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Tax-free college savings grow

But watch out - some brokers of these savings accounts charge more than others

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Kamal Dattani and his wife, Sangita, started worrying about the rising cost of college tuition about a year ago, when the older of their two sons, Neel, turned 15.

The Wilmington couple had put away $100 a month in a regular savings account under Neel's name since he was about 8. But, with only a few years to go before Neel's high school graduation, the Dattanis wanted a better way to grow their investment.

Dattani's cousin, a financial adviser in Wilmington, convinced him to sign up for a state-sponsored, tax-free college savings program known as a 529 tuition savings plan.

"It was great to open an account where you don't pay taxes," said Kamal Dattani, who opened a 529 account for both sons last year.

While most Americans still rely on a regular savings account to pay for their children's college education, more are taking advantage of 529 plans, which have been offering consumers an attractive way to save for college since 1997. Nationwide, nearly 5 million people participate in 529 plans.

About 20,700 parents, grandparents and others interested in setting up accounts for college-bound students are enrolled in Delaware's 529 plan, which became available in 1998.

The Delaware plan is administered by the state Treasurer's Office and managed by Fidelity Investments. Like all 529 plans, it is open to anyone in the United States, not just Delaware residents.

At the end of 2003, Delaware's 529 plan made up $168 million of the $35 billion in plans around the country, according to the Financial Research Corp. in Boston. Total assets in 529 plans in the country are expected to grow to $300 billion by 2010.

Competitive features

Financial advisers point to the following features that make 529 plans attractive to many consumers:

• The person who sets up the account is in control and has the option of changing the name of the beneficiary.

• There is no income or age limitation on the person setting up an account.

• Some states allow their residents a deduction on their income tax returns if they have 529 accounts.

• The money can be used toward tuition and education expenses at any accredited college in any state.

• Consumers are not limited to participating in the 529 plan in their state of residence; they can choose a plan based on fees or features, or both.

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A year ago, Wilmington resident Kamal Dattani (back right) and his wife, Sangita, launched a 529 college-tuition savings plan to assist their two sons, Neel, 16, and Jay, 9. Nearly 5 million people participate in 529 plans nationwide.

DELAWARE'S PLAN

MAIN FEATURES: The account is set up in the donor's name specifically for the college expenses of the beneficiary. Qualified distributions are federal income tax-exempt until 2010. They are not tax-deductible in Delaware, but this is possible in other states.

MAXIMUM CONTRIBUTIONS: Balance can reach $270,000.

MINIMUM CONTRIBUTION: $500 lump sum, or a commitment of $50 per month

FEES AND EXPENSES:

When determining what fund to use, consumers are advised to look carefully at potential tax breaks, fees and administrative expenses, the type of investments that make up the fund and the track record of the investment company that manages it.

Savingforcollege.com rates the various 529 state funds based on many of the same criteria. Delaware gets a rating of 4 (out of 5) for its performance with state and out-of-state clients. About 65 percent of its 529 clients are from out of state.

"In a lot of states, residents get special benefits when they use their own 529 plan," said Joseph Hurley, author of "The Best Way to Save for College: A Complete Guide to 529 Plans" and operator of Savingforcollege.com. "Delaware doesn't provide any special tax break."

Other features help make the Delaware plan competitive. It is not the cheapest plan around, but it offers consumers several choices when it comes to how it invests their money.

For example, Delaware's plan includes a fund that gradually adjusts the amount of investment risk as a student gets closer to college age.

Complexity on the rise

Part of the reason behind the 529 plans' growing popularity is that they are being aggressively marketed by investment firms, said Whitney Dow, director of educational savings research at Financial Research Corp.

Many states allow consumers to contact directly the investment firm that manages their specific 529 plan, but 75 percent of consumers use a broker.

As more people have expressed interest in participating in 529 plans, investment companies have designed 70 types of funds to meet their needs. This has made 529 plans more complex and, at times, difficult for consumers to compare and understand.

Some federal regulators are pushing for more transparency in the industry.

"The original thinking was the states were developing investment programs of fairly limited usage that would be really tailored to the needs of the residents of that particular state," Hurley said. Instead, most states have developed successful programs that have ended up becoming more like nationally marketed mutual fund programs.

Recently, some 529 plans have come under scrutiny. In February, Rep. Michael G. Oxley, R-Ohio, chairman of the House Committee on Financial Services, requested that the Securities and Exchange Commission review the regulation of 529 plans and fees, in view of concerns that some brokerage firms may be charging 529 clients exorbitant fees.

The SEC doesn't regulate 529 plans, but does oversee brokerage firms. The agency has set up a task force to examine the fee structure and sale of state-sponsored 529 plans.

Keeping an eye on fees

One of the main challenges parents and others have with 529 plans is that the plans aren't standardized. The fees vary depending on the state, the fund type and whether a person uses a broker.

"It's awfully difficult to find out the fees and expenses you are paying on these plans," said Peggy Peterson, an Oxley spokeswoman. "It's close to impossible to know whether or not the fees and expenses of the plan would outweigh the tax advantages."

In general, advisers say, consumers should be wary if the fees and expenses cost more than 1.3 percent of the assets.

One way for a consumer to guard against exorbitant fees is to find out whether the broker is getting a commission for selling a particular 529 plan.

"The Delaware fund does not compensate brokers for selling the Delaware plan," said Jack Markell, Delaware's state treasurer and chairman of the Delaware College Investment Plan board. "In other states, the particular provider may actually pay stockbrokers for selling their plan. Obviously, there will be a fee for that."

Even with such safeguards, financial advisers are informing 529 clients that one advantage of state 529 plans may be gone after 2010. Although most experts don't think it will happen, the 529 plan may revert to a tax-deferred plan - as originally designed - after that year, meaning

• $30 a year for accounts less than $25,000 (waived with automatic contributions)

• 0.30 percent of assets annually

• 0.65 percent to 0.81 percent (weighted average of portfolio) annually

RESTRICTIONS:

• No income or age limitation for participants or beneficiaries

• One child per account

• Only cash may be invested into account

MORE INFORMATION:
www.fidelity.com/delaware or (800) 544-1655

Sources: Savingforcollege.com, Fidelity.com, and Paul Baumbach of Wealth Management Division, Mallard Advisors in Wilmington that the portion of withdrawals representing gains will be taxed.

Still, many financial advisers believe a client is better off with a 529 plan, and that clients with existing 529 plans might be able to have their plans grandfathered.

"The 529 right now still makes a lot of sense for many families," Hurley said.

Kamal Dattani agrees. Dattani has increased the contribution to his son Neel's 529 plan to $500 a month. He also has started saving $100 a month for his 9-year-old son, Jay. And, if Neel doesn't use up all the money that's saved for him, Dattani can use it for Jay or anybody else in the family who is going to go to college.

"It's pretty good," Dattani said.

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