

Choosing a Qualified Tuition Plan October, 2001

Qualified tuition programs (sometimes called Section 529 plans) have received a lot of attention recently because the 2001 Tax Act generally makes distributions from such plans tax free starting in 2002. The idea behind these plans is that people will have an easier time saving for their children's (or grandchildren's) college education if the funds they set aside for this purpose grow on a tax-free basis. Currently, each Qualified Tuition Program (QTP) is sponsored by a state. However, beginning next year, private colleges will be able to set up their own plans.

While QTPs aren't for everyone (and we'll be glad to help you determine if they're right in your situation), many people have already decided they want to put at least some of their college savings in such a plan. If you're in that group, your next task is selecting the best plan. This can be a difficult decision since there are currently over 40 state plans—most of which accept funds from out-of-state residents. The purpose of this letter is to walk you through some of the issues you might want to consider as you make that decision.

Prepaid or savings plan? One place to start when comparing plans is to decide which is best—a prepaid tuition plan (that guarantees some portion up to 100% of a student's college costs will be paid for) or a savings plan (that simply provides a tax efficient way to save for college, but doesn't guarantee the funds will be enough). The choice normally depends on the time period until the student enters college and your tolerance for risk. In most cases, savings plans will be preferred; however, when college is imminent or you want assurance that a certain amount of tuition will be paid for, regardless of how the financial markets do, the prepaid plan might be appropriate. Because QTP savings plans are the most popular, we're going to focus on selecting that type of plan.

Should you go with the home team? With nearly every state offering a plan, some people will be tempted to pick their state's plan without any comparison shopping. Sometimes that will be a good (or perhaps even great) choice, other times people can do better looking elsewhere. Many state plans allow residents to deduct all or part of their contributions to the state's QTP and exclude the account earnings for state income tax purposes. However, this is not automatic so it's important to look at each state's specific provisions. For example, New York residents can deduct up to \$5,000 per year (\$10,000 for married couples filing jointly) on their New York state income tax return for contributions to the New York College Savings Program. California, on the other hand, currently doesn't allow residents to claim a deduction for contributions to its plan.

What kind of returns can you expect? Like any investment, it's important that the investment options and manager(s) of the funds be consistent with your risk tolerance and investment style. Until recently, account owners could not change the investment strategy once a plan was selected. However, QTPs can now allow account owners to change investment strategies once per calendar year or, if earlier, when an account's beneficiary changes. This will give account owners limited control over how their funds are invested, provided their QTP adopts this provision.

Many state plans have engaged well-known mutual fund companies or brokerage firms to manage the investment options. For example, the Utah plan uses Vanguard mutual funds, the Missouri plan uses TIAA-CREF, and the Colorado plan has engaged Salomon Smith Barney as its investment manager. Most state plans include age-based investment options whereby the investment strategy goes from a more aggressive style (higher percentage of equities) to a more conservative style (higher percentage of cash and bonds) as the child nears college age. In addition, some states offer other options, including some weighted heavily in equities as well as fixed income accounts. Thus, there are a lot of options available, but it's important to find the one that's right for you.

Another important factor to consider is fees and expenses because they will have a direct impact on your overall investment return. These can vary in type as well as amounts or rates. QTPs

typically charge either a fixed or asset-based annual maintenance fee in addition to the fee charged by the investment manager. Some charge an enrollment fee as well.

And lastly, are there other catches? Some QTPs include unusual or unique features that could be a factor in your decision. One state's plan, for example, is somewhat unusual in that it shifts many of the ownership rights from the contributor to the beneficiary. Another state's plan has a 36-month waiting period before qualified withdrawals can be made. In addition, when this plan was recently amended to take into account the 2001 Tax Act provisions, it surprisingly retained its own 10% penalty on nonqualified withdrawals in addition to the 10% penalty imposed by the IRS beginning in 2002.

Conclusion

As we mentioned earlier, Qualified Tuition Programs aren't for everyone. However, for most people saving for college expenses, QTPs are at least worth a look. We'd be glad to help you answer any questions you have about such plans. Just give us a call at 916-483-8300 or 800-914-8299 (TAXX). You can email us at cate@murray.com