

Guide to 529 Prepaid College Tuition Plans

Presented by Gottfried & Somberg Wealth Management, LLC

Section 529 of the Internal Revenue Code established two types of qualified tuition savings programs: college savings plans and prepaid tuition plans. Both offer attractive tax advantages that have made them popular savings vehicles for families. In the prepaid tuition plan category, plans are offered by states or private colleges and universities. This article focuses on state-sponsored prepaid plans.

The fundamental purpose of prepaid tuition plans is to pay today for tuition costs incurred in the future. These plans allow families to lock in tuition costs at current rates, with a guarantee to match tuition inflation. Participants purchase tuition credits or certificates that entitle the account's beneficiary to a waiver of tuition costs at qualifying colleges when the student (i.e., the beneficiary) enrolls in school at a future date. Although the price paid today is not necessarily equivalent to current tuition costs, prepaid plans use current tuition levels to establish their pricing.

Plan Types

There are two types of prepaid tuition plans: contract plans and unit plans. With a *contract plan*, the participant agrees to purchase a specified number of years of tuition. The plan then pledges to cover that predetermined amount of future tuition expenses at a public college within that state. Contract plans for younger children usually offer lower prices on the premise that the state has a longer time horizon to invest the money.

With a *unit plan*, contributions are used to purchase units that represent a percentage of the average yearly tuition costs at public colleges in the state sponsoring the plan. One unit usually equals 1 percent of tuition costs. Units purchased do not have a predetermined value; instead, they fluctuate in value each year, commensurate with the average tuition increases for that state's public colleges.

Contributions

Contributions to prepaid plans are made with after-tax dollars and then grow income tax deferred at the federal and state levels. Contributions also qualify for the annual federal gift tax exclusion (\$18,000 in 2024). Under a special election, a donor can contribute up to five times the annual gift tax exclusion amount (\$90,000 in 2024) and deem the gift to be spread equally over five years to avoid gift tax. Certain plans may impose limits on annual contributions, and all plans limit the total lifetime contribution, typically to the projected cost of five years of tuition at the most expensive, public, in-state college.

The Effect on Financial Aid

529 prepaid tuition plans are treated as an asset of the account owner and reported on the federal financial aid application, just as 529 savings plans are. Parent-owned plans have minimal effect on financial aid because they are assessed at a maximum rate of 5.64 percent. Plans owned by grandparents are not required to be disclosed on the financial aid application.

Important Considerations

In recessionary periods, when state tax revenues may decline and stock market returns may be lower than expected, state-sponsored prepaid tuition plans may have difficulty fulfilling their obligation to investors. Historically, under these conditions, prepaid plans have either closed to new investors or increased their pricing for new investors. Nevertheless, the risk that prepaid plans may not be able to fulfill their obligation to investors does exist. Therefore, it's important to consider whether a plan is backed by the full faith and credit of the state.

Also, keep in mind that state-sponsored prepaid plans provide maximum benefits when the student attends an in-state public college. If the student attends an in-state private school or an out-of-state school, the plan may yield only a refund of contributions without interest or a refund with a small amount of interest.

Finally, most state-sponsored prepaid tuition plans cover only undergraduate tuition costs. Generally, room and board, fees, books, and graduate school expenses are not covered.

Prepaid Tuition Plans Vs. College Savings Plans

The primary difference between the two types of 529 plans is that contributions to a college savings plan are made to a selected investment portfolio, and the account owner bears the risk of investment returns. In other words, there are no guarantees.

College savings plans do have their advantages, however. Whereas funds in prepaid tuition plans typically must be used at public colleges in a particular state, funds in college savings plans can be used at any college accredited by the U.S. Department of Education, at home or abroad. Also, there is generally no time limit on withdrawals from college savings plans; most prepaid tuition plans, on the other hand, require tuition credits to be used by the time the beneficiary reaches age 30.

The fees, expenses, and features of 529 plans can vary from state to state. 529 plans involve investment risk, including the possible loss of funds. There is no guarantee a college-funding goal will be met. Earnings must be used to pay for qualified higher education expenses to be federally tax free. The earnings portion of a nonqualified withdrawal will be subject to ordinary income tax at the recipient's marginal rate and subject to a 10 percent penalty. By investing in a plan outside your state of residence, you may lose any state tax benefits. 529 plans are subject to enrollment, maintenance, and administration/management fees and expenses.

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Gottfried & Somberg Wealth Management, LLC

340 Hebron Avenue | Glastonbury, CT 06033

860.430.9104 | www.gottfriedsomberg.com