SAGE Scholars

Ten Minute Professor

An Introduction to 529 Plans

What is a 529 plan?

By SAGE Scholars

A 529 plan is a tax-advantaged savings plan designed to encourage saving for future college costs. 529 plans, legally known as qualified tuition plans, are authorized by Section 529 of the Internal Revenue Code. Withdrawals for qualified educational expenses can be used at any accredited college or university.

All 50 states and the District of Columbia sponsor at least one type of 529 plan. There are 2 types of 529 plans:

1) Prepaid tuition plans

2) College savings plans (also known as investment plans)

How does a prepaid tuition plan differ from a college savings investment plan?

Prepaid tuition plans generally allow college savers to purchase units or credits at participating colleges and universities for future tuition (in some cases, room and board as well). Most prepaid tuition plans are sponsored by state governments, have residency requirements, and provide investment guarantees. Only 11 states currently offer prepaid plan options for new account holders.

College savings plans permit the account-holder to establish an investment account on behalf of a student (the beneficiary) for the child's future eligible college expenses. There are 2 types of plans:

1) Advisor-sold

2) Direct investment (in which the account-holder assumes responsibility for managing the investment)

An account-holder typically chooses among several investment contribution options, which the plan management firm then invests. Investment options include stock mutual funds, bond mutual funds, and money market funds. Investments are not guaranteed by state governments or federally insured.

What are the tax benefits?

Investing in a 529 plan offers special tax benefits. Earnings in 529 plans, including interest and dividends, are not subject to federal tax (and, in most cases, state tax) so long as you use withdrawals for eligible educational expenses (such as tuition and room and board).

However, if you withdraw money from a 529 plan and do not use the funds for eligible educational expenses, you will be subject to income tax on any capital gains and an additional 10% federal tax penalty on earnings.

State tax treatment varies. Only a few states allow residents to deduct contributions to any 529 plan from adjusted gross income and do not tax earnings, regardless of which state's 529 plan you choose. Most states limit tax benefits on contributions and earnings to participation in their own state's 529 plan.

For a detailed analysis of state-by-state tax benefits, check out finaid.org/savings/state529deductions.phtml. If you receive state tax benefits, make sure you review your plan's offering circular before you complete a transaction (such as rolling money out of your home state's plan into another state's plan). Some transactions may have negative state tax consequences.

What fees and expenses can be expected?

Fees and expenses vary. Prepaid tuition plans typically charge enrollment and administrative fees. In addition to loads (commissions) for broker-sold plans, college savings plans may charge enrollment fees, annual maintenance fees, and asset-management fees.

Prepaid Tuition Plans (only 12 states)	College Savings Plans (all 50 states)
Investment locks in tomorrow's tuition prices today (at accredited schools).	Some states offer only a direct investment plan; some states offer only a broker-sold plan; some offer both. No locking-in of college costs. Investment returns may match, be above or be below the rate at which tuition increases.
All plans allow tax-free withdrawals to cover tuition and mandatory fees. Some plans allow purchase of a room and board option or provide the ability to use excess tuition credits for other qualified expenses.	Withdrawals tax-free to cover qualified higher education expenses including tuition; room and board, mandatory fees, books, computer, and software for educational purposes.
Most plans set lump sum and installment payments prior to purchase based on age of beneficiary and the number of years of tuition purchased.	Many plans have contribution limits (for example, $200,000 per student).
Value is guaranteed or backed by the state, directly or indirectly.	No guarantees. Investors are subject to market risk. Investments may appreciate or lose value.
Most plans have age or grade limits for the beneficiary.	No age limits. Open to adults as well as children.
Most plans require either owner or beneficiary to be a resident of that state.	No residency requirements. Non-residents may be able to purchase some plans only through financial advisors or brokers.
Most plans have a limited enrollment period.	Enrollment open all year.

Some of these fees are collected by the state sponsor; some fees are collected by the financial service management firms that the states hires. Some college savings plans will waive or reduce some fees if you maintain a large account balance, participate in an automatic contribution plan, or are a resident of the state sponsoring the plan. The asset management fees will depend on the investment option that you select.

Each investment option will typically bear a portfolio-weighted average of the fees and expenses of the selected mutual funds and other investments. You should carefully review the fees of the underlying investments because they usually differ for each investment option.

Investors who purchase a college savings plan from a broker are typically subject to additional fees. If you invest in a broker-sold plan, you may pay a sales commission. Broker-sold plans also charge an annual distribution fee (like the 12b 1 fee charged by some mutual funds) of between 0.25% and 1.00% of your investment balance. Your broker typically receives all or most of these annual distribution fees for selling your 529 plan to you. Many broker-sold 529 plans offer more than one class of shares, which impose different fees and expenses.

Can we avoid extra fees?

Direct-sold college savings plans: many states offer college savings plans through which account-holders can invest without paying a load fee or sales fee. This type of plan, which you can buy directly from the plan's sponsor or program manager, is generally less expensive because it waives or does not charge sales fees.

Broker-sold college savings plans: if you prefer to purchase a broker-sold plan, you may be able to reduce the front-end load if you invest above certain amounts.

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