SAGE Scholars, Inc.

Ten Minute Professor

An Introduction to 529 Plans

What is a 529 Plan?

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 two types of 529 Plans: (1) Pre-paid tuition plans and (2) College savings plans – also known as investment plans.

Students walking on the Wheeling Jesuit University campus.

How does a pre-paid tuition plan differ from a college savings investment plan?

"**Pre-paid tuition plans**" generally allow college savers to purchase units or credits at participating colleges and universities for future tuition -- and, in some cases, room and board. Most pre-paid tuition plans are sponsored by state governments, have residency requirements and provide investment guarantees. Twelve states offer pre-paid tuition plans.

"**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 two 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 on the account-holder's behalf. Investment options include stock mutual funds, bond mutual funds and money market funds; often, age-based portfolios are offered that automatically shift toward more conservative investments as the beneficiary gets closer to college age. Investments are not guaranteed by state governments and are not 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" college expenses, such as tuition, room and board.

However, if you withdraw money from a 529 Plan and do not use the funds for eligible college 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. A few states (Arizona, Kansas, Maine & Pennsylvania) allow residents to deduct contributions to any 529 Plan from your adjusted gross income and do not tax earnings, regardless of which state's 529 Plan you choose to invest in. Most states, however, limit tax benefits on contributions and earnings to participation in their own state's 529 Plan. Some states also offer matching grants or other additional benefits, typically to low-income investors.

For a detailed analysis of state-by-state tax benefits, here's a helpful link:

http://www.finaid.org/savings/state529deductions.phtml

If you receive state tax benefits, make sure you review your Plan's offering

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Pre-Paid Tuition Plans (only 12 states)	College Savings (Investment) Plans (all 50 states)
Investment "locks in" tomorrow's tuition prices today (at eligible public & private colleges & universities).	Some states offer only a direct investment plan; some states offer only a broker-sold plan; some offer both. No "lock" on college costs. Investment returns may match, be above or be below tuition "inflation" rate.
All plans allow tax-free withdrawals to cover tuition & mandatory fees. Some plans allow purchase of a boom & 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 & board; mandatory fees; books; and, purchase of a computer and software for educational purposes.
Most plans set lump sum & installment payments prior to purchase based on age of beneficiary and the number of years of college tuition purchased.	Many plans have contribution limits (for example, $200,000 per student).
Value is guaranteed or backed by the state.	No guarantees. Investors are subject to market risk. Investments may appreciate, be "flat" 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 thru financial advisors or brokers.
Most plans have a limited enrollment period.	Enrollment open all year.

Tax Benefits

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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 & expenses can be expected?

It is important to understand the 529 Plan's fees and expenses because they lower your investment returns. Fees and expenses vary. Pre-paid tuition plans typically charge enrollment and administrative fees. In addition to "loads" for broker-sold plans, college savings plans may charge enrollment fees, annual maintenance fees and asset management fees.

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 if you maintain a large account balance or participate in an automatic contribution plan -- or if you 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

Students at Millikin University (IL)

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 "load" -- a sales commission. Broker-sold plans also charge an annual distribution fee (similar to 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 do offer college savings plans through which residents (and, often, non-residents) can invest without paying a "load"- or sales fee. This type of plan, which you can buy directly from the plan's sponsor or program manager without the assistance of a broker, is generally less expensive because it waives or does not charge sales fees. You can find information by contacting the Plan's sponsor or program manager – or by visiting the Plan's website. Websites such as the one maintained by the *College Savings Plan Network*, founded by state treasurers, and many commercial websites provide information and links.

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 (or plan to invest) above certain threshold amounts. Ask your broker how to qualify for these "breakpoint discounts."

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How do 529 Plan investments impact financial aid eligibility?

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Financial aid treatment depends on whether the owner of the assets is the parent, the student or the grandparent. According to the federal financial aid formula, **5.64%** of parental assets are expected to be contributed toward the student's college expenses for each academic year. However, if the investment is student-owned, **20%** of assets are expected to be contributed each year to pay for college.

529 Plan assets are considered owned **by the investor** – typically, the parent(s) or the grandparent(s). So, if the 529 Plan is "parent-owned" and the end-of-year balance is $10,000, a student's eligibility for need-based financial aid would typically be reduced by 5.64% ($564) for the subsequent year.

However, if the 529 Plan is "grandparent-owned", there would be **no reduction** in the student's financial aid eligibility -- as long as no withdrawals are made. **But:** A withdrawal is typically treated by a financial aid office as student income on the FAFSA in the following year. Therefore, if the student is eligible for financial aid, the standard advice for grandparent-owned 529 Plans is to make withdrawals to pay for the senior year of college, eliminating any financial aid reduction for the student. Or, the grandparent should make the parent be owner of the asset.

If the student becomes legally "independent" -- no longer claimed by a parent as a "dependent" on the income tax return -- it is possible that a 529 Plan can reduce aid eligibility. Students frequently become "independent" and change their state of residence when attending an out-of-state public college; this enables students to claim residency and thus eligibility for "in-state" tuition rates. However, withdrawals from parent-owned 529 Plans (prior to the senior year) may then be considered student income by the college. Likewise, if account ownership passes to the student, there are financial aid implications. Each college sets its own financial aid policy for "independent" students.

What restrictions apply to 529 investments?

Investments: Participants in College Savings Plans have limited investment options and are not permitted to switch freely among available investment options. Under current tax law, an account holder is only permitted to change his or her investment option once per year. Additional limitations may apply. Before you invest, you should read the Plan's offering circular to make sure that you understand and are comfortable with any Plan limitations.

Withdrawals: If the educational institution where the student attends is accredited, you can withdraw 529 Plan assets for "eligible" student expenses without incurring taxes and penalties. "Eligible" expenses include tuition, fees, books, supplies and equipment. Room and board are eligible expenses if the student is enrolled at least "half-time"; "caps" exist. For example, the cost of on-campus residential housing determines the allowable expense for off-campus housing. Purchase of a computer and software (used predominantly for educational purposes) is allowable; so is internet access while attending college. Expenses for special needs services must be incurred

Students at work at a Creighton University lab.

in connection with enrollment or attendance. However, supplemental charges shown on a college's invoice – for example, fraternity dues and student healthcare fees – are generally **not** allowable expenses. A tuition refund plan is considered an insurance policy and not an allowable expense.

Losses: Although profits on a 529 Plan investment are not taxable at the federal level and frequently on the state level, losses (if any) are not fully deductible. If the account is worth less than the investment, you can claim a loss only if: (1) You close the account; and, (2) You liquidate **all** owned 529 accounts for the same beneficiary. If it is then determined that a loss has occurred, the liquidation amount cannot be paid towards qualified educational expenses. This is called a "non-qualified liquidation." And, if there is a loss, the investor must claim it as a "miscellaneous itemized deduction" (not as a capital loss on the Schedule D). Miscellaneous deductions can be taken only to the extent that they exceed 2% of adjusted gross income.

Is investing in a 529 Plan right for me?

Before you start saving specifically for college, you should consider your overall financial situation. You may want to focus on other financial goals — buying a home, saving for retirement or paying off high-interest credit card bills. Remember that you may face penalties or lose benefits if you do not use the money in a 529 account for qualified higher education expenses.

If you decide that saving specifically for college is right for you, then the next step is to determine whether investing in a 529 Plan is your best college saving option. Other tax-advantaged ways to save for college include Coverdell education savings accounts and the purchase of life insurance with cash value

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Consult your advisor

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(that you can borrow against to pay college expenses). Another option is to save for college in a taxable account.

Each college saving option has advantages and disadvantages -- and may have a different impact on your eligibility for financial aid. If you need help determining which options work best for your circumstances, you should consult with your financial professional or tax advisor before you start saving.

When there's a divorce, a 529 Plan may be essential

Natalie Pace, the author of "*You Vs. Wall Street*" and the founder and CEO of the Women's Investment Network, LLC, wrote in the Huffington Post in 2011: "I've spoken to many divorcees who had divorce settlements that mandated money [be set] aside for college -- only to discover, when it came time to pay tuition, that no funds had actually been saved. Or, the college fund had been drained to pay other bills.

It's difficult, expensive, time-consuming and simply *too late* to try and go back to court for a judgment in time to keep your kid in college. That is why setting up a 529 college fund that both parents are able to monitor annually (at a minimum) is a safeguard against this disaster."

What questions should I ask before I invest in a 529 Plan?

- ✓ *Is the plan available directly from the state or plan sponsor?*
- ✓ *What fees are charged by the plan? How much of my investment goes to compensating my broker? Under what circumstances does the plan waive or reduce certain fees?*
- ✓ *What are the plan's withdrawal restrictions? Are there limitations on the colleges and universities where withdrawals can be used?*
- ✓ *What types of investment options are offered by the plan? How long are contributions held before being invested?*
- ✓ *Does the plan offer special benefits for state residents? Would I be better off investing in my state's plan or another plan? Does my state's plan offer tax advantages or other benefits for its plan? If my state's plan charges higher fees than another state's plan, do the tax advantages or other benefits offered by my state outweigh the benefit of investing in another state's less expensive plan?*
- ✓ *What limitations apply to the plan? When can an account-holder change investment options, switch beneficiaries, or transfer ownership of the account to another account holder?*
- ✓ *Who is the program manager? When does the program manager's current management contract expire? How has the plan performed in the past?*

Yes, this is Brooklyn, NY! Spring on the Pratt Institute campus.

Where can I find more information?

Offering Circulars for 529 Plans: You can find out more about a particular 529 plan by reading its "offering circular". Often called a "disclosure statement," "disclosure document," or "program description," the offering circular will have detailed information about investment options, tax benefits and consequences, fees and expenses, financial aid, limitations, risks, and other specific information relating to the 529 plan. Most 529 Plans post their offering circulars on publicly available websites. The National Association of State Treasurers created the College Savings Plan Network, which provides links to most 529 plan websites.

Additional Information about Underlying Mutual Funds: You may want to find more about a mutual fund included in a college savings plan investment option. Additional information about a mutual fund is available in its prospectus, statement of additional information and semi-annual and annual report. Offering circulars for college savings plans often indicate how you can obtain these documents from the plan manager for no charge. You can also review these documents on the SEC's EDGAR database.

Investment Adviser Public Disclosure Website*:* Many college savings plans' program managers are registered investment advisers. You can find more about investment advisers through the Investment Adviser Public Disclosure website. On the website, you can search for an investment adviser and view the Form ADV of the adviser. Form ADV contains information about an investment adviser and its business operations as well as disclosure about certain disciplinary events involving the adviser and its key personnel.

Broker-Dealer Public Disclosure Website: You can find more about a broker through the NASD's National Association of Securities Dealers' BrokerCheck website. On the website, you can search for any disciplinary sanctions against

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Where can I find more information?

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your broker, as well as information about his or her professional background and registration and licensing status.

Other Online Resources: You can learn more about 529 plans and other college saving options on the NASD's ***Smart Saving for College*** *(www.nasd.com, go to investor relations, then college savings center)* website.

The website contains links to other helpful sites, including the ***College Savings Plan Network*** *(www.collegesavings.org)* and the Internal Revenue Service's comprehensive 82 page ***Publication 970*** (Tax Benefits for Higher Education www.irs.gov, click forms and publications, download forms by publication number, scroll down to publication 970).

The **NASD's investor alert**, www.nasd.com, (> Investor Information > Investor Alerts > 529 Plans) on 529 plans also provides valuable information for investors.

Saving for College (www.savingforcollege.com) and **Morningstar** (www.morningstar.com) provide ratings for various state 529 Plans (although we, naturally, don't think states are sufficiently rewarded for offering Tuition Rewards® as an added investor benefit).

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About SAGE Scholars

SAGE Scholars was formed in 1995 to promote the values and affordability of private higher education. Through our unique Tuition Rewards® program, SAGE brings together families, colleges & universities, and investment companies to create college funding solutions. Specializing in college savings and tuition planning, SAGE uniquely brings together scholarships, 529s and other investments, college search and cost calculators to help families and financial professionals plan for college expenses.

SAGE Scholars was started by visionary leaders with higher education experience including the former head of admissions and financial aid at the Wharton School at the University of Pennsylvania.

The SAGE Advisory Council is comprised of senior leaders from SAGE partner schools and other institutions. The Advisory Council consists of college presidents, vice presidents of enrollment, directors of financial aid and other senior staff. The Advisory Council works to promote SAGE's programs to colleges and universities across America and advises SAGE on issues related to higher education.

SAGE Scholars, Inc.
21 South 12th St, 9th Floor
Philadelphia, PA 19107

www.tuitionrewards.com

support@sagescholars.com