Bump In The Road
By Jeff Schlegel

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What's up with 529 college savings plans? On paper, these investment vehicles should be a smashing success––after all, they're generally recognized as the best way to save for a child's college education thanks to their generous tax breaks. Yet various surveys show that many parents have done a poor job saving for college, in part because 529 plans are misunderstood and underutilized. Throw in a lousy economy and rocky days on Wall Street, and 529 plans recently are taking a hit just like most other investments.

According to Financial Research Corp., assets in 529 plans declined during this year's first quarter, marking the first time that's happened since the company began tracking 529s in 2001. Total assets fell to $108.7 billion during the quarter, a 2.9% drop from the fourth quarter (and a 0.7% drop from the third quarter). And the estimated net sales of $2.2 billion in the first quarter were less than half the $5.2 billion total from the same period the year before.

"A lot of parents view college savings as discretionary spending," says Tom Kazmierczak, senior product manager for 529s and college savings at T. Rowe Price. "Rising gas prices and other expenses take precedence over saving for something they won't use for maybe 10 or 15 years."

That might seem surprising given that a college education is one of the pillars of the American dream. But a survey done last October by The Hartford Financial Services Group showed that 43% of parents hadn't started saving at all for college, and that 70% of parents who had started saving weren't using 529 plans.

"No one comes in here and asks for them [529 plans]," says Jorie Barnett Johnson, a CFP licensee with Financial Futures LLC in Manasquan, N.J. She says that's partly because of the lack of knowledge about the plans––and sometimes unrealistic expectations––on the part of clients.

"One of my most financially savvy clients, a couple, are hesitant about putting money into a 529 plan because they think their child is very intelligent and will get a scholarship," Johnson says. "I told them that if their child gets a scholarship they can take out the money from the 529 without penalty. They didn't know that."

College, Or An Island?

Based on average costs for tuition, room and board and fees for 2007-2008, the total four-year tab at a private institution is an estimated $120,000 and for an in-state public four-year institution it's roughly $70,000, according to the College Board, a nonprofit group of schools, colleges and universities. With the assumption of realistic 6% annual increases in college expenses, a child born today faces projected four-year costs of $440,000 at a private college and $216,000 at an in-state public school.

That kind of money can buy a private island. And it isn't going to come from a plain-vanilla savings account at the local bank. That's where 529s come in.

Created in 1996 under Section 529 of the Internal Revenue Code, 529s are state-sponsored college savings programs where investment returns grow tax-free and withdrawals are exempt from federal taxes as long as the money goes toward qualified educational expenses including tuition, room and board, books, required equipment and fees. A large number of states also offer either tax credits or deductions for residents who invest in their state's 529 plans.

There are roughly 95 plans available in 49 states, along with about 20 prepaid plans that are guaranteed to increase in value at the same rate as college tuition (the downside is they offer a limited number of available college choices).

The maximum yearly contribution for individual donors to 529 plans is $12,000 per beneficiary. People getting a late start on the program can make a special lump-sum contribution of up to $60,000—$120,000 if they are married and filing jointly—to a child's account. But annual contributions during the next four years following this lump-sum contribution will trigger gift-tax penalties.

Recent statistics on declining 529 plan assets and sales means the industry "took a fairly big step backwards," says Jeff Troutman, vice president of college savings at Fidelity Investments.

Nonetheless, Troutman says Fidelity's sales have held up relatively well. "I think the real impact has been mostly in new account openings," he notes, adding that strong flows coming from existing accounts indicate that parents currently in 529 plans are consistent, long-term contributors. And those who are tend to be more prepared to handle college costs.

In May, Fidelity released a survey showing that parents of children ages 15-18 who use 529 plans are on pace to cover 46% of college costs. Parents with children of similar ages who don't utilize 529s are on course to cover only 17% of costs.

Troutman says the big issue now is the uncertainty about college loans, which are expected to become more difficult to get and which may perhaps carry higher interest rates and less favorable terms in the future. That will allow advisors to broach the topic of 529 plans as a steady financial underpinning to a college education.

529s In Practice

No doubt that 529 plans are complex beasts with lots of moving parts. A recent poll on savingforcollege.com, a comprehensive clearinghouse for all matters relating to college savings programs, recently asked readers to rate how confusing they thought 529 plans are. Among respondents, 19% chose the "much too confusing" option and 54% agreed with the statement that they're fairly confusing and take a significant effort to understand.

"There are a lot of different aspects to consider such as taxes, control and fees," says Susan Elser, a CFP licensee at Elser Financial Planning in Indianapolis. "Advisors can provide a lot of service to help clients understand them."

That might explain why 67% of total 529 accounts are sold through advisors rather than sold directly through the states, according to the Financial Research Corp.

When it comes to college savings, Elser relies almost exclusively on 529 plans because of their tax advantages. She used to opt for Utah's low-cost plan, but for Indiana residents she now favors using the plan offered by JPMorgan Chase through the state of Indiana, which enacted a 20% tax credit for in-state residents for contributions of up to $5,000. (Upromise Investments is scheduled to take over as manager of JP Morgan's Indiana program in mid-2008).

Elser also likes 529 plans as an estate planning tool. "It's the only estate planning strategy where the assets leave your estate but not your control," she says. "The owner decides when to distribute it, can change the beneficiary and decides how it's invested."

Mark Gleason, a senior financial advisor at Wescap Management Group in Burbank, Calif., formerly used custodial accounts to help a lot of his clients save for college. But he says recent changes in the so-called "kiddie tax" laws make that a less-appealing option. (For 2008, the ceiling on the kiddie tax was raised from 18 to 19 years, or 24 if they are full-time students and don't have earned income equal to half of their annual support.)

"That's pretty much dead as a college planning tool," says Gleason, whose firm has shifted its focus to 529 plans. California doesn't provide any tax credits, so Gleason opts to use Virginia's College America program, which comprises a lineup from American Funds. Gleason likes the program's reasonable costs and that it gives him lots of options to tailor a plan to a client's needs.

Jorie Barnett Johnson, the planner in New Jersey, favors the Utah Educational Savings Plan that uses both the state treasurer's fixed-income fund and Vanguard index funds in five different aged-based options whose allocations change as the beneficiaries more toward college enrollment and four static portfolio options whose allocations stay the same. Johnson likes that the Utah plan comes with a lot of age-based allocation models and with a cheap expense ratio (0.25% to 0.37%).

Don't Neglect The Nest Egg

When it comes to saving for college, 529 plans aren't the only option. Other possibilities include Coverdell Education Savings Accounts, Roth IRAs and trusts. But no matter what the option used, clients with great intentions can't let themselves get carried away by shoveling money into college savings accounts at the expense of their retirement accounts.

"You have to make sure they fund their retirement first," says Buz Livingston, a CFP licensee with Livingston Financial Planning in Santa Rosa Beach, Fla. "You can always borrow money to go to college, but you can't borrow money for retirement."

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