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529 Plans: Three Do's and Don'ts to Help You Navigate These College Savings Plans

By Ian A. Post, CFA

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A frequently asked question is whether 529 plans – state-sponsored college savings plans created under the Small Business Job Protection Act of 1996 – are a good way to save for college. The quick answer is "yes," although the plans can be somewhat complicated so it's important to have a basic understanding of the pros and cons of these plans. The plans offer multiple advantages versus other savings options, primarily through preferential tax treatment if the money is used for qualified higher education expenses. Here are three Do's and Don'ts that can help you get started saving for college with 529 plans:

DO

1. Do Use 529 Plans: These plans have clear advantages over other accounts typically used for college saving such as regular brokerage accounts, UTMA (Uniform Transfers to Minors Act) accounts and trusts. 529 plans offer a combination of tax-deductible contributions (in many states including New York) and tax-free distribution of earnings if used for eligible college expenses that combine to create a tremendous advantage for college savers.

2. Do Use New York's 529 Plan: While college savers are eligible to contribute to any 529 plan, New York State tax payers should use New York's Direct Plan. Taxpayers can deduct up to $10,000 (if married filing jointly) of contributions each year from their New York State taxable income, effectively paying you to save for college. The Direct Plan investments are run by Vanguard, which offers an investment lineup of low-cost index funds.

3. Do Use the Age-Based Fund Options: Most 529 plans offer individual funds and age-based portfolios that automatically shift to more conservative allocations as the student gets closer to college age. The age-based portfolios are also rebalanced by the fund company, thereby taking this responsibility off of the investor. This characteristic is especially valuable in 529 plans as trades can only be made twice each year (up from a previous limitation of one).

DON'T

1. Don't Use Broker-Sold 529 Plans: Most states offer both a direct plan that investors sign up for themselves and broker sold plans that are opened by brokers. Broker sold plan investments tend to carry commissions and high fees while adding little, if any, value beyond what investors obtain in the direct plans.

2. Don't Wait to Begin Funding 529 Plans: You can begin funding 529 plans even before a child is born! Over eighteen plus years of saving, the compounding of returns on contributions made when children are young can have a major impact on the ultimate amount available for college expenses.

3. Don't Fund 529 Plans with Assets Directly from an UTMA Account: A regular 529 plan is owned by the parent and not by the child beneficiary. This feature enables account owners to change the beneficiary on the account or rollover the assets to another family member's 529 plan without incurring taxes or penalties. This can be useful if, for instance, the original beneficiary chose not to go to college. When a 529 plan is funded with UTMA assets, however, the "UTMA 529", must be used for the benefit of that child. In addition, account ownership is transferred to the child once they reach the age of majority (21 in NY).

529 plans are excellent saving vehicles for college expenses. However, they can be complicated so make sure you have a basic understanding first and then get going saving for college. It's going to be a big-ticket item!

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