

How does a 529 plan compare with using U.S. savings bonds for college expenses?

Answer:

Section 529 plans and U.S. savings bonds are very different ways to save for college. Though both strategies offer federal tax advantages if certain conditions are met, there are few other similarities.

U.S. savings bonds--Series EE (which may also be called Patriot bonds) and Series I--are purchased at banks and other financial institutions in face values as low as \$50 (\$25 if purchased electronically). Typically, U.S. savings bonds earn a return in the range of 3 to 5 percent. And since they're backed by the full faith and credit of Uncle Sam, they're virtually guaranteed.

The interest you earn on U.S. savings bonds is exempt from state and local tax at the time you redeem (cash in) the bonds. And 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 must be below \$84,950 if you're single and \$134,900 if you're married (2009 figures)
- ▶ 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 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

Section 529 plans, which include both college savings plans and prepaid tuition plans, work differently. A college savings plan invests primarily in stocks through one or more pre-established investment portfolios that you 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 (though past performance is no guarantee of future results). However, there is a greater risk of loss of principal. Your rate of return is not guaranteed with a college savings plan--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. Remember, in order to exclude federal income tax on the interest earned by U.S. savings bonds, your income can't exceed a certain level, and you must meet other criteria.

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 (you may owe a state penalty too). Also, if you are the recipient of the distribution from the plan, you may owe federal (and in some cases state) income taxes on the earnings portion of your withdrawal, as well.