The ABCs of 529 College Savings Plans

Posted: 5/3/2017 by Fidelity Viewpoints

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

Key Takeaways

- Alleviate the impact on financial aid.
- Be more flexible thanks to fewer account restrictions.
- Control the money and choose among many investment options.

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 $20,090 for the 2016—2017 tuition year, and $45,370 per year for a four-year private college,[1] it's no surprise that college expenses can be overwhelming.

Footing college bills these days often takes every source of potential funding available to a parent, 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 the financial aid available to the student, 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 [UGMA]/Uniform Transfers to Minors Act [UTMA] account), a Coverdell Education Savings Account (ESA), or even setting money aside in a taxable account (see the detailed chart below)—the potential advantages of a 529 college savings plan distinguish it from the rest.

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, as long as the beneficiary of the plan is attending the school at least part time. When 529 funds are used for these qualified purposes, there is no federal income tax on investment gains (no capital gains tax, ordinary income tax, or Medicare surtax).

Typically, a parent or grandparent opens the account and names a child or other 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 of a particular state to invest in its plan.

The ABCs of 529 plan benefits to consider:

A. Alleviate the impact on financial aid.

Many families worry that saving for college will hurt their chances of receiving financial aid. But, because 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 up to 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 potential 20% rate that is assessed on student assets, such as assets in an UGMA/UTMA (custodial) account.

"This lower rate means that every dollar saved in a 529 college savings plan can go a long way toward helping to pay for college without significantly affecting financial aid for the student," says Keith Bernhardt, vice president of college planning at Fidelity Investments.

How do college savings options compare?

There are many investment accounts you can use to help save for a child's education, which differ in features and benefits. Here are three types of accounts that many families consider:

529 College Savings Plan

These tax-advantaged accounts are designed to pay for qualified higher education expenses. They can be used for a student of any age.

UGMA/UTMA Uniform Gifts to Minors Act/ Uniform Transfers to Minors Act Accounts

Custodial accounts invested in the child's name, these accounts can be used for any expense for the benefit of the child.

The Coverdell Education Savings Account

Formerly known as the Education IRA, these accounts offer tax-deferred growth and are designated for a child's educational expenses. They are not offered by Fidelity.

	529 College Savings Plan	UGMA/UTMA	The Coverdell Education Savings Account
Any earnings grow tax-deferred and qualified distributions are federal income tax-free.	✓	Part of investment earnings may be tax exempt.	✓
Annual gift-tax-free transfers.	Up to $70K per beneficiary in a single year ($140K per married couple)**	Standard $14,000 annual ($28,000 per couple)	$2,000 annual account contribution limit
Beneficiary can be changed.*	✓	X	✓
Participant (account owner) maintains control over distribution of assets.***	✓	Distributions must be used for minor.	✓
Contributions not limited by the income of the participant (account holder).	✓	X	Cannot contribute if AGI is over $110,000 (for a single Filer) or $220,000 (for a joint filer).
No age limit for the beneficiary (child)	✓	The child (minor) gains control of the assets at age 18 or 21, depending on state UGMA/ UTMA law.	Balances must be disbursed by age 30 to beneficiary or family member to avoid taxes and penalties.
Low impact on financial aid.	✓	X	✓
Choice of investments.	A choice of portfolios is managed by a professional fund manager.	Owner (custodian) researches and chooses investments.	Owner researches and chooses investments.

*For 529 accounts only, the new beneficiary must have one of the following relationships to the original beneficiary: 1) a son or daughter; 2) stepson or stepdaughter; 3) brother, sister, stepbrother, or stepsister; 4) father or mother or an ancestor of either; 5) stepfather or step-mother; 6) first cousin; 7) son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law; or 8) son or daughter of a brother or sister. The spouse of a family member (except a first cousin's spouse) is also considered a family member. However, if the new beneficiary is a member of a younger generation than the previous beneficiary, a federal generation-skipping tax may apply. The tax will apply in the year in which the money is distributed from an account.

**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 fails to survive the five-year period, a portion of the transferred amount will be included in the donor's estate for estate tax purposes.

***For 529 savings plans, contributions are considered revocable gifts; owner controls the account; child is the beneficiary. For UGMA/UTMA accounts, contributions are considered irrevocable gifts; distributions must be used for minor; custodian controls the account until it is transferred to the minor at the age of majority. For Coverdell accounts, contributions are considered irrevocable gifts; account owner controls the account; child is beneficiary.

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. If they're available, consider using funds in a 529 plan owned by a nonparent for the last year of college, after the last financial aid forms are filed.

B. Be more flexible.

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 income of $110,000 or less if single filers, and $220,000 or less if filing jointly. However, once a 529 plan account reaches a certain value—typically more than $300,000 (varies by state)—further contributions are not permitted.

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

C. Control the money and choose among many investment options.

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 another named beneficiary.

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 twice each calendar year or if you change beneficiaries.

"Whatever age-based portfolio you choose, the first step in the process is defining the investment objective," says Peter Walsh, institutional portfolio manager for the Fidelity-managed 529 plans. "With appropriate, age-based investments, the objective is to grow the assets while maintaining an age-appropriate balance between risk and return."

Think carefully about how you invest your savings. A strategy that's too aggressive for your time frame could put you at risk for losses that you might not have time to recoup before you need to pay for college. Being too conservative can also be a risk because your money might 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, because 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.

Potential tax benefits

If your 529 is used to pay for qualified higher education expenses, no federal income taxes are owed on the distributions, including the 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.

Gifts to an individual above $14,000 a year typically require a form to be completed for the IRS, and any amount in excess of $14,000 in a year must be counted toward the individual's lifetime gift-tax exclusion limits (the federal lifetime limit is $5,490,000 per individual). With a 529 plan, 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.[2] This approach can help an investor potentially make very large 529 plan contributions without eating into his or her lifetime gift-tax exclusion. Of course, you could make additional contributions to the plan during those same five years, but these contributions would count against your lifetime gift-tax exclusion limit. Consider talking with a tax advisor if you plan to make contributions exceeding $14,000 a year.

Dispelling 529 Plan Myths
Here are four 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. "Also, if a 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 the 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 nonresidents that you should consider before deciding to invest with that plan.
- **3. The federal tax benefits associated with a 529 college savings plan will eventually disappear.**
  The Pension Protection Act of 2006 indefinitely extended the federal tax-free qualified withdrawals on 529 college savings plan savings.
- **4. 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 twice per calendar year or when you change beneficiaries.

Who may want to consider a 529?

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 account. 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 can lower the average price you pay for fund units over time and can help mitigate the risk of market volatility. Besides, many investors don't have the financial capacity to make meaningful, lump sum contributions to a 529 college savings plan.

"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."

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.

- 1. Trends in College Pricing, 2016. College Board Advocacy and Policy Center.
- 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.
- Before investing, consider the Plan's investment objectives, risks, charges, and expenses. Contact your investment professional or visit institutional.fidelity.com for a free Offering Statement. Read it carefully before investing.
- The Fidelity Advisor 529 Plan is offered by the state of New Hampshire and managed by Fidelity Investments. If you or the designated beneficiary is not a New Hampshire 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.
- Fidelity does not provide legal or tax advice. The information herein is general and educational in nature and should not be considered legal or tax advice. Tax laws and regulations are complex and are subject to change, which can materially affect investment results. Fidelity cannot guarantee that the information herein is accurate, complete, or timely. Fidelity makes no warranties with regard to such information or results obtained by its use, and disclaims any liability arising out of your use of, or any tax position taken in reliance on, such information. Consult an attorney or tax professional regarding your specific situation.
- Investing involves risk, including risk of loss.