The Other College Acceptance Scandal: How to Afford It Once Your Kid Gets In

You may have read in the news recently about certain rich and powerful people bribing their kids' way into college. Some parents apparently paid as much as half a million dollars to get their progeny into an elite school. For those of us less well-heeled but more law-abiding citizens whose kids are able to get into a good university on their own, there is still the question of how will we to be able to afford the ever-increasing cost of tuition? We have young children of our own, so this is a question near and dear to our hearts and we'd like to share some of our learnings about investing for our children's education.

Investing for College

Arguably the best way to save for college is to invest through a 529 plan. 529 plans are named after Section 529 of the Internal Revenue Code and are tax-advantaged savings plans that were designed to encourage saving for future education costs. There are two types of 529 plans: *prepaid tuition plans* and *education savings plans*.

Prepaid tuition plans let the account holder purchase credits at participating colleges and universities for future tuition and mandatory fees at today's prices. In essence, you are locking in current prices, so that you won't have to pay a much higher price down the road since education inflation tends to grow much faster than standard inflation. Some key disadvantages of these plans are that they typically cannot be used for room and board, and most can only be used at public and in-state institutions. Additionally, they do not allow you to prepay for tuition for elementary and secondary schools. For those reasons, these plans are not very popular, so we will focus the rest of this discussion on education savings plans.

Education savings plans let you open an investment account in which you are the custodian of the account with the typical beneficiary being your child (but it could be anyone else you designate, such as a nephew or granddaughter). The account is funded with after-tax dollars, but subsequent withdrawals are not subject to taxes—as long as the money is used for education expenses. Education expenses include tuition, mandatory fees, *and* room and board. In addition to these standard post-secondary expenses, education savings plans can also be used to pay tuition at any private or religious elementary or secondary school, up to $10,000 per year.

Different State, Different Plan

Once you decide to invest in a 529 plan, you then have to decide *which* 529 plan to invest in and this is where things can get a little tricky. While every U.S. state—with the one weird exception of Wyoming—offers a 529 plan, you do not have to invest in the plan offered by your state. To decide which plan to invest in, you must look at different factors.

The first thing you'll want to look at is whether your state offers a tax deduction for participating in a 529 plan. The following states do offer a tax benefit in you invest in the plan offered by the state: Alabama, Arkansas, Colorado, Connecticut, D.C., Georgia, Idaho, Illinois, Indiana, Iowa, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Nebraska, New Mexico, New York, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Carolina, Utah, Vermont, Virginia, West Virginia, and Wisconsin. In addition, the following states offer a tax benefit even in you invest in the 529 plan of another state: Arizona, Kansas, Missouri, Montana, and Pennsylvania.

If you live in one of the above states that offer a tax benefit, you should seriously consider being in that state's plan. Morningstar has calculated that a tax benefit of 5% or greater is enough compensation to make up for other possible plan shortcomings, such as high fees or inferior investment options.

If you live in a state that offers a small tax benefit or no tax benefit at all (or if you live in a state that does not impose its own income tax, like Texas or Florida), you then need to look at a group of other factors to determine which plan is best. The two most important of these factors are the amount of fees the plan charges and the set of investment options offered by the plan.

As you can imagine, it would be a Herculean effort to investigate every plan for every state, but thankfully someone else has already done the lion's share of that work for you: Morningstar has assigned ratings to 62 plans, representing more than 95% of all assets invested in 529 plans. Morningstar's best-in-class options are assigned ratings of Gold, Silver, and Bronze. According to Morningstar, *"These plans for the most part follow industry best practices, offering some combination of the following attractive features: low fees, a strong set of underlying investments, a solid manager selection process, a well-researched asset-allocation approach, an appropriate set of investment options to meet investor needs, and strong oversight from the state and program manager."*

Only four plans have received a Gold rating from Morningstar: Illinois' Bright Start College Savings, Virginia's Invest529, Nevada's Vanguard 529 College Savings, and Utah's my 529/Utah Educational Savings Plan.

On the other side of the spectrum, Morningstar assigned negative ratings to five plans: North Dakota's College SAVE, Florida's Florida 529 Savings Plan, New Jersey's Franklin Templeton 529 College Savings, Arkansas' GIFT College Investing Plan, and Nebraska's TD Ameritrade 529 College Savings.

To invest in a 529 plan, you can either do so directly with the state or through a brokerage firm such as Fidelity or Vanguard. Going through a brokerage firm might offer the advantage of getting some guidance on which investment options to choose, but if you go that route make sure you pay attention to the fees that the broker charges. In many instances it might not be worth it and going the direct route will prove to be the better way to go.

Conclusion

529 plans offer a great way to save for college, yet not many families are taking advantage of them. According to Morningstar, only 16% of American families use a 529 to help them fund a college education for their children. Most of these families are simply using checking or savings accounts which, relative to 529 plans, have the double whammy of paltry returns and a lack of tax advantages. The great advantage of 529 plans is that you will be investing those savings in higher return options, and neither you nor the child will not be responsible for any capital gains taxes once they do start accessing the funds. Plus, if you are able to start early enough, the power of compounding will have plenty of time to work its magic before Junior moves into the dorm.

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