SmartMoney Magazine

Getting Schooled

By Sarah Breckenridge
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▪ Click here to see our table of 529 portfolios

WHEN IT COMES TO stashing away college money for his kids, Dan Doiron is more hands-on than most. The CPA from Lewiston, Maine, has invested in three state-sponsored 529 plans for his five-year-old son and three-year-old daughter: one in Iowa, one in Illinois and one in his home state. But his enthusiasm for 529s was sorely tried this spring as Maine began making changes to its tax treatment of such plans. First, in March, it passed a law to tax earnings on all out-of-state 529 plans. Then, just three months later, the legislature reversed that decision. It's exactly these ever-shifting winds that have Doiron thinking twice about 529s. He plans to scale back his contributions, focusing instead on the Coverdell accounts he's opened for his kids. "This is a great example of how fast things can change," he says, "and multiply that by 50 [states]. Just trying to paw through all the tax laws, get up to speed on all the rules, it can be very complicated, trying to figure it all out."

Doiron is one of a growing number of investors who have become frustrated with 529 savings plans. These programs are pitched as the panacea for all your college savings worries. But the marketing materials, full of adorable tots in mortarboard caps, belie the plans' complicated nature. And when investors get hit with an unexpected fee or realize they've missed out on a better deal, they feel burned.

"You get this hype about a certain product and everybody jumps on the bandwagon, but you don't know what's going to happen," says Stephen Mathyas, a Nutley, N.J., parent who had a tough time nailing down the fees on his state's new 529 plan. "Just like when everybody was diving into [tech] stocks before they knew the full scope of it."

It's easy to understand why people get caught up in the excitement of 529s. Since they became exempt from federal taxes in 2002, the market for them has exploded: By the end of last year, their assets totaled more than $20 billion nationwide, up from $3 billion just two years earlier. That's big business, not just for the financial firms managing the plans, but also for the sponsoring states. The result: "an arms race," in the words of one financial analyst, to offer a dizzying variety of investment options and selling channels.

A few years ago, most people simply bought their own state's plan and invested in a basic age-based portfolio. But these days parents have some 75 plans nationwide to choose from, many offering individual mutual funds to build a customized portfolio. More choice is a good thing, but it can make plotting your college savings strategy feel like a full-time job. States have also gotten competitive by turning increasingly to advisers to market their 529s. And as more broker-sold plans have come onto the scene, investing in them has become more expensive: From the third quarter of 2001 to the fourth quarter of 2002, the average front-end load for broker-sold plans jumped from 3.42 to 4.69%.

All this can leave you ready to throw up your hands in despair: How do you pick from so many plans? How do you keep from getting socked with excessive fees? How can you be sure you'll wind up with enough money to send your child to the school of his choice? Here are some of the most common pitfalls of 529 plans, and how to avoid them.

Pitfall No. 1: Opening a 529 in the First Place

Make no mistake: The 529 plan is one of the best college savings tools to come along

in years. But that doesn't mean it's for everyone. In fact, in many cases you're better off with other vehicles, such as Coverdell or custodial savings accounts. The most important question to ask is: Do you expect to qualify for need-based financial aid? To get a rough idea, do a preliminary needs test, using a financial aid calculator like the one here. Even if your kids are years away from college, this exercise will provide a good starting point that can be revised over time.

If your household income is well into the six figures, you probably won't be getting financial aid, unless you have an extenuating factor such as more than one child in college at the same time. You're likely in a higher tax bracket, which means you'll get the most bang from the 529's tax advantages. Still, your first $2,000 each year should go into a Coverdell account, which is also free of federal taxes. The Coverdell is more flexible than a 529. You can choose your own investments and use the money for almost any education costs, including high school tuition and even a computer.

Though the tax advantages of 529s typically trump those of custodial accounts, also known as UGMAs or UTMAs, the new tax law passed this spring evens up the playing field in certain cases. Kids 14 and older who fall into the lowest income-tax brackets, 10 or 15%, will pay only a 5% capital gains and dividend tax on UGMA stocks sold between now and 2007. In 2008 that tax drops to zero, before reverting back the next year to the original rate of 8 or 10%. Also, the first $750 in earnings from an UGMA are tax-exempt. But stick to the 529 for your fixed-income investments-or if the thought of Junior getting full control of that college kitty as early as age 18 makes you queasy.

At the other end of the spectrum, parents with adjusted household income of less than $56,800, which puts them in the 10 or 15% tax bracket and makes them prime candidates for need-based aid, won't gain much advantage from tax-sheltered plans of any variety. Since any savings can be difficult at this income level, Judy Miller, principal of planning firm College Solutions in Alameda, Calif., recommends maxing out your contributions to a Roth IRA and any workplace retirement plans, which aren't counted in federal aid formulas, before considering a dedicated college fund.

But what if you are somewhere in the middle? If your needs test shows that you might qualify for at least some financial aid, you'll want to avoid the prepaid 529s like the plague. These lesser-known cousins of the 529 savings plans allow state residents to buy future tuition at local schools at-or just above-today's rates. The problem? Assets in those plans reduce aid dollar for dollar. Also steer clear of any savings vehicle that's considered the child's asset, including Coverdells and UGMAs. Under the federal financial aid formula, colleges expect children to contribute 35% of their assets each year. The 529 savings plans are probably your best bet. Considered assets of the parents, they're assessed at only 5.6%. And if they're in the grandparents' names, they're not counted at all. Once you start pulling from the 529, though, the earnings portion of those withdrawals may get counted as the child's income and assessed at 50% for the following year's financial aid.

Just don't make the mistake Marnie Aznar, a Morris Plains, N.J., financial planner, sees often. "So many people dump all this money into [college savings], and neglect retirement," she says. It sounds trite, but it's true: You can always get grants and loans for college, but not for retirement.

Pitfall No. 2: Buying the Plan Pushed by Your Broker

Dan Doiron, the Maine CPA, recounts with amazement how uninformed some of his clients are when they call him about 529 plans. "I've had some mention a plan by name, and I ask what state it is, and they say, 'What do you mean what state?' They don't even realize that they are affiliated with particular states." It's something that happens all too often: People miss out on tax breaks offered by their state's plan-usually because their broker is eager to sell another one.

In 2002, 68% of new assets in 529s were generated through broker-sold programs,

according to Boston consulting firm Financial Research Corp. That's evidence that more often than not these plans are "sold" rather than "bought." Though a broker can help you navigate through the increasingly complex maze of plans out there, you just may find yourself steered toward the plan that will earn him the biggest commission, not the one that's best for you.

About half of states offer residents a tax writeoff on contributions to their plan. For example, Mississippi has an annual deduction cap of $20,000 for a couple filing jointly. Parents in the top tax bracket there could see savings of as much as $1,000. In 2002 the Municipal Securities Rulemaking Board, which governs brokers' sales of 529 plans, issued a Fair Practice Notice stating that brokers must inform clients of any favorable tax treatment from in-state plans. However, brokers can do this by simply passing on a plan's brochure, and in a document that often runs 30 pages or more, the disclosure is easy to overlook.

There are other reasons to look locally. "Many people don't realize their state offers benefits beyond tax deduction," says Joe Hurley, founder of the 529 Web site Savingforcollege.com. Perks can include scholarships to in-state schools and matching grants for lower-income contributors. To look into the benefits of your state's plan, head to Hurley's Web site, where you'll find links to each plan's site.

Pitfall No. 3: Clinging to Your Own State's Plan

So now you know better than to jump on the first plan your broker tries to sell you. Your best deal is probably in-state, right? Not so fast. Though checking out your home state first is the rule of thumb, you need to calculate just how much it's worth for you to stay in-state. Sometimes the state tax deduction on contributions can be tiny and may not make up for a plan with high fees and poor performance.

Nebraska, for instance, allows account holders to deduct just $1,000 of contributions each year, netting you an annual tax savings of less than $70, even if you're in the highest bracket. Not much of an inducement. Meanwhile, its AIM College Savings Plan, one of three it offers, has some of the highest fees in the country-at 1.71% of assets per year-which quickly eat through any tax savings. Worse is Indiana, which offers no state tax deduction, and its sole 529 charges even residents a sales load for all investments other than the age-based portfolio. To help sort out whether to stick with your own state's plan, check out the Grade Your 529 Plan calculator here.

Pitfall No. 4: Paying Fees You Can Avoid

After thoroughly checking out what's available, perhaps you like a particular plan's investment options but cringe at its fees or sales loads. Here's a tip: You may be able to get around them. "If you do your research, in many cases you can get the exact same investments without going to a broker and paying the fees," says Michael Weissman of Deloitte & Touche's Private Client Advisors Group. Out of the 46 broker-sold plans, more than half allow in-state residents to buy the plan direct, without paying a load. Sixteen of those plans, including American Century's Learning Quest in Kansas and Citigroup's Colorado and Illinois plans, allow even nonresidents to take the direct route. (Of course, that means you'll be on your own when it comes to investment choices.) Also, sales commissions of broker-sold plans are often waived or reduced when you buy them through your employer.

When you contact the plan manager about buying direct, just be sure you're not getting hit with loads anyway: Plans in Texas, Pennsylvania and Washington, D.C., all charge nonresidents commissions even when they forgo a broker's services.

Pitfall No. 5: Not Taking Enough Risks Early On

You've heard many times that it's important to start saving for college early. But it's not just about being a disciplined saver. Investing in a 529 when your kids are young allows you to get adequate exposure to stocks without too much risk. Over the past 20

years, college tuition has increased at more than twice the rate of inflation. Equities may not have done well over the past few years, but they are the only investment with the potential to keep up with that kind of rise.

"Obviously, you should be able to sleep at night, but when children are young, [families] should be heavily in equities," says K.C. Dempster, program development director of Marlton, N.J., planning firm College Money. "If they're under five, you could go 90/10 equity to fixed income," scaling back as they get older. "Even in high school you don't necessarily need to be all in cash, because they're not going to use it all in the first year." She usually recommends a 50/50 or 40/60 balance of stocks to bonds during those years.

Considering the stock market's performance over the past three years, it's no wonder that guaranteed and "stable-value" investment options have flourished. Twenty-two states plus Washington, D.C., have 529s that offer such an option, which ensures a minimum return-lately about 3% a year. But if your child is young, it's dangerous to give in to the temptation to protect your investment by parking it all in such a conservative vehicle instead of equities.

Investors' demand for "safe" investments has led plan providers to extend the stable-value concept to even stock funds. North Carolina recently introduced one of the most unusual 529 investments on the market yet: the Protected Stock Fund from MetLife. It guarantees returns of either 70% of the S&P 500's growth or 2% per year, whichever is greater. The catch? You are locked into the contract for five years, making it too restrictive for families with children about to enter college and not aggressive enough for families with young children.