

# 529 Savings Plans vs. Prepaid Tuition Plans

## *Wealth Managed to a Fiduciary Standard*

*At RDM, we help you coordinate what is often multiple financial goals (wealth accumulation, retirement income, legacy planning, etc.) through a maze of tax, legal and investment possibilities. It is critical to understand, develop and implement effective, long-term strategies that align with your objectives and prepare you for the future.*





# 529 Savings Plans vs. Prepaid Tuition Plans



Section 529 plans are popular education savings vehicles. To choose the type of 529 plan that's right for you, it's important to understand how 529 savings plans and 529 prepaid tuition plans work and the differences between them.

## Who can offer each type of plan?

At one time, only states could offer 529 savings plans and 529 prepaid tuition plans. (In practice, states designate an experienced financial institution, to manage and administer their plans). However, colleges can now offer their own prepaid tuition plans. These plans are sometimes referred to as private prepaid tuition plans, and they are less common. The remainder of this discussion refers to state-sponsored prepaid tuition plans.

## How does each plan work?

As 529 plans, both savings plans and prepaid tuition plans offer the same significant federal tax advantages. Funds in each type of plan grow tax deferred, and withdrawals from either plan used for the beneficiary's qualified education expenses are completely income tax free at the federal level. But despite these shared tax advantages, savings plans and prepaid tuition plans are different creatures.

A 529 savings plan lets you save for college or K-12 tuition within an individual investment account, similar to a 401(k) plan. Money you contribute is invested in one or more of the plan's specific investment portfolios. Each portfolio consists of a mix of investments (typically mutual funds) that are chosen and managed exclusively by the plan's designated money manager. You generally pick your investment portfolios at the time you open an account. Your investment return is not guaranteed.

By contrast, 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.

There are generally two types of prepaid tuition plans: contract plans and unit plans. The most common type of prepaid tuition plan is a contract plan (sometimes known as a guaranteed interest 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.

With a unit plan, you purchase a certain percentage of units or credits and the plan guarantees that whatever the percentage of college costs such units cover now, the same percentage will be covered in the future. For example, assume that 100 tuition credits are required to fund one year's worth of tuition at State University today. You purchase 100 credits today for \$8,000. The result is that when your child starts college at State University in 12 years, your \$8,000 will theoretically pay the entire first year of tuition, even though tuition costs may have risen to \$20,000 per year by then.

Note: Even though prepaid tuition plans typically guarantee your investment return, plans sometimes announce modifications to the benefits they'll pay out due to projected actuarial deficits. 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?

### How are contributions invested with each type of plan?

529 savings plans and 529 prepaid tuition plans differ on the way your contributions are invested. With a prepaid plan, there are no individual investment accounts. Instead, your contributions go into a general fund, and the plan's money manager is solely responsible for investing the pooled money to meet the plan's future obligations to its participants. Your only concern is with the predetermined amount of tuition that the plan has agreed to cover in the future, or the percentage of tuition costs that the units or credits you've just purchased will eventually cover.

With a savings plan, your contributions are held in an individual investment account in one or more specific investment portfolios that you've chosen. Typically, plans offer a variety of options from aggressive to conservative so you can choose a portfolio that matches your risk tolerance, time horizon, and other factors. Specifically, 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 asset mix gradually and automatically becomes more conservative — for example, from stock mutual funds to bond and money market funds — as the beneficiary gets closer to college. But remember, the plan's money manager handles the underlying investment mix in each portfolio on a day-to-day basis — you have no say in this process.

Once you've settled on an investment portfolio(s) for your savings plan account, you have limited opportunities to change it if you're not happy with its investment performance. Under federal rules, plans are authorized, but not required, to let you change your investment portfolio twice per calendar year or at any time you change the beneficiary. (However, you can generally direct future contributions to a new investment portfolio at any time.) Such investment flexibility can make one plan stand out among others, so it's always a good idea to check the specific investment rules of any plan you're considering.

You also have another option guaranteed by federal law. You can roll over the funds in your existing saving plan account to another 529 plan (savings plan or prepaid tuition plan) once per calendar year without penalty. The beneficiary must stay the same.

In your effort to pick a suitable portfolio, keep in mind that no investment in a savings plan is guaranteed — you could lose money that you've contributed. That's why it's important to investigate the reputation and overall investment performance of the institution that manages the plan, as well as the performance history of individual portfolios in the plan.

### Are there any restrictions on joining either type of plan or accessing the funds?

Yes. Most 529 savings plans are open to residents of every state. This means you can shop around for the plan that offers the combination of features you want. (But keep in mind that if you join another state's savings plan, your state may limit any state tax benefits, if any, to the in-state 529 plan only.) Beyond that, you can open a 529 savings plan at any time of the year, and the account can generally remain open indefinitely. This gives you flexibility if your child decides to postpone his or her education.

By contrast, state-sponsored prepaid tuition plans are limited to state residents only. And once you open an account, all tuition credits generally must be used by the time your child turns 30, and all withdrawals completed within 10 years from the time your child starts college. Also, at some point before your child starts college, you (the account owner) are required to inform the plan administrator when you expect to start redeeming credits. Finally, some prepaid tuition plans let you join only during specific enrollment periods.

### What education expenses are covered by each plan?

529 savings plans give you more flexibility in paying your beneficiary's education expenses. Funds in the account can be used to pay the full cost of tuition, fees, books, equipment, and room and board (assuming the beneficiary is enrolled at least half-time) at any college in the United States or abroad that's accredited by the Department of Education. This includes undergraduate colleges, graduate and professional schools, two-year colleges, technical and trade schools, as well as some foreign colleges and universities. Funds in a 529 savings plan can also be used to pay K-12 tuition expenses, up to \$10,000 per year.

By contrast, prepaid tuition plans are typically designed to pay only for undergraduate tuition costs at in-state public colleges — other expenses like room and board, books, and graduate school may not be covered. However, such restrictions are imposed by







the individual prepaid tuition plans, because Section 529 of the Internal Revenue Code allows a broader interpretation of qualified education expenses. Make sure you understand exactly what education expenses your prepaid tuition plan covers, as well as the tuition equivalent you'll receive if your child attends a private or out-of-state college.

### What are the fees and expenses with each type of plan?

529 savings plans, like other types of managed accounts such as mutual funds and annuities, are managed by professional money managers who pass along their investment expenses to account owners. In addition, the plan manager will charge a fee for administering your account. Both of these fees are usually equal to a percentage of your total account value. Some savings plans may also tack on a flat annual maintenance fee, though this may be waived if you sign up for automatic payroll deduction or direct debiting of your checking account. Because fees and expenses vary among plans and can affect your account's total return, examine them carefully.

Prepaid tuition plans typically charge a flat enrollment fee at the time you open your account, but generally there are no ongoing charges. However, you may be assessed fees for late payment, returned checks, changing the beneficiary, changing the beneficiary's enrollment date, document replacement, or other administrative matters.

You may want to ask the following questions to help you better compare the fees of savings plans vs. prepaid tuition plans:

- Is there an application fee, beneficiary substitution fee, or account owner substitution fee?
- What other fees and costs are charged, and what are the amounts?
- Will my fees be less if I contribute through payroll deduction or automatic deduction from my checking account?
- Is there a fee to do a rollover to another state's plan?
- Will I be penalized if I move my account out of the plan within a short time after I open the account? How short a time?
- Is there a fee if I terminate the account?
- Do I pay the fees separately, or is the fee deducted from my account?

### What is the income tax treatment of withdrawals from each plan?

Withdrawals from a savings plan or prepaid tuition plan used to pay the beneficiary's qualified education expenses (as defined by the individual plan within federal guidelines) are completely income tax free at the federal level. States may offer their own tax benefits, but may make them contingent on joining the in-state 529 plan.

A withdrawal not used for the beneficiary's qualified education expenses is called a nonqualified withdrawal. A nonqualified withdrawal from a savings plan or a unit type of prepaid tuition plan (where you purchase tuition credits) will result in a 10% federal penalty on the earnings portion of the withdrawal (a state penalty may also apply). What's more, the earnings portion of the withdrawal will be subject to federal and typically state income tax, too.

A nonqualified withdrawal isn't possible if you have a contract type of prepaid tuition plan. If you want to get your money out of this type of plan, your only choice is to cancel your contract and have your money refunded. (If you do cancel, you may only get back your actual contributions, with no interest or earnings included. Other plans will refund your principal plus a low rate of interest, which is then taxable at regular income tax rates.)

**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.

## DISCLOSURES

RDM Financial Group does not give tax or legal advice. Consult your tax advisor and attorney on all tax and legal matters.

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