



of San Diego

HOME

PLANNER RESOURCES

## **FAMILIES NEED TO CHECK PREPAID TUITION PLANS CAREFULLY**

It was beginning to look too good for families saving for college, and maybe it was.

After the bear market battered accounts invested in the popular tax-favored 529 college savings plans, which operate much like a mutual fund, families began taking a second look at the 529 plan's older cousin, the prepaid tuition plan, offered by 20 states. In this type of plan, the family buys "tomorrow's tuition at today's prices" by buying "units" or a contract with their state that generally guarantees that the plan will cover future tuition costs, and often fees, for the child at a state school regardless of how much tuition rises between now and the child's enrollment.

The amount a family pays is generally based on the state's average tuition costs, the child's grade level, and the number of school years the family wants to pay for. Payments are made monthly or in a lump sum. Earnings are tax-free.

Considering that tuition for four-year public universities jumped an average of 9.6 percent for the 2002-2003 school year, according to the College Board, and with schools seeing double-digit increases, the "safe" return on prepaid plans was looking pretty good in such a dismal investment market.

Alas, the portfolios needed to fund these plans' obligations are no more immune to the bear market than anyone else. If the portfolios' average returns less than the average tuition increases, they can't meet their obligations as planned. Several state plans are projecting long-term shortfalls unless the markets heal quickly and tuition increases slow down. Current participants won't likely lose their principal, which they can with a 529 plan or some other forms of investments. But they may have to pay more than originally anticipated, such as through tacked-on annual fees, or they may decide to leave the programs.

What exactly will happen is varying from state to state. Colorado's prepaid tuition program stopped taking new enrollees in August 2002, for example, and has announced it may not be able to cover its full obligation unless the legislature kicks in the difference, leaving participants to cover the gap. Colorado is giving current participants until February 20, 2003, the option of switching to other college-savings plans offered by the state without forfeiting tax benefits, staying put, or taking out what they put in and leaving the plan with no penalty.

Several states have begun dramatically raising the price of their prepaid programs for new enrollees-over 50 percent in some cases. At least one state, Florida, is considering dropping its prepaid plan, and others are limiting or suspending enrollment.

Financial planners who help parents save for college aren't saying that prepaid plans are no longer a good idea. But they are suggesting a careful review of the plans.

- " Check out the solvency of the state's program. Carefully review how the plan is invested.
- " Read the fine print. Most plans guarantee that once a family joins, they've locked in tuition costs regardless of the size of future increases. The Colorado plan also guaranteed to cover tuition increases-as long as they didn't exceed 5.5 percent a year. In 2001-2002, the state's tuition rose an average of 6.7 percent.
- " The concerns may lessen if the market recovers and tuition increases slow.
- " On the other hand, some plans may liquidate, returning principal to investors but possibly not interest.
- " If a prepaid plan makes sense for you, it will probably be better to join sooner rather than later in order to get in at a lower price.

Moreover, weigh any prepaid plan against alternatives such as 529 savings plans, custodial accounts and mutual funds. Each has their advantages and disadvantages. For example, unlike 529 savings plans, dollars saved in prepaid plans currently reduce federal financial aid, though that may change in the future. Funds accumulated in 529 plans can be used for all qualified college expenses, not just tuition and fees. On the other hand, investments in prepaid plans don't face the risk of loss of principal faced by 529 plans and mutual funds.

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