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Are 529 college savings plans a good way to save for college?

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Answer:

Yes, they can be an excellent way to save for college. College savings plans are established by states and typically managed by an experienced financial institution designated by the state. Each plan has slightly different features.

A 529 college savings plan lets you save money for college in an individual investment account that offers federal tax advantages. You (or anyone else) open an account in your child's name and thereafter contribute as much money as you wish, subject to the plan's limit.

The state's selected money manager takes your contribution and invests it in one or more of the plan's pre-established investment portfolios, which typically consist of mutual funds. Some plans automatically place your contribution in a portfolio that's tailored to the age of your child. (The younger your child, the more aggressive the percentage of stocks. As your child grows older, the portfolio gradually shifts to more conservative investments.) Other plans let you choose the portfolio you want at the time you join the plan, without regard to your child's age. This lets you take into account your risk tolerance and other factors that may be important to you.

College savings plans are popular because they combine many desirable tax features with the ability to use the money at any accredited college in the country or abroad. Your contributions grow tax deferred, and if withdrawals are used to pay the beneficiary's qualified education expenses, the earnings are completely free from income tax at the federal level. Many states also add their own tax benefits, such as tax deductions for contributions and exemption of the earnings from state income tax. However, if a withdrawal isn't used to pay the beneficiary's qualified education expenses (known as a nonqualified withdrawal), the earnings portion is subject to a 10 percent federal penalty and is taxed as income at the rate of the person who receives the withdrawal (a state penalty may also apply).

There are no income limits that determine whether you are eligible to open a college savings plan account--everyone is eligible. And if your child decides not to go to college or gets a full scholarship, the money in the plan can be transferred to a qualified family member without penalty.

But investment returns aren't guaranteed. If your investment portfolio performs poorly, you're still bound by the investment decisions of the plan's money manager, unless the plan lets you change the investment strategy for your existing contributions, which it may do twice per calendar year. College savings plans are also free to let you change your investment option for future contributions. If your plan doesn't provide this flexibility, then you are allowed by federal law to roll over your college savings plan account to a different 529 plan (college savings plan or prepaid tuition plan) without penalty once every 12 months.

You are not limited to your own state's college savings plan. Most states allow anyone to participate in their plan. You may also participate in the college savings plan of more than one state.

Note: Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.

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