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The ABCs of 529 Plans

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529 plans are tax-advantaged education savings vehicles and one of the most popular ways to save for education today. Much like the way 401(k) plans revolutionized the world of retirement savings a few decades ago, 529 plans have changed the world of education savings.

An overview of 529 plans

Congress created 529 plans in 1996 in a piece of legislation that had little to do with college — the Small Business Job Protection Act. Known officially as qualified tuition programs, or QTPs, under federal law, 529 plans get their more common name from section 529 of the Internal Revenue Code, which governs their existence.

Over the years, 529 plans have been modified by various pieces of legislation. The most recent change was in 2017 in the Tax Cuts and Jobs Act, which expanded the definition of a 529 plan "qualified education expense" to include K-12 tuition, up to $10,000 per year.

529 plans are governed by federal law but run by states through designated financial institutions who manage and administer specific plans. There are actually two types of 529 plans — savings plans and prepaid tuition plans. The tax advantages of each are the same, but the account features are very different. 529 savings plans are far more common.

529 savings plans

A 529 savings plan is an individual investment account, similar to a 401(k) plan, where you contribute money for college or K-12 tuition. To open an account, you fill out an application, where you choose a beneficiary and select one or more of the plan's investment options. Then you simply decide when, and how much, to contribute.

529 savings plans offer a unique combination of features that no other education savings vehicle can match:

- Federal tax advantages: Contributions to a 529 account accumulate tax deferred and earnings are tax free if the money is used to pay the beneficiary's qualified education expenses. (The earnings portion of any withdrawal not used for qualified education expenses is taxed at the recipient's rate and subject to a 10% penalty.) This is the same tax treatment as Coverdell education savings accounts (ESAs).
- State tax advantages: States are free to offer their own tax benefits to state residents. For example, some states exempt qualified withdrawals from income tax or offer a tax deduction for your contributions. A few states even provide matching scholarships or matching contributions. (Note: 529 account owners who are interested in making K-12 contributions or withdrawals should understand their state's rules regarding how K-12 funds will be treated for tax purposes as not all states

may follow the federal tax treatment.)

- High contribution limits: Most plans have lifetime contribution limits of $350,000 and up (limits vary by state).
- Unlimited participation: Anyone can open a 529 savings plan account, regardless of income level. And you don't need to be a parent to open an account. By contrast, your income must be below a certain level if you want to contribute to a Coverdell ESA.
- Simplicity: It's relatively easy to open a 529 account, and most plans offer automatic payroll deduction or electronic funds transfer from your bank account to make saving even easier.
- Wide use of funds: Money in a 529 savings plan can be used to pay the full cost (tuition, fees, room and board, books) at any college or graduate school in the United States or abroad that is accredited by the Department of Education, and for K-12 tuition expenses up to $10,000 per year.
- Professional money management: 529 savings plans are managed by designated financial companies who are responsible for managing the plan's underlying investment portfolios. Plans typically offer static portfolios that vary in their amount of risk and where the asset allocation in each portfolio remains the same over time, and age-based portfolios, where the underlying investments gradually and automatically become more conservative as the beneficiary gets closer to college.
- Plan variety: You're not limited to the 529 savings plan offered by your own state. You can shop around for the plan with the best money manager, performance record, investment options, fees, and customer service.
- Beneficiary changes and rollovers: Under federal rules, you are entitled to change the beneficiary of your account to a qualified family member at any time as well as roll over (transfer) the money in your account to a different 529 plan (savings plan or prepaid tuition plan) once per calendar year without income tax or penalty implications. This lets you leave a plan that's performing poorly and join a plan with a better track record or more investment options.
- Accelerated gifting: 529 savings plans offer an estate planning advantage in the form of accelerated gifting. This can be a favorable way for grandparents to contribute to their grandchildren's education while paring down their own estate, or a way for parents to contribute a large lump sum. Under special rules unique to 529 plans, a lump-sum gift of up to five times the annual gift tax exclusion amount ($15,000 in 2019) is allowed in a single year, which means that individuals can make a lump-sum gift of up to $75,000 and married couples can gift up to $150,000. No gift tax will be owed, provided the gift is treated as having been made in equal installments over a five-year period and no other gifts are made to that beneficiary during the five years.
- Transfer to ABLE account: 529 account owners can roll over (transfer) funds from a 529 account to an ABLE account without federal tax consequences if certain requirements are met. An ABLE account is a tax-advantaged account that can be used to save for disability-related expenses for individuals who become blind or disabled before age 26.

529 prepaid tuition plans

A 529 prepaid tuition plan lets you save money for college, too. But it works quite differently than a 529 savings plan. Prepaid tuition plans are generally sponsored by states on behalf of in-state public colleges and, less commonly, by private colleges. For state-sponsored prepaid tuition plans, you are limited to the plan offered by your state. Only a handful of states offer prepaid tuition plans.

A prepaid tuition plan lets you prepay tuition expenses now at participating colleges, typically in-state public colleges, for use in the future. The plan's money manager pools your contributions with those from other investors into one general fund. The fund assets are then invested to meet the plan's future obligations. Some plans may guarantee you a minimum rate of return; others may not. At a minimum, the plan hopes to earn an annual return at least equal to the annual rate of college inflation for the most expensive college in the plan.

The most common type of prepaid tuition plan is a contract plan. With a contract plan, in exchange for your up-front cash payment (or series of payments), the plan promises to cover a predetermined amount of future tuition costs at a particular college in the plan. For example, if your up-front cash payment buys you three years' worth of tuition at College ABC today, the plan might promise to cover two and a half years of tuition in the future. Plans have different criteria for determining how much they'll pay out in the future. And if your beneficiary attends a school that isn't in the prepaid plan, you'll typically receive a lesser amount according to a predetermined formula.

The other type of prepaid tuition plan is a unit plan. With a unit plan, you purchase units or credits that represent a percentage (typically 1%) of the average yearly tuition costs at the plan's participating colleges. Instead of having a predetermined value, these units or credits fluctuate in value each year according to the average tuition increases for that year. You then redeem your units or credits in the future to pay tuition costs; many plans also let you use them for room and board, books, and other supplies.

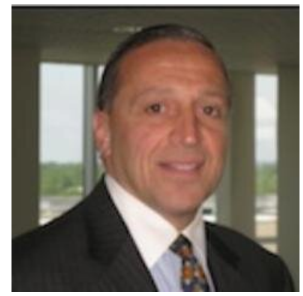
Note: It's important to understand what will happen if your prepaid plan's investment returns don't keep pace with tuition increases at the colleges participating in the plan. Will your tuition guarantee be in jeopardy? Will your future purchases be limited or more expensive?

What are the drawbacks of 529 plans?

Here are some drawbacks of 529 plans:

- Investment guarantees: 529 savings plans don't guarantee your investment return. You can lose some or all of the money you have contributed. And even though 529 prepaid tuition plans typically guarantee your investment return, plans may announce modifications to the benefits they'll pay out due to projected actuarial deficits.
- Investment flexibility: With a 529 savings plan, while you can choose among a variety of investment portfolios offered by the plan, you can't direct the portfolio's underlying investments. And if you're unhappy with the investment performance of the portfolios you've chosen, you can only change the investment portfolios on your existing contributions twice per calendar year or upon a change in the beneficiary. (However, you can also do a "same beneficiary" rollover to another 529 plan once per calendar year without penalty, which gives you another opportunity to change plans and investment options.) With a 529 prepaid tuition plan, you don't pick any investments — the plan's money manager is responsible for investing your contributions.
- Nonqualified withdrawals: If you use the money in your 529 plan for something other than a qualified education expense, it'll cost you. With a 529 savings plan, you'll pay a 10% federal penalty on the earnings portion of any nonqualified withdrawal and you'll owe income taxes on the earnings, too (state income tax and a penalty may also apply). With a 529 prepaid plan, you must either cancel your contract to get a refund or take whatever predetermined amount the plan will give you (some plans may make you forfeit your earnings entirely; others may give you a nominal amount of interest).
- Fees and expenses: There are typically fees and expenses associated with 529 plans. Savings plans may charge an annual maintenance fee, administrative fees, and an investment fee based on a percentage of your account's total value. Prepaid tuition plans may charge an enrollment fee and various administrative fees.

Note: *Before investing in a 529 plan, please consider the investment objectives, risks, charges, and expenses carefully. The official disclosure statements and applicable prospectuses - which contain this and other information about the investment options, underlying investments, and investment company - can be obtained by contacting your financial professional. You should read these materials carefully before investing. As with other investments, there are generally fees and expenses associated with participation in a 529 plan. There is also the risk that the investments may lose money or not perform well enough to cover college costs as anticipated. Investment earnings accumulate on a tax-deferred basis, and withdrawals are tax-free as long as they are used for qualified higher-education expenses. For withdrawals not used for qualified higher-education expenses, earnings may be subject to taxation as ordinary income and possibly a 10% federal income tax penalty. The tax implications of a 529 plan should be discussed with your legal and/or tax advisors because they can vary significantly from state to state. Also be aware that most states offer their own 529 plans, which may provide advantages and benefits exclusively for their residents and taxpayers. These other state benefits may include financial aid, scholarship funds, and protection from creditors.*



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