

HEDGING THE TUITION EXPLOSION

BY JOSEPH ORSOLINI

Section 529 of the Internal Revenue Code offers parents and grandparents a substantial hedge against the rapidly rising cost of a college education. This section of the code creates two distinct state-sponsored plans: prepaid tuition plans and college savings plans. Deciding whether to invest in a 529 plan—and which of the two kinds of plans is better for you—depends on your individual situation.

Each of the 50 states, as well as the District of Columbia, sponsors its own 529 plan. Most states, but not all, offer both prepaid tuition and savings plans.

Anyone may establish and contribute to a 529 plan, and name any minor (not necessarily a child or grandchild) as the beneficiary. Although the plans' specifics vary from state to state, the following features are common to most.

Prepaid Tuition Plans

These plans let you pay tomorrow's tuition at today's prices. When you contribute funds to your account, your contribution is used to purchase tuition credits or units, based on current tuition rates at in-state, public universities. If you buy a year's worth of credits, for example, those credits can always be used to pay a year's tuition at an in-state public school, even if tuition has doubled or tripled in the meantime. If tuition is lower in the future (fat chance!), you won't lose your principal investment.

If the student ultimately decides to attend an out-of-state or private college with higher tuition, he or she can still use the credits, but will be responsible for paying the difference in tuition cost.

Prepaid plans have the advantage of low risk, but that's offset by the high impact on financial aid eligibility. Prepaid tuition plans are treated as an outside resource, which reduces financial aid eligibility dollar-for-dollar. Another disadvantage of prepaid plans is that you can only use the

funds to pay tuition, not for books or room and board.

College Savings Plans

Section 529 savings accounts earn interest and dividends free of federal income tax, as long as your beneficiary uses the funds to attend college. Unlike prepaid tuition plans, there's no guarantee that the funds in your account will keep pace with tuition growth—in fact, your funds could actually shrink, depending on how they're invested.

Your beneficiary can use the money in a 529 savings to pay for tuition, books, room and board, and even supplies and equipment at any qualified college in the U.S.

Section 529 savings plans have a much lower impact on financial aid eligibility than prepaid plans. If a parent owns the 529 savings account, the financial aid formula counts 5.65 percent of the funds as a student's resource. If a grandparent (or unrelated adult) is the account owner, there's no impact at all. This advantage is offset, of course, by the higher risk—the state doesn't guarantee your principal investment.

Most states let you choose from various asset allocation strategies, and some offer a plan that shifts the assets into more conservative investments as the beneficiary approaches college age.

Rollovers and Early Withdrawal

For both prepaid and savings plans, if your beneficiary dies or decides not to attend college, you can simply change beneficiaries, as long as the new beneficiary is a member of the same family.

You can cancel your account and receive a refund, but you'll have to pay federal income tax on the earnings, and most states will assess a 10 percent tax penalty as well, except in cases of death or disability of the beneficiary.

The decision of which type of 529 plan—the prepaid tuition plan or the savings plan—to invest in depends on three main factors:

■ **What kind of school will the student attend?** This may seem like a ridiculous question to ask if the child is very young. But remember that prepaid tuition plans offer a better return on investment if the student attends an in-state public college.

■ **What expenses do you want to cover?** Proceeds from prepaid plans cover only the cost of tuition, so you or the student will have to be prepared to pay for books, room and board, supplies and equipment. On the other hand 529 savings plan funds can be used for all those expenses. (The current rate for room and board is in the \$5,000 to \$6,000 per year range.)

■ **How much risk can you bear?** One way to understand the difference between the two kinds of 529 plans is to think in terms of the choice between a defined-benefit plan and a defined-contribution plan, similar to the choice between a pension and a 401(k). The prepaid tuition plan offers a defined benefit, typically the future value of the college tuition credits or shares. The 529 savings plan lets you define the contribution, but doesn't guarantee the future benefit. But in return for the greater risk, there's also the potential for unlimited returns in a savings plan.

You should also compare the advantages and risks of 529 plans with other sources of tuition funding, such as Coverdell Education Savings Accounts, Roth IRAs, student loans, scholarships, financial aid, work-study arrangements and lifetime learning credits.

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