EDUCATION»

The Best College-Savings Plans

State 529 plans usually trump other options. The right one for you depends on what kind of investor you are. BY NELLIE S. HUANG and JANE BENNETT CLARK

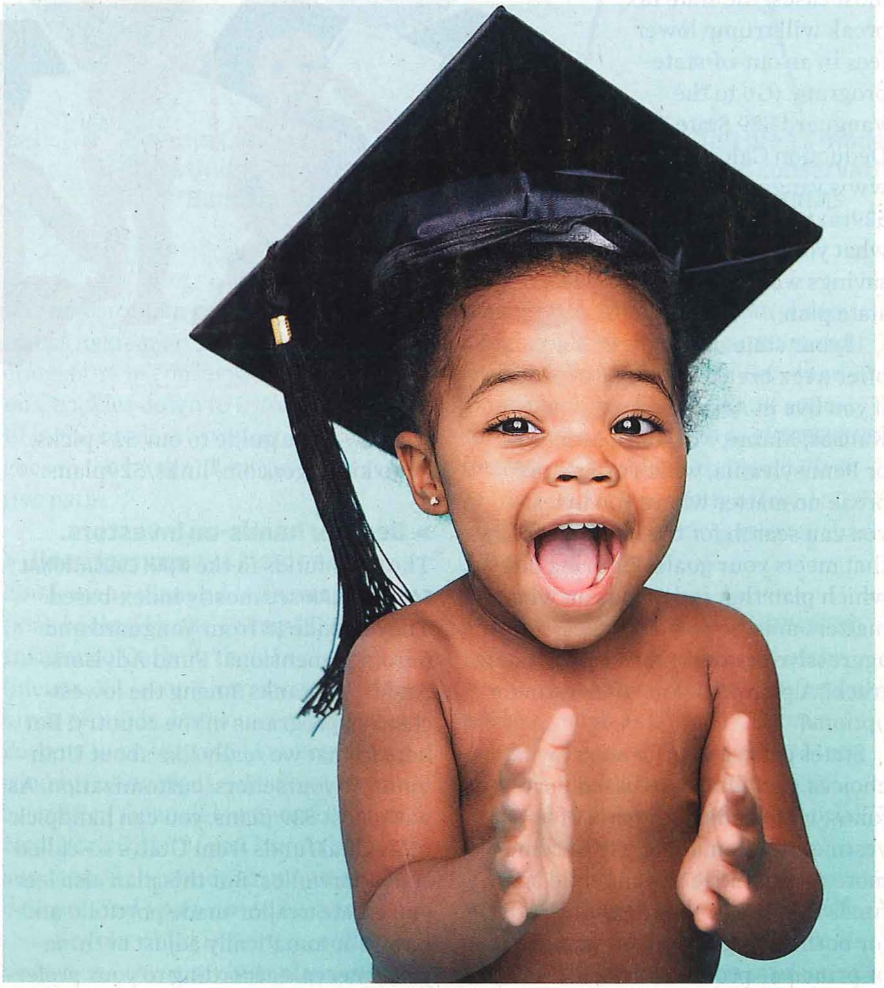
FOR MOST PARENTS, SAVING FOR COLLEGE feels like climbing to the summit of a very tall mountain. And it doesn't help that the path keeps getting steeper; tuition hikes have far exceeded inflation over the past several decades. If your child is a newborn, expect a degree from a four-year, in-state public college to run about $222,000, assuming 5% annual growth in the cost of college; four years at a private school could be double that.

Luckily, tools are available to help you scale the heights. State-sponsored investment programs known as 529 plans, as well as other kinds of savings programs (see the box on page 56), can provide the momentum you need to reach your goal. And you probably won't need to save the full amount. Most families get a discount in the form of grants, scholarships and education tax breaks and use loans to fill the gap—more than two-thirds of college seniors graduate with student debt.

A more realistic goal: Save about one-third of your expected college costs. When the time comes, current income, grants and loans can cover the rest. "Planning ahead is the key," says Betty Lochner, of the College Savings Plans Network, which collects data on 529 plans. (To estimate what you'll need to save under different scenarios, use the college-savings calculator at https://bigfuture.collegeboard.org.)

The best place to save is in a 529 plan. Sponsored by 48 states and the District of Columbia (neither Washington State nor Wyoming offers a 529 savings plan), these investment accounts let your savings grow tax-free, and the earnings escape tax completely if the withdrawals are used for qualified college expenses, which include tuition, fees, and room and board. The appeal of 529 plans lies in their easy access as well as their tax benefits. The plans have no income limit and set a high cap on contributions. Two-thirds of the states and the District of Columbia give a tax deduction or credit for contributions. If your child skips college, you can make the recipient a sibling, grandchild, niece or nephew (or even yourself) without losing the tax break.

There are a few drawbacks. If you cash out for non-college purposes,



JGI/JAMIE GRILL/GETTY IMAGES

you'll owe income tax and a 10% penalty on earnings (but not on contributions). You may have to return any state tax deductions, too. Plus, you're limited to the investment options in your plan. After you pick a portfolio, you must wait 12 months before you can change the investment mix or transfer the money to another plan.

WHICH PLAN?

Buy a 529 plan directly from your state if it offers a tax break. Most states offer two types of college-savings plans: a low-cost plan sold directly by the state and a higher-cost plan sold by a broker. The lower expenses of a direct-sold plan mean more of your money will go toward building your college fund. And in most cases, the state tax break will trump lower fees in an out-of-state program. (Go to the Vanguard 529 State Tax Deduction Calculator, www.vanguard.com/529taxtool, to find out what your potential tax savings would be in your state plan.)

If your state doesn't offer a tax break—or if you live in Arizona, Kansas, Maine, Missouri, Montana or Pennsylvania, which offer a tax break no matter where you invest—you can search for the best state plan that meets your goals. Figuring out which plan that is depends on what matters most to you. Low fees? An aggressive or conservative investment track? A plan with lots of investment options?

States generally offer an array of choices, including age-based portfolios, which adjust the mix of investments automatically to become more conservative as your child ages; funds that focus on stocks or bonds (or both); and guaranteed-principal or principal-protected funds. But some plans offer better-performing funds and a more diversified mix of investments than others. And some plans charge lower maintenance fees, have funds with lower annual expense ratios, or both.

With the help of several databases—including research firm Morningstar's 529 plan center (http://529.morningstar.com/state-map.action?), the College Savings Plans Network (www.collegesavings.org) and Savingforcollege.com, all of which you can access—we looked for direct-sold plans that excel in various categories. For a state-by-state guide to our 529 picks, go to kiplinger.com/links/529plans.

ELYSE LEWIN/GETTY IMAGES

➤ **Best for hands-on investors.** The solid funds in the **UTAH EDUCATIONAL SAVINGS PLAN** are mostly index-based. They include 18 from Vanguard and 6 from Dimensional Fund Advisors. And UESP ranks among the lowest-cost 529 programs in the country. But here's what we really like about Utah for do-it-yourselfers: customization. As with most 529 plans, you can handpick individual funds from Utah's so-called static portfolios. But this plan also lets you create a tailor-made portfolio and have it automatically adjust at three-year intervals according to your preferences as your child nears his college years. No other state plan offers this feature in its age-based tracks.

➤ **Best for low fees.** **NEW YORK'S 529 COLLEGE SAVINGS PROGRAM** uses Vanguard funds, so it should come as no surprise that it has low costs. The average expense ratio charged by its underlying funds (0.17%, according to Morningstar) is significantly lower than the 0.76% expense ratio charged by the typical U.S. stock index fund. Even better, the plan has no annual maintenance fee.

We also like that the plan offers three age-based tracks with different risk profiles: aggressive, moderate and conservative. The aggressive track starts at birth with 100% in stocks and ends with 0% in stocks at age 19 (it's 25% in the last three years of high school). New York's age-based portfolios don't include an international stock fund. But the program's assortment of individual funds does have a foreign-stock option: Vanguard Developed Markets Index fund.

➤ **Best age-based plan for aggressive investors.** If an aggressive track with top-tier funds is what you seek, you'll find it in the **MARYLAND COLLEGE INVESTMENT PLAN**. From birth through age 4, the portfolio holds 100% stocks—including stocks in developed and emerging countries. As your child ages, the track adjusts every three years, ticking down its stock investments to 40% when your child hits age 14 and 23% at age 18. By contrast, the average 529 plan's age-based allocation to stocks is 80% in the early years and 10% at age 19.

What's more, Maryland's 529 plan is packed with good funds from T. Rowe Price, including Blue Chip Growth, Mid-Cap Growth, Small-Cap Stock

and International Growth & Income. The lineup helped the age-based track targeted for 2030 post a 14.0% three-year annualized return (through June 30), two percentage points ahead of the typical age-based track for children between birth and 6 years old.

➤ **Best age-based plan for conservative investors.** This one is tricky. Some conservative age-based tracks are simply too conservative. The conservative age-based track of New York's 529 plan, for instance, sets out at birth with 50% invested in stocks and pares that to zero by age 11. But at that age, you still have six or seven years before your child matriculates, and stocks offer the best chance of increasing the size of your portfolio. That's why we like **UTAH'S** moderate and conservative tracks for conservative investors. In the early years, both tracks load up on stocks (80% in moderate; 60% in conservative), but the mix trickles down to 0% stocks by age 19 in the moderate trajectory, and it goes to 0% by age 13 in the conservative path.

➤ **Best for nervous Nellies.** After 2008, many plans added savings options backed by the Federal Deposit Insurance Corp. to their investment lineups. You won't lose money in these kinds of funds, but you certainly won't keep up with the rate of college-tuition inflation. Still, says Scott Kahan, a certified financial planner based in New York City, "If you have a big lump sum—enough money to put away for college—and you want to be conservative, or your child is going to college next year," these savings plans can make sense. Many state plans have a high-yield savings account among their investment options. For stand-alone plans, we like the bank-sponsored option offered through **VIRGINIA'S COLLEGEWEALTH** plan with Union First Market Bank. It recently offered a 2% yield (2.25% for balances greater than $10,000).

➤ **Best if you want hand-holding.** Rather have an adviser do all of the work? That can be okay. Some fee-only advisers, such as Gifford Lehman, a certified financial planner in Monterey, Calif., set their clients up in direct-sold plans. (Lehman's favorite plan is Utah's.)

But if your adviser puts you in an adviser-sold plan, consider yourself warned: You'll pay for that. Funds in adviser-sold plans cost an average of

1.28% in annual expenses, more than double the 0.60% average expense ratio for funds in direct-sold plans, according to Morningstar.

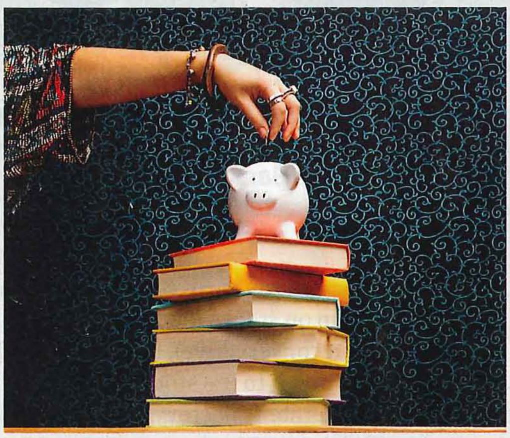
If you think the hand-holding is worth the cost, go with **VIRGINIA'S COLLEGE AMERICA** plan. It holds many top-notch American Funds, such as International Growth and Income and New Economy, which charge an average of 1.19% in expenses. (There is a $10 annual maintenance fee per account.) If your broker or adviser doesn't have access to CollegeAmerica, try **ARKANSAS'S ISHARES 529 PLAN,** which invests in thrifty exchange-traded funds. The average annual expense ratio of the funds in the iShares plan is a low 0.59%. There's also a $10 annual fee per account. **ADDITIONAL REPORTING BY DYLAN CUNNINGHAM AND KATHRYN MOODY**

KipTip

Other Ways to Save for College

A state 529 plan isn't the only way to save for college. You have additional tax-favored options.

PREPAID PLANS. Sending your child to school in-state? Sign up for a state prepaid tuition plan. These plans, most of which are available only to state residents, let you lock in tuition at public colleges in your state years in advance. They offer the same tax benefits—and penalties, if you don't use the money for qualified expenses—as 529 savings plans. Currently, only 12 states offer prepaid plans to new enrollees: Alaska, Florida, Illinois, Maryland, Michigan, Massachusetts, Mississippi, Nevada, Pennsylvania, Texas, Virginia and Washington. (More than 270 private colleges let you prepay through the Private College 529 Plan; see www.privatecollege529plan.com.)



All these states require that you buy several years before your child starts college, and they charge somewhat more than the current year's tuition. If your student goes to an out-of-state or private school, you can get a refund or transfer the money, but the amount won't necessarily cover the full cost.

COVERDELLS. Coverdell education savings accounts are similar to 529s in that the money in the accounts grows tax-deferred and escapes tax if you use it for qualified education expenses. But the total amount you contribute per child cannot exceed $2,000 a year, and the beneficiary has to be under age 18. Coverdells expand the definition of *qualified* to include certain elementary and high school expenses.

You can set up a Coverdell at a bank or brokerage firm and tweak the investments as often as you like. You must have a modified adjusted gross income of less than $110,000 as a single filer or $220,000 as a married couple filing jointly. Use the money for nonqualified expenses and you'll owe tax and a 10% penalty on earnings.

ROTH IRAs. As a last-minute strategy for paying for college, raiding a Roth IRA is a loser; you're jeopardizing your own retirement security (for which you can't borrow) for the sake of your kids, and there's no way to get that money back. But if you start early enough, the Roth's tax-favored status and flexibility can help you hit both goals.

Currently, you can contribute up to $5,500 annually ($6,500 if you're 50 or older). The money grows tax-free, and you avoid tax on withdrawals that don't exceed your contributions. You also avoid a 10% early-withdrawal penalty on earnings if you use the money for qualified educational expenses. If both you and your spouse save the max over 18 years (not including catch-up contributions), contributions will add up to $198,000. With earnings of 7% a year, the total will top $400,000—enough to carve out a slice for college and still have a decent retirement fund to supplement, say, a 401(k) account. You'll owe tax on any earnings (but not on contributions) you withdraw unless you are 59½ and have held the account for at least five years. In 2014, the ability to contribute to a Roth IRA disappears after modified adjusted gross income surpasses $191,000 for married couples filing jointly and $129,000 for single filers.

CUSTODIAL ACCOUNTS. With custodial accounts, known as UGMAs (for the Uniform Gifts to Minors Act) and UTMAs (for the Uniform Transfers to Minors Act), you put money or other assets in trust for a minor child and, as trustee, manage the account until the child reaches the age of majority (usually 18 or 21). At that age, the child owns the account and can use the money for whatever she wants.

Full-time students younger than age 24 pay no tax on the first $1,000 of unearned income and the child's tax rate on the next $1,000. Earnings above $2,000 are taxed at the parents' marginal rate. Custodial accounts have another disadvantage: Students are expected to contribute a higher percentage of assets than parents in financial-aid formulas. Still, the accounts do offer more flexibility than 529 savings plans because the funds can be used for any purpose (let's hope your child chooses wisely) and you can invest wherever you'd like, not just in a fixed menu of funds. **JANE BENNETT CLARK**

ISTOCKPHOTO.COM

Help her grow wings.

Utah Educational Savings Plan®

A Nonprofit 529 College Savings Program

- Morningstar Gold rating, 2013 Gold
- Multiple investment options
- 529-plan tax advantages
- Low fees

Learn more
800.418.2551 | uesp.org

Read the Program Description for more information and consider all investment objectives, risks, charges, and expenses before investing. Call 800.418.2551 for a copy of the Program Description or visit uesp.org. Investments are not guaranteed by UESP, the Utah State Board of Regents, Utah Higher Education Assistance Authority, or any other state or federal agency. However, Federal Deposit Insurance Corporation (FDIC) insurance is provided for the FDIC-insured accounts. Please read the Program Description to learn about the FDIC-insured accounts. Your investment could lose value. Non-Utah taxpayers and residents: You should determine whether the state in which you or your beneficiary pays taxes or lives offers a 529 plan that provides state tax or other benefits not otherwise available to you by investing in UESP. You should consider such state tax treatment and benefits, if any, before investing in UESP.