COLLEGE SAVINGS PLANS: A GUIDE TO HOW THEY WORK

By Julie Vore

Savings placed in a section 529 account grow tax-deferred until the designated beneficiary withdraws funds to pay for college, at which time accumulated earnings are taxed to the beneficiary at the beneficiary's tax rate.

In 1997, the same year that the Roth and Education IRAs came into existence, Congress made changes to section 529 of the U.S. tax code that paved the way for the creation of state-sponsored college savings plans that offer great tax benefits and—sometimes—good investment options.

Since 1997, more than 20 states have implemented college savings plans specifically designed to allow investors to take advantage of the federal income tax deferral and estate tax benefits provided under section 529. As icing on the cake, most of these states have added state tax benefits for in-state investors. Curiously, these plans have received little media attention. So, since the state sponsors have little incentive or ability to advertise, these college savings plans have remained a wonderful little secret among the initiated.

HOW THEY WORK

College savings plans should not be confused with prepaid tuition plans, in which today's tuition rates are locked in by the contributor. In contrast, a college savings plan allows participants to save money in a special college savings account on behalf of a designated beneficiary's qualified higher education expenses.

In a college savings plan, a contributor places funds into a section 529 account, and savings grow tax-deferred until the designated beneficiary is ready to attend college. When the funds are withdrawn to pay for college, accumulated earnings are taxed to the beneficiary at the beneficiary's current federal income tax rate. Because taxes have been deferred and because a student beneficiary is likely to be in a lower tax bracket than the contributor, a tax savings will most likely result. (In 1999, a proposal to make all qualified withdrawals tax-free was passed by Congress, but vetoed by President Clinton.)

In addition to tax deferral and the transfer of tax liability to a potentially lower-rate payer, there are also attractive estate planning benefits. Although the contributor retains complete control over funds within a 529 plan and can change beneficiaries or withdraw funds (with penalty) at any time, a contribution is treated as a completed gift and is immediately excluded from the contributor's estate, resulting in a potential estate tax savings. Additionally, whereas the normal gift tax rules permit the tax-free transfer of only $10,000 per donee per year, a 529 contributor can transfer up to $50,000 at one time for each designated beneficiary without triggering gift taxes. As long as the contributor lives four more years after the year of transfer and does not give the beneficiary any additional gifts during that time, no gift taxes will be owed and the entire $50,000 will be excluded from the contributor's estate. If the contributor dies within the window period, a prorated amount will be included within the contributor's taxable estate.

HOW THE MONEY IS INVESTED

Once money is invested in a section 529 account, the investor has no

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discretion over future investment decisions. This makes the original decision as to which state program to use of paramount importance, since not all state plans are created equal. The most typical method used involves a mixture of mutual funds, with the mixture becoming more conservative as the designated beneficiary approaches college.

Iowa's plan is a good example of this strategy. The plan utilizes the Vanguard Lifestrategy funds, which use an index approach. Five-year-olds and younger are invested in the Growth Portfolio (80% stocks/20% bonds). Six- to 10-year-olds are invested in the Moderate Growth Portfolio (60% stocks/40% bonds). Eleven- to 15-year-olds are invested in the Conservative Growth Portfolio (40% stocks/60% bonds), and all older beneficiaries are invested in the Income Portfolio (20% stocks/80% bonds).

New Hampshire's Plan is similar, but differs in important ways. It utilizes 16 different Fidelity mutual funds, most of which are managed funds, to create six different portfolios for accounts with designated beneficiaries who are 0–4, 4–7, 7–10, 10–13, 13–16 and 16+ years of age. Investment performance will almost certainly differ between the Iowa and New Hampshire plans, if only because one has an index focus and the other has a managed fund focus. Of course, other variables are certain to contribute to varying performance as well.

A few other states have significantly different options. Maine and Colorado allow the contributor a one-time choice between different investment styles. Typically, one choice is an age-based allocation that will change over time while the other choices offer a static asset allocation approach. In Arizona, an investor can choose between an FDIC-insured account with CDs or mutual funds.

DISADVANTAGES

Federal law requires the imposition of penalties on any refund of earnings that are not: used for qualified higher education purposes of the designated beneficiary, made on account of the death or disability of the designated beneficiary, or made on account of a scholarship received by the designated beneficiary. This penalty provision makes 529 plans much less attractive to anyone not saving for college. And, it requires contributors to risk the possibility that their intended beneficiary will not pursue higher education.

Also, a state sponsor could change its plan and leave unhappy plan participants trapped. Once funds have been invested with one state plan, there are no federal provisions that allow tax-free transfers to another state's plan. While it is likely that this lack of mobility will be changed by future legislation, there is no guarantee.

Other disadvantages include the inability to contribute to both an Education IRA and a section 529 plan in the same year, the inability to change beneficiaries (without penalty) to anyone outside the nuclear family of the original beneficiary, and the uncertainty caused by various unresolved loose-ends that currently exist in connection with section 529 plans. In regard to the Education IRA, if any money is contributed on behalf of an individual child, then the total maximum contribution for both the Education IRA and section 529 plan is $500. This means that it is necessary to forgo the potential, albeit limited, tax benefits of the Education IRA in order to utilize the tax benefits of a section 529 plan. Also, a grandparent cannot move funds between cousin beneficiaries. That is, if Grandma places money in accounts for her two grandchildren who are cousins to each other and only one goes to college, she won't be able to transfer funds between the accounts, as she would be able to do in the case of brothers and sisters. In order to use both accounts to benefit the college student, she must withdraw the funds from the non-college student's account, pay penalties, and then apply the remaining funds to the college student's expenses.

Last but not least, it deserves to be mentioned that these plans have only existed for a short period of time and there are still inevitable glitches that need to be resolved. These problems range from inexperienced customer service representatives and longer service times, to serious contractual flaws in some of the state programs. For example, most states have no provisions that allow for the contractual passing of account ownership in the event of the contributor's death. And most state plans do not allow account ownership to be held within a trust. In these cases, account ownership must pass through the owner's will in a probate court proceeding. Unless the owner specifically designated an appropriately benevolent person in their will, the new owner could take all of the account assets for themselves, leaving the intended beneficiary out in the cold. The Iowa plan allows for the contractual appointment of a successor owner and, if none has been designated, provides that the account will contractually pass to the designated beneficiary. This method of ownership transfer is better, although not perfect.

THE BEST STATES

If you like the tax benefits 529 plans offer and are willing to put up with the current disadvantages and uncertainties, you should examine the different state-sponsored options carefully. Because most of the plan benefits apply regardless of the beneficiary's or contributor's state of residence and regardless of the state in which the beneficiary plans to attend college, you should not automatically limit yourself to a particular state. Of course, if your own state offers a plan with state-tax benefits, that plan should be given preferential consideration. But if its investment options are

TABLE 1. A COMPARISON OF SECTION 529 COLLEGE SAVINGS PLANS BY STATE

State	Affiliated Investment Company	Comments	Contact
Arizona	College Savings Bank (offers CD investments) and Securities Management & Research (offers seven proprietary mutual funds)		(602) 229-2591
Arkansas	Merrill Lynch		(877) 442-6553
California	TIAA-CREF		(877) 728-4338
Colorado	Salomon Smith Barney		(800) 478-4651
Connecticut	Uses a variety of money management firms	Either contributor or beneficiary must be CT resident at time account is opened.	(888) 799-2438
Delaware	Fidelity		(800) 544-1655
Florida	Plan anticipated Fall 2000		(800) 552-4723
Hawaii	Plan anticipated		(808) 586-1518
Illinois	Plan anticipated March 2000		(877) 877-3724
Indiana	Bank One—One Group Mutual Funds		(888) 814-6800
Iowa	Vanguard	State endowment fund may enhance earnings; $2,000 maximum annual contribution.	(888) 672-9116
Kansas	Plan anticipated July 2000		(785) 296-3171
Kentucky	TIAA-CREF	Must have a connection with Kentucky.	(877) 598-7878
Louisiana	State of Louisiana	Principal is guaranteed and savings can earn “competitive” interest rates; savings may be enhanced by state tuition assistance grants; must have Louisiana connection.	(800) 259-5626 x1012
Maine	Merrill Lynch		(800) 228-3734
Massachusetts	Fidelity		(800) 544-2776
Minnesota	Plan anticipated March 2000		(800) 657-3866 x3201
Missouri	TIAA-CREF		(888) 414-6678
Montana	College Savings Bank	Savings are FDIC insured and are invested in certificates of deposit.	(800) 888-2723
New Hampshire	Fidelity		(800) 544-1722
New Jersey	State of New Jersey	Either contributor or beneficiary must be NJ resident at time account is opened.	(877) 465-2378
New York	TIAA-CREF		(877) 697-2837
North Dakota	Plan anticipated April 2000		(800) 472-2166 x85792
Oklahoma	TIAA-CREF—Plan anticipated Feb. 2000		(405) 858-4422
Oregon	Plan anticipated 2001	Plan is currently under study.	(503) 378-4329
Rhode Island		Must have RI connection.	(877) 474-4378
Tennessee	TIAA-CREF—Plan anticipated Feb. 2000		(888) 486-2378
Utah	Vanguard	State endowment fund may enhance earnings; $1,290 maximum annual contribution.	(800) 418-2551
Vermont	TIAA-CREF—Plan anticipated ASAP		(800) 637-5860
Virginia	Uses a variety of money management firms; initial investment choice available but all accounts will eventually move toward 100% fixed-income allocation.		(888) 567-0540
Wyoming	Merrill Lynch Plan anticipated March 2000		(307) 777-7408

lousy, you should not feel locked-in to that plan.

At the time of this writing, 31 states have developed, or are in the process of developing, a section 529 college savings plan. Some plans are administered completely by the state sponsor, others are managed by an investment company, and still others offer some sort of combination of benevolent state oversight and well-known mutual fund investments.

Among the better plans are those of Iowa, New York and Massachusetts. Not only does the Iowa plan use Vanguard Funds, which have low operating expenses, but it also charges no service fees and is connected with a charitable endowment fund that will (if it is successful and receives contributions) distribute its earnings among participant accounts as an incentive to save for college. The only drawback to the Iowa program is a maximum annual contribution amount of $2,000.

For those who would like to contribute more at one time or would like to take advantage of the $50,000 estate planning feature described above, the New York and Massachusetts programs are more attractive. The New York program is administered by TIAA-CREF, has an expense ratio of 0.65% and allows contributions of up to $100,000 per beneficiary.

The Massachusetts program is administered by Fidelity, has an expense ratio of 1% and allows contributions of up to $158,750 per beneficiary.

COMPARING THE PLANS

The information in Table 1 summarizes some of the important variables that make each of the state plans different.

Because all existing plans are run either directly or indirectly by the states, all accounts must be purchased and held from the state programs directly; phone numbers are provided so you can get in touch with the individual plan administrators. With few exceptions, section 529 plans are sold without a “load.” Investments in a 529 plan cannot be made through your local financial advisor. If you want independent advice from a local source, an hourly fee or other non-commission compensation arrangement, if available, may be the only option.

For a current listing of the available plans, refer to the Web site www.collegesavings.org. This site is sponsored by the College Savings Plans Network, which is an affiliate of the National Association of State Treasurers. If you do not have Web access, you can call this organization at (877) 277-6496 for more information. ✦