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 sponsored by states, state agencies, or educational institutions and are authorized by Section 529 of the Internal Revenue Code.

There are two types of 529 plans: pre-paid tuition plans and college savings plans. All fifty states and the District of Columbia sponsor at least one type of 529 plan. In addition, a group of private colleges and universities sponsor a pre-paid tuition plan.

What are the differences between pre-paid tuition plans and college savings plans?

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 prepaid tuition plans are sponsored by state governments and have residency requirements. Many state governments guarantee investments in pre-paid tuition plans that they sponsor.

College savings plans generally permit a college saver (also called the "account holder") to establish an account for a student (the "beneficiary") for the purpose of paying the beneficiary's eligible college expenses. An account holder may typically choose among several investment options for his or her contributions, which the college savings plan invests on behalf of the account holder. Investment options often include stock mutual funds, bond mutual funds, and money market funds, as well as, age-based portfolios that automatically shift toward more conservative investments as the beneficiary gets closer to college age. Withdrawals from college savings plans can generally be used at any college or university. Investments in college savings plans that invest in mutual funds are not guaranteed by state governments and are not federally insured.

The following chart outlines some of the major differences between pre-paid tuition plans and college savings plans.

Prepaid Tuition Plan	College Savings Plan
Locks in tuition prices at eligible public and private colleges and universities.	No lock on college costs.
All plans cover tuition and mandatory fees only. Some plans allow you to purchase a room & board option or use excess tuition credits for other qualified expenses.	Covers all "qualified higher education expenses, "including : • Tuition • Room & board • Mandatory fees • Books, computers (if required)

Most plans set lump sum and installment payments prior to purchase based on age of beneficiary and number of years of college tuition purchased.	May plans have contribution limits in excess of $200,000.
Many state plans guaranteed or backed by state.	No state guarantee. Most investment options are subject to market risk. Youy investment may make no profit or even decline in value.
Most plans have age/grade limit for beneficiary.	No age limits. Open to adults and children.
Most state plans require either owner or beneficiary of plan to be a state resident.	No residency requirement. However, non-residents may only be able to purchase some plans through financial advisers or brokers.
Most plans have limited enrollment period.	Enrollment open all year.

1 Source: *Smart Saving for College*, FINRA®

How does investing in a 529 plan affect federal and state income taxes?

Investing in a 529 plan may offer college savers special tax benefits. Earnings in 529 plans 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 and room and board.

However, if you withdraw money from a 529 plan and do not use it on an eligible college expense, you generally will be subject to income tax and an additional 10% federal tax penalty on earnings. Many states offer state income tax or other benefits, such as matching grants, for investing in a 529 plan. But you may only be eligible for these benefits if you participate in a 529 plan sponsored by your state of residence. Just a few states allow residents to deduct contributions to any 529 plan from state income tax returns.

If you receive state tax benefits for investing in a 529 plan, make sure you review your plan's offering 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 state tax consequences for residents of certain states.

What fees and expenses will I pay if I invest in a 529 plan?

It is important to understand the fees and expenses associated with 529 plans because they lower your returns. Fees and expenses will vary based on the type of plan. Prepaid 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 of the plan, and some are collected by the financial services firms that the state sponsor typically hires to manage its 529 program. Some college savings plans will waive or reduce some of these fees 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 529 plan. Your asset management fees will depend on the investment option you select. Each investment option will typically bear a portfolio-weighted average of the fees and expenses of the mutual funds and other investments in which it invests. You should carefully review the fees of the underlying investments because they are likely to be different for each investment option.

Investors that 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." Broadly speaking, the load is paid to your broker as a commission for selling the college savings plan to you. 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. 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. Here are some key characteristics of the most common 529 plan share classes sold by brokers to their customers:

- Class A shares typically impose a front-end sales load. Front-end sales loads reduce the amount of your investment. For example, let's say you have $1,000 and want to invest in a college savings plan with a 5% front-end load. The $50 sales load you must pay is deducted from your $1,000, and the remaining $950 is invested in the college savings plan. Class A shares usually have a lower annual distribution fee and lower overall annual expenses than other 529 share classes. In addition, your front-end load may be reduced if you invest above certain threshold amounts – this is known as a breakpoint discount. These discounts do not apply to investments in Class B or Class C shares.

- Class B shares typically do not have a front-end sales load. Instead, they may charge a fee when you withdraw money from an investment option, known as a deferred sales charge or "back-end load." A common back-end load is the "contingent deferred sales charge" or "contingent deferred sales load" (also known as a "CDSC" or "CDSL"). The amount of this load will depend on how long you hold your investment and typically decreases to zero if you hold your investment long enough. Class B shares typically impose a higher annual distribution fee and higher overall annual expenses than Class A shares. Class B shares usually convert automatically to Class A shares if you hold your shares long enough.

  Be careful when investing in Class B shares. If the beneficiary uses the money within a few years after purchasing Class B shares, you will almost always pay a contingent deferred sales charge or load in addition to higher annual fees and expenses.

- Class C shares might have an annual distribution fee, other annual expenses, and either a front- or back-end sales load. But the front- or back-end load for Class C shares tends to be lower than for Class A or Class B shares, respectively. Class C shares typically impose a higher annual distribution fee and higher overall annual expenses than Class A shares, but, unlike Class B shares, generally do not convert to another class over time. If you are a long-term investor, Class C shares may be more expensive than investing in Class A or Class B shares.

Is there any way to purchase a 529 plan but avoid some of the extra fees?

Direct-Sold College Savings Plans

States offer college savings plans through which residents and, in many cases, 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 that may apply to broker-sold plans. You can generally find information on a direct-sold plan by contacting the plan's sponsor or program manager or visiting the plan's website. Websites such as the one maintained by the College Savings Plan Network, as well as a number of commercial websites, provide links to most 529 plan websites.

Broker-Sold College Savings Plans

If you prefer to purchase a broker-sold plan, you may be able to reduce the front-end load for purchasing Class A shares if you invest or plan to invest above certain threshold amounts. Ask your broker how to qualify for these "breakpoint discounts."

What restrictions apply to an investment in a 529 plan?

Withdrawal restrictions apply to both college savings plans and pre-paid tuition plans. With limited exceptions, you can only withdraw money that you invest in a 529 plan for eligible college expenses without incurring taxes and penalties. In addition, 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 one time per year. Additional limitations will likely apply to any 529 plan you may be considering. Before you invest in a 529 plan, you should read the plan's offering circular to make sure that you understand and are comfortable with any plan limitations.

Does investing in a 529 plan impact financial aid eligibility?

While each educational institution may treat assets held in a 529 plan differently, investing in a 529 plan will generally reduce a student's eligibility to participate in need-based financial aid. Beginning July 1, 2006, assets held in pre-paid tuition plans and college savings plans will be treated similarly for federal financial aid purposes. Both will be treated as parental assets in the calculation of the expected family contribution toward college costs. Previously, benefits from pre-paid tuition plans were not treated as parental assets and typically reduced need-based financial aid on a dollar for dollar basis, while assets held in college savings plans received more favorable financial aid treatment.

Is investing in a 529 plan right for me?

Before you start saving specifically for college, you should consider your overall financial situation. Instead of saving for college, you may want to focus on other financial goals like 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 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. Investing in a 529 plan is only one of several ways to save for college. Other tax-advantaged ways to save for college include Coverdell education savings accounts, Uniform Gifts to Minors Act ("UGMA") accounts, Uniform Transfers to Minors Act ("UTMA") accounts, tax-exempt municipal securities, and savings bonds. Saving for college in a taxable account is another option.

Each college saving option has advantages and disadvantages, and may have a different impact on your eligibility for financial aid, so you should evaluate each option carefully. 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.

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

Knowing the answers to these questions may help you decide which 529 plan is best for you.

1. Is the plan available directly from the state or plan sponsor?

2. 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?

3. What are the plan's withdrawal restrictions? What types of college expenses are covered by the plan? Which colleges and universities participate in the plan?

4. What types of investment options are offered by the plan? How long are contributions held before being invested?

5. 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 investment in the plan it sponsors? 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?

6. 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?

7. Who is the program manager? When does the program manager's current management contract expire? How has the plan performed in the past?

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 semiannual 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 FINRA's BrokerCheck website. On the website, you can search for any disciplinary sanctions against 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 FINRA's Smart Saving for College website. The website contains links to other helpful sites, including the College Savings Plan Network and the Internal Revenue Service's Publication 970 (Tax Benefits for Higher Education). FINRA's investor alert on 529 plans also provides valuable information for investors.