Saving for College with a 529 Plan – Video Transcript

A 529 savings plan is one way to save for college. It offers tax benefits, a variety of investment options, and high contribution limits.

Here's how it works.

You (or a grandparent, other relative, or friend) select a plan and open an individual 529 investment account. The person who opens the account is the account owner and the child is the beneficiary.

Tip: 529 savings plans are established by individual states and you can join any state's plan.

Next you decide how much to contribute. Contributions are made with after-tax dollars. You can contribute money on a regular basis or on a random basis in varying amounts.

Tip: 529 savings plans allow larger, lump sum contributions to be structured in a way that can help reduce or possibly eliminate federal gift tax—a feature that may be attractive to grandparents who want to contribute to a grandchild's college fund.

You can automate your college savings effort by setting up recurring, automatic transfers from your bank account. But you're not locked in. You can increase, decrease, or stop your contributions at any time as your financial resources change. Your only limit is the 529 plan's lifetime contribution cap, which is typically over $300,000 and varies by state.

Tip: Your state may offer a tax deduction for contributions to a 529 plan, but any deduction might be limited to residents who have joined the in-state 529 plan.

Your contributions flow into the investment options you select. 529 savings plans generally offer a variety of options that range from aggressive to conservative, including age-based options, where the underlying investment mix automatically becomes more conservative as your child gets closer to college.

Tip: An age-based investment option is another way to automate your savings because the ongoing rebalancing is done for you by the plan's money manager.

In the best-case scenario, your contributions generate earnings that accumulate and remain in your 529 account – you don't need to pay taxes on these earnings each year. There are no guarantees your 529 account will grow. Your balance will depend on the market performance of the investment options you've chosen.

The main benefit of a 529 savings plan comes at college time. Any earnings in the account are tax free at the federal level, and typically at the state level, when money is withdrawn to pay the beneficiary's qualified education expenses. This broad category includes tuition, fees, room and board, books, and a computer for any accredited college or graduate school in the United States or abroad. Tax-free earnings can help boost the amount of overall savings you have to put toward college costs.

If a withdrawal is used for a non-education purpose, the earnings portion is subject to income tax *and* a 10% federal penalty. This is Uncle Sam's way of encouraging you to use the money for college. But if your child ends up getting a scholarship or doesn't go to college, you can change the 529 account beneficiary to another family member with no penalty or income tax consequences.

Any successful college financing plan starts with your savings. A 529 savings plan is one option that can help you build a college fund.

Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. This information and more are available in the plan's official statement and applicable prospectuses, including details about investment options, underlying investments, and the investment company; read it carefully before investing. Also consider whether your state offers a 529 plan that provides residents with favorable state tax benefits and other benefits, such as financial aid, scholarship funds, and protection from creditors. As with other investments, there are generally fees and expenses associated with participation in a 529 plan. There is also the risk that the investments may lose money or not perform well enough to cover college costs as anticipated. For withdrawals not used for higher-education expenses, earnings may be subject to taxation as ordinary income and a 10% federal income tax penalty. The tax implications for a 529 savings plan should be discussed with your legal and/or tax professional because they can vary significantly from state to state.