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Improving the long term financial security of all women through education and advocacy.

Saving for College with Education Savings Accounts and 529 College Savings Plans

Education Savings Accounts

In 2002, Congress recognized the growing challenge of paying for college by establishing Coverdell Education Savings Accounts (ESAs). ESAs replaced the underpowered, Education IRA. Parents, grandparents or friends can contribute a total of $2,000 a year for each child's ESA compared to the former Education IRA's limit of $500. Benefits must be fully withdrawn by the time the child is 30.

While ESA contributions are not tax-deductible, account savings or investments grow tax-free, significantly increasing total returns. Withdrawals are not subject to federal (nor often state) income tax either, as long as they are used to pay for qualified educational expenses. Congress also expanded the eligible expenses for withdrawals. In addition to college expenses, many kindergarten-through-high school expenses qualify as well.

Parents can earn a high level of income and still be eligible to contribute to an ESA: up to $220,000 for couples filing jointly and $110,000 for single taxpayers.

Drawbacks

There are a few drawbacks with ESAs. First, the child owns the assets, which means that financial aid may be reduced or eliminated. Also there are a variety of fees that may be associated with different types of ESA investments.

529 Plans

Congress has also expanded important provisions for state-based, college-based, qualified tuition programs, called 529 plans. Created in 1996, 529 plans are named after the section of the IRS code that governs them. Each state has its own investment plan designed to help families save for college. Today, all states have at least one plan available. There's a common belief that these plans only have value if you send your child to a state school. But, if you use a 529 savings plan, the value of the account can be used at any accredited college or university, even certain foreign schools.

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Advantages:

Higher Contributions

In general, 529 savings plans allow dramatically higher contributions than the Education Savings Accounts. The limits are established by each program, and can exceed $300,000 per student beneficiary. The 529s do not have an income limit for donor contributions and they have estate-planning benefits as well. Since the account stays in the contributor's name, the student beneficiary can be changed to another family member. You can also roll a Coverdell ESA into a 529 plan although experts warn that the process can be a complicated hassle.

Federal tax advantages

Contributions to 529 plans are taxed but the earnings grow tax-free. When the plan distributes the money to pay for the college costs, the distribution is free of federal taxes.

State taxes

Over 30 states and the District of Columbia allow a deduction for contributions to a 529 plan. In order to get the deduction you have to live or work in the state and choose its plan. The exception are residents of Arizona, Kansas, Maine, Missouri, Montana and Pennsylvania who are offered tax deductions even if the plan is out of state.

Investing in 529 Plans

Contributions to 529 college savings plan go into one or more investment portfolios offered by the plan. Portfolios are managed either by the state or, increasingly, large money management or investment firms. Investment portfolio options are typically sorted by type of security held and associated level of risk – for example, portfolios largely made up of stocks, which offer more growth potential but higher risk, or safer fixed-income investments such as bonds, with their lower earnings rate. Choosing the right investment mix is important for reaching all long-term savings goals, including college plans.

Some state 529 plans make choosing a portfolio easier by offering "age-adjusted" investment options. That is, for families saving for a child who is still some years away from high school graduation, they suggest a higher proportion of stocks or stock mutual funds, with their higher growth potential. Then, as the student gets closer to attending college, the family's contributions are shifted to a less volatile portfolio make up largely of more conservative investments such as bonds or bond funds. That way, the account's value is protected from a sharp drop in the stock market just as the money is needed to pay tuition and other costs.

Even with advice from the plan's investment manager (among others, these might include TIAA, Vanguard, or Fidelity), it is still up to you to learn basic investment principles in order to act according to you own needs and level of risk tolerance. Beyond the "risk-reward" trade-off between stocks and bonds mentioned above, other fundamental concepts include diversification, asset allocation, and what to do (or not do), in a volatile market.

Impact on Financial Aid Eligibility

Maintaining a 529 plan generally reduces a student's eligibility to participate in needs-based financial aid. Assets in the plan are treated as parental assets in calculating the expected family contribution toward college costs.

Pay Attention to Fees

If you don't like your state's plan, you can choose other states' plans, but you should watch out for extra fees or missed tax advantages. Some employers offer a 529 plan through a payroll deduction, like a 401(k), but the employee may miss out on tax advantages and other state incentives, like matching grants, or state financial aid preference.

If you use a broker, make sure you understand how the broker is paid, because you may pay a sizable sales fee otherwise. Better yet, see if you can start a plan on your own. For instance, *The Wall Street Journal* reported that if you buy an account in the Rhode Island plan directly, there is no fee. But if you go through a broker, there is as much as a 4.25% sales fee. Also, watch the annual fees, they vary.

And, speaking of fees, whatever plans you consider, ask what fees apply. There are a variety of different fees such as a "load," enrollment fee, annual maintenance fee, asset management fee, paper statement fee, cancelation fee, or transaction fee. Some fees may be waived for those who maintain healthy balances or who sign up for automatic deposit.

Consider the choice of investments – do they fit your needs? Some states' plans have only a few choices, while others have many.

529 Prepaid Tuition Plans

In addition to the 529 college savings plans, there are also 529 prepaid tuition plans. Contributions to prepaid tuition plans allow parents to lock in today's tuition rates. The plan pools contributions and makes long-range investments to cover college tuition increases in the state. While these plans initially could be used to pay tuition only at the state's public colleges and universities, most states now have more liberal rules that also allow account withdrawals to be used to pay tuition at private and out-of-state institutions.

Resources

College Savings Plans Network, an affiliate of the National Association of State Treasurers. Call 877-277-6496 to be connected to your state's 529 plan. Or visit the website at collegesavings.org.

The Best Way to Save for College: A Complete Guide to 529 Plans. Book by Joseph F. Hurley, CPA who also manages a website, savingforcollege.com, which contains comparative information on states' 529 plans, as well as basic introductory information.

Security and Exchange Commission (SEC)'s Investor Bulletin, *An Introduction to 529 Plans*. Visit **SEC.gov** and enter the title into the search bar.

IRS News Release, *529 Plans: Questions and Answers*. Visit IRS.gov and enter the title into the search bar.