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An Education in College Saving

Why 529 plans may offer estate-planning benefits

By Michaela Cavallaro
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Chances are, your extended family or circle of close friends includes at least one grandchild, niece, nephew, or other young person who will be heading off to college in the near future -- and maybe you'd like to offer some help in the form of a financial gift. But, before you reach for your checkbook, it's a good idea to stop and consider the impact this well-meaning gift may have on you and your beneficiary of choice.

Although your young relative or friend is sure to appreciate any contribution you make to his or her college savings, the thank-you note may be met with some challenges. Some types of gifts may carry hidden costs to the recipient and his or her family. In fact, gifts of cash, securities, or savings bonds may reduce the child's chances of qualifying for financial aid.

"You should consider your gift choices carefully," says Brooke Salvini, a CPA and financial advisor representative in San Luis Obispo, Calif.

The financial aid dilemma

There's no question that paying for college is a concern for many American families. In fact, college costs continue to rise at twice the rate of inflation, according to a recent analysis by the College Board,[1] even as the weak economy is hurting parents' ability to save for their children's education.

A full 60% of parents surveyed for Fidelity's second annual College Savings Indicator (CSI) cited day-to-day expenses as a common barrier to saving more for college.[2] Indeed, parents are projected to meet just 21% of the total cost of their children's education out of their own assets -- a decrease of three percentage points from 2007, according to the CSI. This is where many parents hope financial aid will make up the difference on the tuition bill.

Students and parents must fill out the Free Application for Federal Student Aid (FAFSA) to qualify for such aid. Using that information, the federal government and the colleges in question calculate a student's "expected family contribution" (EFC) based upon the student's income and assets as well as the parents' income and assets. If the EFC is less than the cost of a particular school, the student typically receives a financial aid package to make up all or part of the difference.

That package may consist of a combination of grants, subsidized and unsubsidized loans, and work-study funds

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from federal, state, and college sources. A Uniform Gift to Minors Act account (UGMA) is one example of a custodial account that reflects student-owned assets. However, the income from a custodial account must be reported on the child's tax return and is taxed at the child's rate, subject to the "kiddie tax" rules. When it comes to qualifying for financial aid, custodial accounts are considered assets of the student, meaning their eligibility is likely to be impacted.

Fortunately, there may be a solution. A 529 college savings plan can provide a great way to help a potential student with little to no impact on his or her financial aid eligibility.

Inside 529 college savings plans
Each state (and the District of Columbia) offers its own 529 plan, and students generally can use the proceeds to cover costs at any qualified college nationwide. In most cases, you can invest in any plan, regardless of whether it's sponsored by a state where the prospective student lives or plans to attend school.

Most 529 plans are structured as investment accounts. They come in two varieties. You can open a "direct-sold" account through the sponsoring state or its investment manager, or you can open a "broker-sold" account via a broker or financial advisor. A good first step may be to explore your in-state college savings plan to determine if it offers tax advantages. However, there may be other factors you'll want to consider, such as fees, expenses, investment options, and performance. It's also important to note that the value of your account will rise and fall with the value of the investments you've selected in the plan.

Learn more about college savings plans.

Any adult can open a 529 account for a specific beneficiary -- usually a college-bound child or grandchild. When parents of a college-bound student own a 529 account, up to 5.6% of the money in the account is included in the FAFSA's calculation of their expected family contribution. That's far better than the 20% figure applied to student assets -- but the advantage is even greater for non-parents.

When you open a 529 account in your own name for a young person who is not your child, the money isn't included in that child's FAFSA calculations at all. As a result, your gift won't reduce the child's financial aid eligibility by a single dime -- so 100% of the account's value can go toward defraying your loved one's or the beneficiary's college costs. "This makes 529 plans a great vehicle for grandparents," notes Joe Ciccariello, vice president of college planning for Fidelity Personal and Workplace Investments.

Benefits for account holders
Investing in a 529 plan for the benefit of a grandchild or other young person provides additional benefits, including some that may be good for your own bottom line. For example:

You keep control over the assets. Grandparents in particular may be concerned about making an irrevocable gift. "People often worry about running into medical or financial problems later in life and may need this money back," Salvini says. "A 529 is revocable -- and it remains under your ownership until withdrawals are made. You'll have to pay penalties and taxes for noneducation-related withdrawals, but the bulk of the money is available if you need it."

Your contributions can grow tax free. Section 529 plans provide significant tax breaks. Contributions are not tax deductible, but investment earnings in the plan are free from federal income taxes as long as all withdrawals are used to pay for qualified higher education expenses. You might qualify for a state tax break, too, if you contribute to your own state's plan. Such breaks vary from state to state. Investigate your state's 529 plan and then compare it with other options to see which one works best for you. (Savingforcollege.com can help you compare the features of various state plans.)

You might reap estate-planning benefits. Money in a 529 plan is removed from your taxable estate. Fred Amrein, a principal with Amrein Financial in Wynnewood, Pa., says 529 contributions are treated as a gift to the beneficiary. As of 2009, you can give up to $13,000 per beneficiary per year free of gift taxes -- and that amount includes contributions to 529 plans. You also can make five years' worth of gifts in a single year, giving up to $65,000 per beneficiary ($130,000 if you are married, filing jointly) without triggering the gift tax.[3] The IRS will treat the contribution as if it were spread over five years.

You have an array of investment choices. The plans typically offer a dozen or more portfolios, ranging from aggressive, all-stock portfolios to conservative portfolios that include cash and bond holdings. Many states' 529 plans offer at least one portfolio that chooses investments based on the beneficiary's age. These portfolios start stock-heavy when the child is very young, then slowly shift their allocation toward bonds as the beneficiary nears college age.

You can change your beneficiary designations. You must designate a specific beneficiary when you open a 529 account. You can change the beneficiary as many times as you want -- as long as the new beneficiary is another member of the original beneficiary's family.

How to choose a 529 plan

The first step to investing in a 529 college savings plan is to choose a plan. Each state sponsors at least one 529 plan, and many states -- including Arizona, Texas, and Virginia -- offer investors multiple plan options. You can choose from any state's plan, no matter where you live. Keep in mind that many 529 plans offer special tax breaks or other incentives to their own residents, so it may behoove you to check out your home state's plan first.

Fidelity manages five state-sponsored 529 plans -- from Arizona, California, Delaware, Massachusetts, and New Hampshire -- that offer a range of investment options, including access to actively managed funds and index funds, as well as custom and age-based investment strategies. In fact, Fidelity was a pioneer in age-based investing and currently has more assets in age-based funds than any other mutual fund company.

Learn more about Fidelity managed 529 plans.

One more way to save
When saving for a long-term goal such as college, every little bit you can invest now can aid your potential returns over time because of compounding. If you save for college in a Fidelity-managed 529 plan account, consider increasing your contributions by applying for the Fidelity Investments 529 College Rewards® American Express® Card. The card offers reward points on everyday purchases such as groceries, gas, and clothing. Those reward points can convert to cash that is automatically deposited into your Fidelity-managed 529 account.

You'll earn reward points of 2% on your net retail purchases1 and there are no limits to the amount of rewards you can earn. Family and friends can also contribute to your family's college savings by carrying 529 College Rewards Cards linked to your Fidelity-managed 529 Plan account.

Save more for college expenses with the Fidelity Investments 529 College Rewards® American Express® Card.

1. "Trends in College Pricing 2007," collegeboard.com.

2. "Fidelity College Savings Indicator Finds Parents Are Projected to Meet Only 21 Percent of Future College Costs," Fidelity press release, Oct. 1, 2008.

3. In order for an accelerated transfer to a 529 Plan (for a given Beneficiary) of $65,000 (or $130,000 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.

The UNIQUE College Investing Plan, U.Fund College Investing Plan, Delaware College Investment Plan, Fidelity Arizona College Savings Plan, and ScholarShare® College Savings Plan are offered by the State of New Hampshire, MEFA, the State of Delaware, the Arizona Commission for Postsecondary Education, and the ScholarShare Investment Board, an agency of the State of California, respectively, and managed by Fidelity Investments.

Units of the Portfolios are municipal securities and may be subject to market volatility and fluctuation.

If you or the designated beneficiary are not a resident of the state sponsoring the 529 college savings plan, you may want to consider, before investing, whether your or the designated beneficiary's home state offers its residents a plan with alternate state tax advantages or other benefits.

Please carefully consider the Plan's investment objectives, risks, charges, and expenses before investing. For this and other information on any 529 College Savings Plan managed by Fidelity, call or write to Fidelity for a free Fact Kit, or view it online. Read it carefully before you invest or send money.

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