of your options.

### U.S. savings bonds

U.S. savings bonds are backed by the full faith and credit of the federal government. They're very easy to purchase, and available in face values as low as \$50 (\$25 if purchased electronically). Two types of savings bonds, Series EE (which may also be called Patriot bonds) and Series I bonds, are popular college savings vehicles. Not only is the interest earned on them exempt from state and local tax at the time you redeem (cash in) the bonds, but you may be able to exclude at least some of the interest from federal income tax if you meet the following conditions:

- ▶ Your modified adjusted gross income (MAGI) must be below \$84,950 if you're filing single and \$134,900 if you're married filing jointly in 2009
- ▶ The bond proceeds must be used to pay for qualified education expenses
- ▶ The bonds must have been issued in 1990 or later
- ▶ The bonds must be in the name of one or both parents, not in the child's name
- ▶ Married taxpayers must file a joint return
- ▶ The bonds must have been purchased by someone at least 24 years old
- ▶ The bonds must be redeemed in the same year that qualified education expenses are being paid

But a 529 plan, which includes both college savings plans and prepaid tuition plans, may be a more attractive way to save for college. A college savings plan invests primarily in stocks through one or more pre-established investment portfolios that you generally choose upon joining the plan. So, a college savings plan has a greater return potential than U.S. savings bonds, because stocks have historically averaged greater returns than bonds (though past performance is no guarantee of future results). However, there is a greater risk of loss of principal with a college savings plan. Your rate of return is not guaranteed--you could even lose some of your original contributions. By contrast, a prepaid tuition plan generally guarantees you an annual rate of return in the same range as U.S. savings bonds (or maybe higher, depending on the rate of college inflation).

Perhaps the best advantage of 529 plans is the federal income tax treatment of withdrawals used to pay qualified education expenses. These withdrawals are completely free from federal income tax no matter what your income, and some states also provide state income tax benefits. The income tax exclusion for Series EE and Series I savings bonds is gradually phased out for couples who file a joint return and have a MAGI between \$104,900 and \$134,900. The same happens for single taxpayers with a MAGI between \$69,950 and \$84,950. These income limits are for 2009 and are indexed for inflation.

However, keep in mind that if you don't use the money in your 529 account for qualified education expenses, you will owe a 10 percent federal penalty tax on the earnings portion of the funds you've withdrawn. And as the account owner, you may owe federal (and in some cases state) income taxes on the earnings portion of your withdrawal, as well. Plus, there are typically fees and expenses associated with 529 plans. College savings plans may charge an annual maintenance fee, an administrative fee, and an investment fee based on a percentage of total account assets, while prepaid tuition plans typically charge an enrollment fee and various administrative fees.

### Mutual funds

At one time, mutual funds were more widely used for college savings than 529 plans. Mutual funds do not impose any restrictions or penalties if you need to sell your shares before your child is ready for college. However, if you withdraw assets from a 529 plan and use the money for noneducational expenses, the earnings part of the withdrawal will be taxed and penalized. Also, mutual funds let you keep much more control over your investment decisions because you can choose from a wide range of funds, and you're

typically free to move money among a company's funds, or from one family of funds to another, as you see fit.

By contrast, you can't choose your investments with a prepaid tuition plan, though you are generally guaranteed a certain rate of return or that a certain amount of tuition expenses will be covered in the future. And with a college savings plan, you may be able to choose your investment portfolio at the time you join the plan, but your ability to make subsequent investment changes is limited. Some plans may let you direct future contributions to a new investment portfolio, but it may be more difficult to redirect your existing contributions. However, states have the discretion to allow you to change the investment option for your existing contributions once per calendar year or when you change the beneficiary. (For 2009 only, states may permit 529 college savings plan investors to change the investment options for their existing contributions twice per year instead of once per year.) Check the rules of your plan for more details.

In the area of taxes, 529 plans trump mutual funds. The federal income tax treatment of 529 plans is a real benefit. You don't pay federal income taxes each year on the earnings within the 529 plan. And any withdrawals that you use to pay qualified higher education expenses will not be taxed on your federal income tax return. (But if you withdraw money for noneducational expenses, you'll owe income taxes on the earnings portion of the withdrawal, as well as a 10 percent federal penalty)

Tax-sheltered growth and tax-free withdrawals can be compelling reasons to invest in a 529 plan. In many cases, these tax features will outweigh the benefits of mutual funds. This is especially true when you consider how far taxes can cut into your mutual fund returns. You'll pay income tax every year on the income earned by your fund, even if that income is reinvested. And when you sell your shares, you'll pay capital gains tax on any gain in the value of your fund. Many 529 college savings plans offer mutual funds whose returns may beat the after-tax return on a taxable mutual fund account.

### **Custodial accounts**

A custodial account holds assets in your child's name. A custodian (this can be you or someone else) manages the account and invests the money for your child until he or she is no longer a minor (18 or 21 in most states). At that point, the account terminates and your child has complete control over the funds. Many college-age children can handle this responsibility, but there's still a risk that your child might not use the money for college. But you don't have to worry about this with a 529 plan because you, as the account owner, decide when to withdraw the funds and for what purpose.

A custodial account is not a tax-deferred plan. The investment earnings on the account will be taxed to your child each year. Under special rules commonly referred to as the "kiddie tax" rules, children are generally taxed at their parent's (presumably higher) tax rate on any unearned income over a certain amount. For 2009, this amount is \$1,900 (the first \$950 is tax free and the next \$950 is taxed at the child's rate). The kiddie tax rules apply to: (1) those under age 18, (2) those age 18 whose earned income doesn't exceed one-half of their support, and (3) those ages 19 to 23 who are full-time students and whose earned income doesn't exceed one-half of their support. The kiddie tax rules significantly reduce the tax savings potential of custodial accounts as a college savings strategy. Remember that earnings from a 529 plan will escape federal income tax altogether if used for qualified higher education expenses; the state where you live may also exempt the earnings from state tax.

But a custodial account might appeal to you for some of the same reasons as regular mutual funds. Though the funds must be used for your child's benefit, custodial accounts don't impose penalties or restrictions on using the funds for noneducational expenses. Also, your investment choices are virtually unlimited (e.g., stocks, mutual funds, real estate), allowing you to be as aggressive or conservative as you wish. As discussed, 529 plans don't offer this degree of flexibility.

Note: Custodial accounts are established under either the Uniform Gifts to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA). The two are similar in most ways, though an UTMA account can stay open longer and can hold certain assets that an UGMA account can't.

Finally, there is the issue of fees and expenses. Depending on the financial institution, you may not have to pay a fee to open or maintain a custodial account. But generally you can count on incurring at least some type of fee with a 529 plan. College savings plans may charge an annual maintenance fee, an administrative fee, and an investment fee based on a percentage of total account assets, while prepaid tuition plans typically charge an enrollment fee and various administrative fees.

## Trusts

Though trusts can be relatively expensive to establish, there are two types you may want to investigate further:

**Irrevocable trusts:** You can set up an irrevocable trust to hold assets for your child's future education. This type of trust lets you exercise control over the assets through the trust agreement. However, trusts can be costly and complicated to set up, and any income retained in the trust is taxed to the trust itself at a potentially high rate. Also, transferring assets to the trust may have negative gift tax consequences. A 529 plan avoids these drawbacks but still gives you some control.

**2503 trusts:** There are two types of trusts that can be established under Section 2503 of the Tax Code: the 2503c "minor's trust" and the 2503b "income trust." The specific features and tax consequences vary depending on the type of trust that is used, and the details are beyond the scope of this discussion. Suffice it to say that either type of trust is much more costly and complicated to establish and maintain than a 529 plan. In most cases, a 529 plan is a better way to save for college.

## Legislative impact

The Jobs and Growth Tax Relief Reconciliation Act of 2003 and the Tax Increase Prevention and Reconciliation Act of 2005 reduced the tax rates on dividends and long-term capital gains. (Through 2010, the maximum tax rate on dividends and long-term capital gains is 15 percent, and for individuals in the 10 and 15 percent tax brackets, the tax rate is zero percent in 2008-2010.) As a result, the comparative advantage of a tax-favored strategy like a 529 plan over a non tax-advantaged strategy like a mutual fund is somewhat lessened. However, further complicating the picture, the reduced tax rates for dividends and long-term capital gains are scheduled to expire beginning in 2011.

**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 the 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.*