College Savings Plans vs. Prepaid Tuition Plans
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Section 529 plans are popular college savings vehicles. Due to the demand for them, nearly every state now operates at least one type of 529 plan (either a prepaid tuition plan or a college savings plan), and an increasing number are offering both. To choose the type of 529 plan that's right for you, it's important to understand how prepaid tuition plans and college savings plans work and the differences between them.

How does each plan work?

As 529 plans, both college savings plans and prepaid tuition plans offer significant federal tax advantages. Funds in each type of plan grow tax deferred, and withdrawals from either plan used for the beneficiary's qualified education expenses are completely income tax free at the federal level. But despite these shared tax advantages, college savings plans and prepaid tuition plans are different creatures.

A college savings plan lets you build an education fund within an individual investment account. Money you contribute is invested in one or more specific investment portfolios. Each portfolio consists of a mix of investments (typically mutual funds) that are chosen and managed exclusively by the plan's designated money manager. You generally pick your investment portfolio at the time you open an account, or else one is automatically chosen for you. Your investment return is not guaranteed.

In contrast, a prepaid tuition plan lets you purchase tuition now for use in the future. There are generally two types of prepaid tuition plans: contract plans and unit plans. A contract plan (sometimes known as a guaranteed interest plan) promises to cover a predetermined amount of tuition expenses in the future, in exchange for your lump sum or periodic contributions.

With a unit plan, you purchase a certain percentage of units or credits and the plan guarantees that whatever the percentage of college costs such units cover now, the same percentage will be covered in the future. For example, assume that 100 tuition credits are required to fund one year's worth of tuition at State University today. You purchase 100 credits today for $8,000. The result is that when your child starts college at State University in 12 years, your $8,000 will theoretically pay the entire first year of tuition, even though tuition costs may have risen to $20,000 per year by then.

Note: Even though prepaid tuition plans typically guarantee your investment return, plans sometimes announce modifications to the benefits they'll pay out due to projected actuarial deficits.

Who can offer these plans?

At one time, only states could offer prepaid tuition plans and college savings plans. (In practice, the states designate an agent, usually an experienced financial institution, to manage and administer their plans). But colleges and universities can now offer their own prepaid tuition plans. These plans are sometimes referred to as private prepaid tuition plans, and the beneficiary is limited to attending the college(s) in the plan. However, the remainder of this discussion refers to state-sponsored prepaid tuition plans.

How are your contributions invested with each type of plan?

College savings plans and prepaid tuition plans differ on the way your contributions are invested. With a prepaid tuition plan, there are no individual investment accounts. Instead, your contributions go into a general fund, and the plan's money manager is solely responsible for investing the pooled money to meet the plan’s future obligations to its participants. Your only concern is with the predetermined amount of tuition that the plan has agreed to cover in the future, or the percentage of tuition costs that the units or credits you’ve just purchased will eventually cover.

With a college savings plan, your contributions are held in an individual investment account in one or more specific investment portfolios. The trend is for plans to let you choose your investment portfolio at the time you open an account. Typically, plans offer a variety of options--from aggressive to conservative--so you can choose a portfolio that matches your risk tolerance, time horizon, and other factors. But remember, the plan's money manager handles the underlying investment mix in each portfolio on a day-to-day basis--you have no say in this process.
Some states may not let you choose your investment portfolio when you join the plan. Instead, they will automatically assign you a portfolio based on the beneficiary's age (called an age-based portfolio). With an age-based portfolio, the underlying asset mix consists of more aggressive investments when the beneficiary is young (such as stock mutual funds) and then is gradually and automatically shifted to less volatile investments (like bond funds and money market funds) as the beneficiary nears college. The idea is to take advantage of the potential for higher returns (with the accompanying risk) when the beneficiary is young, and then preserve principal as the beneficiary approaches college age.

Once you've settled on an investment portfolio for your college savings plan account, you have limited opportunities to change it if you're not happy with its investment performance. Under IRS rules, plans are authorized, but not required, to let you change your investment portfolio once per calendar year or at any time you change the beneficiary. Some plans may also allow you to direct future contributions to a new portfolio. Such investment flexibility can make one plan stand out among others, so it's always a good idea to check the specific investment rules of any plan you're considering.

You also have another option guaranteed by federal law. You can roll over the funds in your existing college saving plan account to another 529 plan (college savings plan or prepaid tuition plan) once every 12 months without penalty. The beneficiary stays the same.

In your effort to pick a suitable portfolio, keep in mind that no investment in a college savings plan is guaranteed—you could lose money that you've contributed. That's why it's important to investigate the reputation and overall investment performance of the institution that manages the college savings plan, as well as the performance history of individual portfolios in the plan.

Are there any restrictions on joining either type of plan or accessing the funds?

Yes. Most college savings plans are open to residents of every state. This means you can shop around for the plan that offers the combination of features you want. (But keep in mind that if you join another state's college savings plan, you'll generally be entitled only to the state tax benefits offered by your state.) Beyond that, you can open a college savings plan at any time of the year, and the account can generally remain open indefinitely. This gives you flexibility if your child decides to postpone his or her education.

By contrast, most prepaid tuition plans are limited to state residents only. And once you open an account, all tuition credits generally must be used by the time your child turns 30, and all withdrawals completed within 10 years from the time your child starts college. Also, at some point before your child starts college, you (the account owner) are required to inform the plan administrator when you expect to start redeeming credits. Finally, some prepaid tuition plans let you join only during specific enrollment periods.

What education expenses are covered by each plan?

College savings plans give you more flexibility in paying your beneficiary's education expenses. Funds in a college savings plan account can be used to pay for tuition, books, equipment, fees, other costs, and room and board (assuming the beneficiary is enrolled at least half-time) at any college accredited by the U.S. Department of Education. This includes undergraduate colleges, graduate and professional schools, two-year colleges, technical and trade schools, as well as some foreign colleges and universities.

By contrast, prepaid tuition plans are typically designed to pay only for undergraduate tuition costs at in-state public colleges—other expenses like room and board, books, and graduate school may not be covered. However, such restrictions are imposed by the individual prepaid tuition plans themselves, because Section 529 of the Internal Revenue Code allows a broader interpretation of qualified education expenses. Make sure you understand exactly what education expenses your prepaid tuition plan covers, as well as the tuition equivalent you'll receive if your child attends a private or out-of-state college.

What are the fees and expenses associated with each type of plan?

College savings plans, like other types of managed accounts such as mutual funds and annuities, are managed by
professional money managers who pass along their investment expenses to account owners. In addition, the plan manager will charge you a fee for administering your account. Both of these fees are usually equal to a percentage of your total account value. Some college savings plans may also tack on a flat annual maintenance fee, though this may be waived if you sign up for automatic payroll deduction or direct debiting of your checking account. Because fees and expenses vary among plans and can affect your account’s total return, examine them carefully.

Prepaid tuition plans typically charge a flat enrollment fee at the time you open your account, but generally there are no ongoing charges. However, you may be assessed fees for late payment, returned checks, changing the beneficiary, changing the beneficiary’s enrollment date, document replacement, or other administrative matters.

You may want to ask the following questions to help you better compare the fees of college savings plans vs. prepaid tuition plans:

- Is there an application fee, beneficiary substitution fee, or account owner substitution fee?
- What other fees and costs are charged, and what are the amounts?
- Will my fees be less if I contribute through payroll deduction or automatic deduction from my checking account?
- Is there a fee to do a rollover to another state’s plan?
- Will I be penalized if I move my account out of the plan within a short time after I open the account? How short a time?
- Is there a fee if I terminate the account?
- Do I pay the fees separately, or is the fee deducted from my account?

What is the income tax treatment of withdrawals from each plan?

Withdrawals from a college savings plan or a prepaid tuition plan used to pay the beneficiary’s qualified education expenses (as defined by the individual plan within federal guidelines) are completely income tax free at the federal level. And if your state exempts such withdrawals from income tax too, it does so for both college savings plans and prepaid tuition plans.

A withdrawal not used for the beneficiary’s qualified education expenses is called a nonqualified withdrawal. If you make a nonqualified withdrawal from a college savings plan account or a unit type of prepaid tuition plan (where you purchase tuition credits), a 10 percent federal penalty will apply on the earnings portion of the withdrawal (a state penalty may also apply). What’s more, the earnings portion of the withdrawal will be subject to federal and state income tax.

A nonqualified withdrawal isn't possible if you have a contract type of prepaid tuition plan. If you want to get your money out of this type of plan, your only choice is to cancel your contract and have your money refunded. (If you do cancel, you may only get back your actual contributions, with no interest or earnings included. Other plans will refund your principal plus a low rate of interest, which is then taxable at regular income tax rates.)

What impact does each type of plan have on financial aid?

Under the federal financial aid rules, assets are classified either as a parent's asset or a child's asset. This classification determines the assessment rate of the asset. The assessment rate is the portion of the asset that you are expected to use for the current year's college expenses. (Income is also classified this way.)

The federal government treats prepaid tuition plans the same as college savings plans for financial aid purposes. These plans are reported on the federal aid application as an asset of the parent, if the parent is the account owner, and assessed at a rate of 5.6 percent (they're not reported at all if the account owner is someone else, for example, a grandparent). Any distributions (withdrawals) from the plan that are used to pay the beneficiary's qualified education expenses are not counted as either parent or student income.
Regarding institutional aid (aid distributed by colleges from their own endowments), most colleges treat both college savings plans and prepaid tuition plans as parental assets and withdrawals as student income.

The availability of the tax or other benefits mentioned above may be conditioned on meeting certain requirements.

**Note:** Investors should consider the investment objectives, risks, changes, and expenses associated with 529 plans before investing. More information about 529 plans is available in the issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.