The ABC's of 529 college savings plans

The benefits include a variety of investment options and potential tax advantages.

FIDELITY VIEWPOINTS - 02/08/2013

Whether you’ve got toddlers, teenagers, or even grandchildren, one thing is certain—paying for college seems to get more expensive every year. Given that the average annual cost (tuition, fees, and room and board) for a four-year, in-state public college is $17,860 for the 2012–2013 tuition year, and $39,518 per year for a four-year private college, it’s no surprise that college expenses can be overwhelming.

Footing college bills these days often takes every line of defense an investor can muster, and there may be no better place to start than by opening and contributing to a 529 college savings plan account. Why? The restrictions are few and the potential benefits can be significant for the account holder, including certain tax advantages, potential minimal impact on financial aid, and control over how and when the money is spent.

Understanding the ins and outs of a 529 college savings plan may help you unlock one of the biggest bangs for your college savings buck.

A 529 college savings account offers many advantages

While there are several ways to save for college—such as opening a custodial account (Uniform Gifts to Minors Act/Uniform Transfers to Minors Act accounts), a Coverdell Education Savings Account (ESA), or even setting money aside in a taxable account (see detailed chart below)—few would argue with the potential advantages of a 529 college savings plan.

Designed specifically to help pay for qualified costs associated with higher education, a 529 college savings plan is a tax-advantaged account that allows for distributions to pay for things like tuition, fees, books, supplies, and any approved equipment the student may need to study at accredited institutions. In addition, you can take distributions for room and board, so long as the beneficiary of the plan is attending the school at least half time. When 529 funds are used for these qualified purposes, there is no federal income tax on investment gains (no capital gains, ordinary income tax, or Medicare surtax).

Typically, a parent or grandparent opens the account and names a child or loved one as the beneficiary. Each plan is sponsored by an individual state, often in conjunction with a financial services company that manages the plan, although you don't have to be a resident to invest in a state's plan.

Minimal impact on financial aid. Many families worry that saving for college will hurt their chances of receiving financial aid. But, since 529 college savings plan assets are considered parental assets, they are factored into federal financial aid formulas at a maximum rate of about 5.6%. This means that only about 5.6% of the 529 assets are included in the Expected Family Contribution (EFC) that is calculated during the federal financial aid process. That's far lower than the 20% rate that is assessed on student assets, such as assets in an UGMA/UTMA (custodial) account. Learn more about how the EFC is calculated.

"This lower rate means every dollar saved in a 529 college savings plan can go a long way toward helping to pay for college without significantly impacting financial aid," says Keith Bernhardt, vice president of college planning at Fidelity Investments. "What's more, earnings from a 529 college savings plan used to pay college expenses will not be considered part of parental or child income that would otherwise reduce future financial aid eligibility. This is not the case for taxable savings options."
One important caveat is the difference in treatment if someone other than the parents or student—such as a grandparent—owns the 529 plan. In that case, while these 529 savings are not reported as a student asset on the Free Application for Federal Student Aid (FAFSA), any distribution from this 529 plan is reported as income to the beneficiary, potentially resulting in a significant reduction in eligibility for need-based aid the following year.

More control for the account owner. Unlike a custodial account that eventually transfers ownership to the child, with a 529 college savings plan the account owner (not the child) calls the shots on how and when to spend the money. Not only does this oversight keep the child from spending the money on something other than college, it allows the account owner to transfer the money to another beneficiary (e.g., a family member of the original beneficiary) for any reason. For example, say the original child for whom the account was set up chooses not to go to college—or doesn’t use all the money in the account—the account owner can then transfer the unused money to a named beneficiary.

Greater flexibility. In many ways, a 529 college savings plan has fewer restrictions than other college savings plans. These plans have no income or age restrictions and have no upper limit on annual contributions, unlike the Coverdell ESA, which limits contributions to $2,000 annually and restricts eligibility to those with adjusted gross incomes of $110,000 or less (single), and $220,000 or less if filing jointly. However, once a 529 plan account reaches a certain value—typically more than $300,000—further contributions are not permitted.

Anyone can open and fund a 529 college savings plan including parents, grandparents, relatives, and family friends. You may even open one to pay for your own college expenses.

Investment choices. Each 529 college savings plan offers its own range of investment options, which might include age-based strategies, conservative, moderate, and aggressive portfolios, or even a mix of funds from which you can build your own portfolio. Typically, plans allow you to change your investment options once each calendar year or if you change beneficiaries.

"Whatever strategy you choose, however, the first step is to define your investment objective, which can help set expectations," says Peter Walsh, institutional portfolio manager for the Fidelity-managed 529 plans. "With target-date strategies, the objective is to achieve a targeted level of college..."
Think carefully about how you invest your savings. A strategy that’s too aggressive for your time frame could put you at risk for any potential losses that you may not have time to recoup before you need to pay for college. Being too conservative can also be a risk because your money may not grow enough to meet costs.

“This is where an age-based strategy may really help people who don’t want to actively manage their investments, since it maintains a mix of assets based on when the beneficiary is expected to start college and rolls down the risk as that time gets closer,” says Bernhardt.

Who may want to consider investing?

Anyone with children or grandchildren likely going to college, whether they are babies or teenagers, may want to consider investing in a 529 college savings plan. The sooner you start, the longer you have to take advantage of the tax-deferred growth and generous contribution limits.

Investors also may want to consider setting up regular, automatic contributions to take advantage of dollar cost averaging—a strategy that lowers the average price you pay for fund shares over time and helps mitigate the risk of market volatility.

“It cannot be stressed enough that asset allocation cannot solve poor savings behavior,” Walsh says. “Regular, disciplined saving is the most important factor in growing the amount you put away for college.”

Potential tax benefits

As mentioned earlier, for distributions from a 529 used to pay for qualified higher education expenses, there are no federal income taxes on investment earnings. This alone is a significant benefit, but there are other tax benefits as well.

A 529 college savings plan may offer added estate planning benefits. Any contributions made to a 529 college savings plan are considered ‘completed gifts’ for estate tax purposes, so they come out of your taxable estate, even though the account remains under your control,” Bernhardt says.

Although you are typically allowed to give an individual up to $14,000 a year without paying gift taxes, the gift amount can potentially be much higher via a 529 college savings plan. For example, you could give $70,000 per beneficiary in a single year and treat it as if you were giving that lump sum over a five-year period. This approach can help an investor potentially make very large 529 plan contributions without incurring gift taxes. Of course, if you make additional contributions to the plan during those same five years, you would have to pay gift taxes.

Being smart about the way you save for college also means being mindful of your other financial priorities. “Fidelity believes that retirement saving should be a priority, because while you can’t borrow money to pay for retirement, you can for college,” Bernhardt says. Still, if college saving is among your financial goals, choosing to invest in a 529 college savings plan may be one of the most educated decisions you can make to help pay for qualified college costs.

Dispelling 529 Plan Myths

Here are some of the most common myths, and actual truths, about 529 college savings plans:

1. If I don't use my 529 college savings plan savings for higher education, I lose the money.

Actually, the money is still yours, but you'll pay both a 10% penalty and ordinary income taxes on the earnings if you don't spend it on qualified higher education costs. To avoid these penalties, you could transfer the account to another beneficiary who plans to go to college. “If the child gets a scholarship and you don't need all the money for college, you pay only ordinary income taxes on the earnings portion of the money you take out to offset the scholarship, not the penalty,” Bernhardt says.

2. I can only invest in my own state's plan.

Not true. Most plans have no state residency requirements for either the account owner or beneficiary. Also, most plans have no restrictions on where (which state) you can go to college. It's important to note, however, that some state plans have extra fees for non-residents that you should consider before deciding to invest with that plan.

3. I can't contribute more than $14,000 a year to a 529 college savings plan account.

The $14,000 limit is for gift tax purposes only for one parent. Two parents could contribute $28,000. You can actually make up to a $70,000 gift to one beneficiary and treat it as though the gift were made over five years (or $140,000 for two parents). Additional contributions could also come from friends and family (again, gift tax limits should be considered). Most plans allow total assets in the account to exceed $300,000 before they stop allowing additional contributions.

4. The federal tax benefits associated with a 529 college savings plan will eventually disappear.

Not true. In fact, the Pension Protection Act of 2006 permanently extended the federal tax-free qualified withdrawals on 529 college savings plan savings, which were previously set to expire in 2010.

5. Once I choose a 529 college savings plan and its underlying investments, I am locked in and cannot make changes.

Actually, you are typically allowed to roll your 529 account savings over to another college savings plan. Additionally, you are allowed to change investments within your plan once per calendar year or when you change beneficiaries.

Learn more

Use our College Planner to understand costs and monthly savings needs.

Learn more about Fidelity-managed 529 college savings plans.

2. In order for an accelerated transfer to a 529 plan (for a given beneficiary) of $70,000 (or $140,000 combined for spouses who gift split) to result in no federal transfer tax and no use of any portion of the applicable federal transfer tax exemption and/or credit amounts, no further annual exclusion gifts and/or generation-skipping transfers to the same beneficiary may be made over the five-year period, and the transfer must be reported as a series of five equal annual transfers on Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return. If the donor dies within the five-year period, a portion of the transferred amount will be included in the donor’s estate for estate tax purposes.

The UNIQUE College Investing Plan, UFund College Investing Plan, Delaware College Investment Plan, and Fidelity Arizona College Savings Plan are offered by the state of New Hampshire, MEFA, the state of Delaware, and the Arizona Commission for Postsecondary Education, respectively, and managed by Fidelity Investments. If you or the designated beneficiary is not a New Hampshire, Massachusetts, Delaware, or Arizona, resident, you may want to consider, before investing, whether your state or the designated beneficiary’s home state offers its residents a plan with alternate state tax advantages or other benefits.

Units of the portfolios are municipal securities and may be subject to market volatility and fluctuation.

Please carefully consider the plan’s investment objectives, risks, charges, and expenses before investing. Contact Fidelity for this and other information on any 529 college savings plan managed by Fidelity, call or write to Fidelity for a free Fact Kit, or view one online. Read it carefully before you invest.

Investing involves risk, including risk of loss.

Fidelity Brokerage Services LLC, Member NYSE, SIPC, 900 Salem Street, Smithfield, RI 02917

613840.3.0