What you need to know about 529 College Savings Plans

By Christina Couch • Bankrate.com

One of the most popular college savings vehicles -- with good reason -- is the 529 plan:

- Offers federal and, in some cases, state tax advantages.
- Low maintenance.
- Provide tax-deferred growth
- Has less of an affect on a student's financial aid package than money stored in checking and savings accounts.

These plans are also complex, and choosing the one that fits your family can be daunting. Know these 7 points before opening a 529.

Some are pricier than others: According to the U.S. Securities and Exchange Commission, 529 plans come in 2 flavors:

- **Prepaid plans** that allow families to buy "units" of tuition at a rate close to today's prices. They are cashed in when the student attends school.
- **529 college savings plans** that allow families to invest in preselected investment portfolios that grow (or shrink) in accordance with the markets.

Many states and the District of Columbia offer 529 college savings plans, according to Morningstar, an independent investment research company. But only a handful of states offer a prepaid option. Both types of plans come with annual fees and operating costs. They range from close to 0% to just under 2% of invested assets, depending on the types of investments and the fund company.

One of the main factors that drives costs up is whether a 529 plan is broker-sold and overseen by a financial professional or direct-sold, wherein plan holders control their own assets. "The broker-sold adviser plans: There's a higher expense structure to those plans, but what you do get for those higher costs is the advice of the financial professionals you're working with," says Paul Paeglis, former executive director of the Ohio Tuition Trust Authority, which oversees that state's 529 plan.

There's risk involved: Many 529 college savings plans hold mutual funds that are tied to the stock and bond markets, meaning families can potentially lose money if their investments falter. "The question you have to ask yourself is: 'How diversified is the 529 itself?'" says Sam Mikhail, president of College Planning Advisors, a college planning firm in Burbank, California.

When deciding on the right college savings plan, Mikhail advises families to evaluate whether a particular 529 plan is the best saving vehicle, then analyze the underlying funds in the plan and investigate each fund's historical performance. There are generally multiple investment options for you to choose from in 529 plans.

Families may also want to consider the growing number of no-risk 529 plan options. Several states like Wisconsin, Virginia and Montana have certificates of deposit insured by the Federal Deposit Insurance Corp. and savings options that provide families with 529 tax benefits without the risk (or growth) associated with market fluctuations.

They might not keep up with your kid: Among the most popular 529 college savings options are age-based, target-date funds that automatically shift from aggressive to conservative investments as the child approaches college age. Stuart Ritter, vice president and CFP professional with T. Rowe Price Investment Services, advises families considering age-based portfolios to evaluate how they change over time.

"It's important to understand what the investments are, and make sure that how your money is allocated between stocks, bonds and short-term investments is appropriate for the time horizon you're looking at," Ritter says.

How fast investments change varies among 529 plans. To ensure your age-based portfolio is keeping up with your savings needs, Ritter advises families to evaluate several age-based portfolios before picking one and to periodically re-evaluate how their 529 plan is evolving. If a plan isn't changing according to your needs, the IRS allows families to change portfolios once per year.

Your state may not offer the best plan: While all 529 plans come with federal tax advantages, certain states also offer state income tax deductions or credits, too. These can be significant. For example, Indiana offers a tax credit of up to $1,000 per year. Meanwhile, New York and Oklahoma offer annual tax deductions of up to $5,000 and $10,000, respectively, for single filers. The limits double for married couples filing jointly.

A few states, such as Arkansas, make it more enticing by offering matching grant programs that match a certain amount of a family's contributions. Eligibility requirements for tax advantages and matching grants vary by state. While these incentives can provide an extra push to invest in their home state's plan, families should still compare different plans and evaluate whether tax incentives are enough to make a home state's plan the best financial vehicle, says Deborah Goodkin, managing director of college savings plans at First National Bank of Omaha, the entity that oversees Nebraska's 529s.

"If (a 529 plan offers) tax advantages, it may or may not be the best reason to invest in your home state's plan," she says. "That's up to the investor and their financial adviser." Independent investors may want to take a close look at fees, which can make a sizable dent on investment returns.

Most prepaid plans aren't guaranteed: Prepaid 529 plans aren't subject to market ups and downs, but they're not always a certainty either. "There are not a lot of states that even offer prepaid plans anymore, and the level of guarantee amongst those states definitely varies," Paeglis says.

Among prepaid 529s, only a scant few, such as Washington's Guaranteed Education Tuition program, come with a legally binding promise the state will pay if the plan folds between the time parents open the account and Junior goes off to school. Families eyeing prepaid plans are urged to inquire about a state-backed guarantee before opening an account, to research the plan's historic performance and stability and to ask what happens if tuition prices sharply increase.

529s impact financial aid*: **It's true 529 plans will factor into how much financial aid a student may qualify for, but it shouldn't be an obstacle.***

"People think if I have $100 saved in a 529 plan, that means I'm getting $100 less in financial aid. That is wrong," says Ritter. "About 5.6% of a parent's assets are expected to be used for college. That means for every $100 that the parent has saved, their financial aid would be reduced $5.60."

Money saved in a 529 plan will affect your federal financial aid package, but not as much as funds stored in some other types of accounts. The Department of Education reports that every dollar stored in a 529 account in a parent's name will subtract up to 5.6 cents from your family's federal need-based financial aid package. By contrast, funds stored in checking and savings accounts in a child's name will subtract up to 20 cents per dollar from federal financial aid, whereas funds invested in an individual retirement account in either the parent's or child's name won't be considered at all until the family begins taking withdrawals, at which point those funds would be considered untaxed income and could make a severe impact on financial aid.

Relatives can help (and also hurt): One way to get around the federal financial aid assessment is to put 529 cash in an account held in a relative's name. Accounts held by family, friends and relatives for 529 plans will be sheltered from the federal financial aid needs analysis, reports FinAid.org. The needs analysis is the primary formula used to figure financial aid at public colleges and universities. However, those funds will still be factored in for students attending private colleges that use the CSS Profile needs analysis formula.

Even if the money is sheltered, it's only temporary, reports the Department of Education. Once students begin taking withdrawals from 529 accounts held in relatives' names, the money counts as income and it can subtract up to 50 cents in federal aid for every dollar withdrawn. To get maximum federal aid and minimal 529 impact, families can postpone taking 529 withdrawals from relatives until after the student has received financial aid for his or her last year of school.

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