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ICI VIEWPOINTS

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# Investing Basics: 529 Savings Plans

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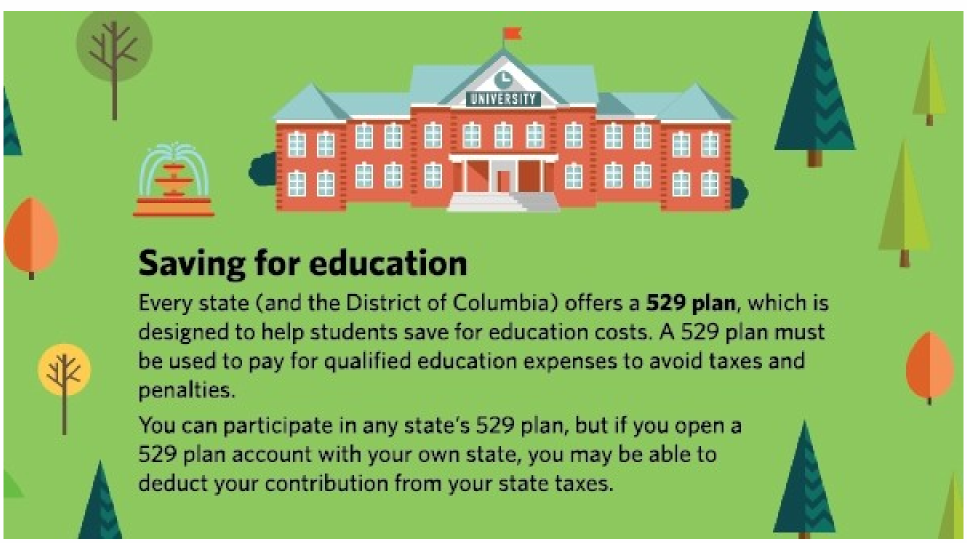
*As part of the ICI Education Foundation's 30th anniversary celebration, we are sharing a series of* ICI Viewpoints *explaining basic investing concepts, drawn from the ICI Education Foundation's Investing Road Trip.*

One thing you can expect when you're expecting a baby is to pay a lot for diapers—you might pay about $600 by your child's first birthday. But the cost of diapers is child's play compared to the costs that could come later when paying for college.

As the previous post in this series explains, saving for far-off goals can be inherently challenging—and even tougher when current needs can be so pressing (order more diapers already?!). To encourage people to save for these education costs, nearly all the states and the District of Columbia offer 529 plans, and most offer special tax treatment for state residents participating in those plans.

## The 411 on 529s

There are two types of 529 plans—savings plans and prepaid tuition plans—which collectively held $371.5 billion at the end of 2019. By a wide margin, savings plans are the most popular choice: they made up 93 percent of all 529 plan assets and 92 percent of accounts at year-end 2019.




*Prepaid tuition plans.* Prepaid tuition plans lock in future tuition costs for a specified number of academic periods or course units at current prices. Currently, 12 states and the Private College 529 Plan offer prepaid tuition plans. Contributions to these accounts purchase tuition certificates, which can be redeemed to pay for tuition at a future date.

*Savings plans.* With savings plans, savers allocate their investment dollars among the plan's investment options, much like a 401(k) account or individual retirement account. Investment earnings grow tax-free, and withdrawals, which may be used at virtually all accredited postsecondary institutions, are free from federal tax, as well as state tax in most states, when used to pay for qualified higher education expenses. Qualified expenses include tuition, fees, books, supplies, other equipment, and, in some cases, the cost of room and board.

## Benefits of 529 Savings Plans

*State tax benefits.* In addition to tax-free qualified withdrawals, 529 savings plans may offer another tax benefit: residents who open an account through their own state's plan may be able to claim a credit or deduction on their state income taxes, or even receive a matching grant, for the amounts they contribute. Savers are wise to compare plans, including the plan available in their home state, to take advantage of any of these benefits available to them. The College Savings Plan Network's online comparison tool is a great place to start.

*Flexibility and control.* Account owners can compare the varying investments—mutual funds are the most common offering—and fees among state plans to find the best college savings option for them. Each account must have a named beneficiary, but the designated beneficiary can be replaced at any time with another qualifying family member without tax consequences. For example, a parent may create an account to benefit a child. But if the child doesn't use all the funds, the parent can name another child—or even name herself—as the account beneficiary, and use the funds for education expenses.

*Dedicated, goal-specific savings.* Setting up an account focused on education savings, especially with automatic contributions, makes it easier to set aside small amounts of money that add up over time. ICI research finds indicates that education savings is a priority for households most likely to have young children. Households that own mutual funds and are headed by younger individuals tend to be more focused on saving for education than other households.

## Recent Changes to 529 Plans

*2017 Tax Cuts and Jobs Act*. Changes to tax law in 2017 expanded qualified uses of 529 plans to allow use of up to $10,000 per year in distributions for tuition at the elementary or secondary school level.

*SECURE Act*. This law, which passed in December 2019, allows tax-free 529 plan withdrawals to repay student loans, up to a $10,000 lifetime limit per beneficiary, as well as an additional $10,000 for each of the beneficiary's siblings. The law also expanded qualified costs to include some apprenticeship programs.

Many, but not all, states have conformed to these new federal tax law changes. Account owners should check to see if their plan's state has adopted these expanded definitions of qualified education costs. If not, account owners can still take advantage of the federal tax benefits.

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Much like budgeting for—and changing—diapers, saving for college can be a daunting task. But using a 529 plan can make saving simpler, automatic, and significantly less overwhelming. And, as next month's installment in this series on compound returns will explain, getting started early goes a long way toward achieving long-term financial goals.

## Other Posts in This Series

- Investing Basics: What Is Investing?
- Investing Basics: What Is Risk?
- Investing Basics: Types of Investments
- Investing Basics: Diversification
- Investing Basics: Dollar-Cost Averaging
- Investing Basics: Benefits of Mutual Funds
- Investing Basics: Tax Benefits to Encourage Saving
- Investing Basics: 529 Savings Plans
- Investing Basics: Compound Returns and the Power of Reinvestment

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