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Tax-advantaged ways to save for college

In the college savings game, all strategies aren't created equal. The best savings vehicles offer special tax advantages if the funds are used to pay for college. Tax-advantaged strategies are important because over time, you can potentially accumulate more money with a tax-advantaged investment compared to a taxable investment. Ideally, though, you'll want to choose a savings vehicle that offers you the best combination of tax advantages, financial aid benefits, and flexibility, while meeting your overall investment needs.

Planning Well includes considering the detailed next steps that fits your financial needs and goals. It is important to know the advantages of each savings vehicle. There are two types of 529 plans--college savings plans and prepaid tuition plans. Though each is governed under Section 529 of the Internal Revenue Code (hence the name "529" plans), college savings plans, and prepaid tuition plans are very different college savings vehicles.

529 plans: college savings plans

A 529 college savings plan is a tax-advantaged college savings vehicle that lets you save money for college in an individual investment account. Some plans let you enroll directly, while others require that you go through a financial professional.

The details of college savings plans vary by state, but the basics are the same. You'll need to fill out an application, where you'll name a beneficiary and select one or more of the plan's investment portfolios to which your contributions will be allocated. Also, you'll typically be required to make an initial minimum contribution, which must be in cash.

529 college savings plans offer a unique combination of features that no other college savings vehicle can match. The federal tax advantages is tax deferred growth on contributions and completely tax-free if the money is used to pay the beneficiary’s qualified education expenses.

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Another benefit are high contribution limits. Most savings plans have a lifetime maximum contribution limits of over $300,000. College savings plans are managed by designated financial companies responsible for managing the plan's underlying investment portfolios. These plans are also flexible. You may change the beneficiary of your account at anytime without penalty. You can also rollover the money in your 529 plan account to a different 529 plan once a year without penalty or tax implications. It can be used at any college in the United States or abroad that's accredited by the U.S. Department of Education.

But college savings plans have drawbacks too. You relinquish some control of your money. Returns aren't guaranteed — you roll the dice with the investment portfolios you've chosen, and your account may gain or lose money.

529 plans: prepaid tuition plans

Prepaid tuition plans are distant cousins to college savings plans--their federal tax treatment is the same, but just about everything else is different. A prepaid tuition plan is a tax-advantaged college savings vehicle that lets you pay tuition expenses at participating colleges at today's prices for use in the future. Prepaid tuition plans can be run either by states or colleges. For state-run plans, you prepay tuition at one or more state colleges; for college-run plans, you prepay tuition at the participating college(s).

As with 529 college savings plans, you'll need to fill out an application and name a beneficiary. But instead of choosing an investment portfolio, you purchase an amount of tuition credits or units (which you can then do again periodically), subject to plan rules and limits. Typically, the tuition credits or units are guaranteed to be worth a certain amount of tuition in the future, no matter how much college costs may increase between now and then. As such, prepaid tuition plans provide some measure of security over rising college prices. The federal and state tax advantages given to prepaid tuition plans are the same as for college savings plans. Prepaid tuition plans also offer flexibility in terms of changing the beneficiary or rolling over to another 529 plan once per year.

Prepaid tuition plans have some limitations, though, compared to college savings plans. One major drawback is that your child is generally limited to your own state's prepaid tuition plan, and then your child is limited to the colleges that participate in that plan. If your child attends a different college, prepaid plans differ on how much money you'll get back. Also, some prepaid plans have been forced to reduce benefits after enrollment due to investment returns that have not kept pace with the plan's offered benefits. Even with these limitations, some college investors appreciate the peace of mind that comes with not worrying about college inflation each year by locking in college costs today.

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Plan Well – When planning for major milestones like education planning, it is important to have a dialogue about where you want to go, and a detailed plan personalized for you.

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