

## 529 college planning

With the price of one year's tuition at the average private four-year college climbing above \$119,646 (\$54,936 at the average public university), it is little wonder that many American families are concerned about their college savings.<sup>1</sup>

### Less taxing, greater growth potential

An investment that is allowed to grow tax deferred has the potential to accumulate much more money over a long period of time.



■ Tax deferred ■ 30% Tax

Annual return: 6%  
Initial investment: \$55,000  
Tax bracket: 30%

This example is for illustrative purposes only and is not intended to predict the returns of any investment choices. The performance of the investments will fluctuate with market conditions. If there were no earnings, the account would not grow. Fees and expenses have not been taken into account.

529 plans are investment programs designed with one basic purpose in mind — providing families with an easy and effective means to save for future college costs. But they also have tax, retirement, and estate planning implications that extend far beyond this basic purpose.

All states have a 529 plan of some sort. Most of these programs are open to residents and to nonresidents of the sponsoring state, so you can shop among them for the one that best meets your objectives.

### Anyone can use a 529 plan

Don't immediately assume that you are not in a position to use a 529 plan. Unlike most other tax-advantaged programs, 529 plans are open to everyone, no matter what their income level or the age of their children or grandchildren. You don't even need to have children or grandchildren — you can establish an account for your favorite niece, or with some plans, yourself! Many plans will allow you to place up to \$250,000 into an account with no time limit on its use.

Your investment professional can show you how a 529 plan may fit into your financial picture and help you select the one that is right for your family. You can do the research on your own, but you will find that the investment options and program features vary considerably among the different programs and the comparisons can become confusing.

### Types of 529 plans

There are two general types of 529 plans: prepaid tuition plans and savings plans. States may choose to offer one type of plan or the other, and some states are now offering both.

- **Prepaid tuition plans** are state- or institution-operated trusts offering contracts that promise to cover future tuition costs at public and private institutions. The price of the contract is pegged to current tuition levels, although some plans may provide discounts under certain circumstances. These programs may be restricted to in-state residents.

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<sup>1</sup>Source: MFS estimates using College Board 2002-2003 tuition and college inflation data. Assumes college costs increase at 4.5% and 5.2% a year on average for public and private schools, respectively.

### Key points

With the right planning, you can work toward making college a reality for your children, grandchildren, other relatives, or even yourself. Key benefits include

- tax-advantaged investing<sup>2</sup>
- generous gifting provisions\*
- control of assets
- important estate planning features

<sup>2</sup> The provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 will expire after December 31, 2010. Unless Congress extends the law, the federal tax treatment of 529 plans will revert back to its status prior to January 1, 2002, meaning that the account would be tax deferred until monies are withdrawn. Upon withdrawal, the distributions would be taxed at the rate of the beneficiary.

\* See "Estate tax benefits, page 2."

NOT FDIC INSURED  
NOT A DEPOSIT

MAY LOSE VALUE  
NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY

NO BANK GUARANTEE  
NO BANK GUARANTEE



- **Savings plans**, on the other hand, are essentially state-sponsored investment portfolios, and many are open to residents as well as nonresidents. The account owner's contribution to the 529 plan potentially will grow in value over time to help keep up with the increasing price of higher education. As with any investment, returns will depend on the market and the portfolio's allocation between stocks and bonds.

Most of the newer plans are 529 savings plans, and they generally are viewed as more flexible than prepaid tuition plans.

### Income tax benefits

You won't get a federal tax deduction for your contribution to a 529 plan, but you will receive the benefit of tax-deferred earnings. Any growth in your account is not taxed when withdrawals are taken in the future if they are used to pay for the beneficiary's qualified higher education expenses.<sup>2</sup>

Note, however, that if you take a refund or other nonqualified withdrawal, you will pay federal income tax and a 10% penalty on the withdrawn earnings (you'll get your principal back without penalty). There are exceptions to the penalty if the beneficiary dies, becomes disabled, or receives a scholarship that reduces his or her need for college funds.

Qualified education expenses from a 529 savings plan include the following costs at just about any accredited

post-secondary institution in the country, including graduate schools:

- tuition
- fees
- books
- equipment
- supplies

In addition, room and board expenses can qualify (subject to limits) if the student is attending college on at least a half-time basis.

As its name implies, prepaid tuition plans cover only tuition and mandatory fees.

### Estate tax planning

Another benefit with a 529 plan is the exclusion of the value of the account from your taxable estate, which makes it a great tool for many grandparents. Under current rules, you may make a gift of \$11,000 (\$22,000 per married couple) per beneficiary, per year without paying federal gift tax. And, there is an election available to apply five years' worth of annual exclusions, up to \$55,000 in a single year, to each beneficiary. You will not incur federal gift taxes as long as you don't make any additional gifts to the same beneficiary for the following four years. One set of grandparents of one grandchild, for example, could make a gift of as much as \$110,000 in one day, removing the assets from their estates without paying any gift tax.<sup>3</sup>

### Control benefits

For each prepaid tuition contract or savings plan account, there is an "owner" (generally the donor) and a "beneficiary." You name a beneficiary

when you set up an account; the individual you name does not have to be related to you.

With a 529 plan, you are the owner and retain all rights to the account, including the right to determine when withdrawals are taken and what they are used for. You can change the beneficiary to another relative at any time, and you can even decide to revoke the account and obtain a refund!

**The following example demonstrates how powerful this opportunity can be:**

Grandma and Grandpa have significant wealth, including \$1 million in bonds and cash. They want to reduce their estate tax exposure and like the idea of targeting some of their money for the college education of their seven young grandchildren. They decide to contribute a combined \$110,000 into a 529 plan on behalf of each grandchild. The result is that Grandma and Grandpa have removed \$770,000 (\$110,000 x 7 grandchildren) from their estates in one day, without gift tax consequences and without incurring the costs associated with irrevocable trusts. Further, the contributions are invested in a professionally managed investment account that may grow tax deferred without the burden of annual income taxes. And best of all, Grandma and Grandpa can always get the money back if they don't mind paying the 10% penalty tax on their earnings. That's effective estate planning!

### Financial aid treatment

According to the U.S. Department of Education, if the parent is the account

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owner, the assets in a 529 savings plan account are treated in the federal financial aid formula as assets of the parent. Since parental assets are assessed at a maximum 5.6% in determining aid eligibility (as compared with 35% for assets owned by the student), a 529 plan helps families qualify for more student aid.

### Investment issues

Each state-sponsored 529 plan is free to design an investment approach that it feels will best accomplish the goal of saving for college. One condition imposed by tax law is that the participant in the 529 plan may not have unlimited ability to direct the investment of the account.<sup>4</sup> Although this somewhat paternalistic provision is seen by some people as a reason not to use 529 plans, the fact of the matter is that, among the many 529 plans offered, there are a variety of investment approaches. Many plans have outsourced the investment and program management to large financial services companies that provide professional investment management to plan participants.

Many plans now offer an “age-adjusted” investment program. Your account is invested primarily in equity funds while your child is young and shifts to more conservative fixed-income funds as your child gets closer to college age. In addition to an age-adjusted program, some plans now include a menu of fixed allocation investment portfolios, ranging from all-equity portfolios to 100% fixed-income portfolios.

### Important considerations

A 529 plan may not be appropriate for every investor. Some states may limit your ability to rollover your 529 account from that state to another state's plan. In addition, investments in mutual funds can fluctuate and do not guarantee that future income will be enough to cover all education expenses.

Be sure to investigate the 529 plan in your own state and see if it offers any special benefits to state residents (*e.g.*, tax deduction for your contribution, matching grants, or state financial aid preference).<sup>5</sup> But then shop around, and look at other 529 programs, both those sponsored by other states and those by institutions. Although it may take some effort to understand how 529 plans work and to compare the details of competing plans, the effort may be well worth it if you are looking for a tax-advantaged way to save for future college expenses.

*This info sheet was written by Joseph F. Hurley, CPA, president of SavingForCollege.com LLC and author of The Best Way to Save for College — A Complete Guide to Section 529 Plans. He has more than 20 years of experience in providing tax planning services to individuals and has appeared in hearings before the IRS and Treasury Department to provide comments on the proposed regulations issued under Code Section 529.*

Contact your investment professional for more information.

### Resources for additional information

Hurley, Joseph F., *The Best Way to Save for College — A Complete Guide to Section 529 Plans*. BonaCom Publications. 2003, \$22.95.

[www.savingforcollege.com](http://www.savingforcollege.com)

Saving for College

An Internet guide to 529 plans, this site offers investment results, news developments, and a frequently asked questions section.

<sup>2</sup> The provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 will expire after December 31, 2010. Unless Congress extends the law, the federal tax treatment of 529 plans will revert back to its status prior to January 1, 2002, meaning that the account would be tax deferred until monies are withdrawn. Upon withdrawal, the distributions would be taxed at the rate of the beneficiary.

<sup>3</sup> Account owner will not incur federal gift taxes as long as he/she does not make any additional gifts to the same designated beneficiary for four years after the year during which he/she makes the one-time gift.

<sup>4</sup> Recent guidance from the IRS permits the account owner to reallocate investments once per 12-month period and upon a change of designated beneficiary.

<sup>5</sup> Depending on your state of residence and the state residence of the beneficiary, an investment in a 529 savings plan may not afford you or your beneficiary state tax benefits. There are additional fees with 529 savings plans.

This material is not intended to replace the advice of a qualified attorney, tax adviser, investment professional, or insurance agent. Before making any financial commitment regarding the issues discussed here, consult with the appropriate professional.



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