# State Sponsored §529 College Savings Plans:
# The Influence of Tax and Non-Tax Factors on Investors' Choice

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**Study summary**

Taxpayers have invested over $54 billion dollars in state sponsored Section 529 college savings plans and this amount is predicted to be $400 billion by 2010. Created by federal legislation in 1996 and enhanced by a 2001 tax law change, §529 plans are offered in all 50 states and the District of Columbia. Section 529 plans are attractive investments; contribution limits are high ($205,175 in Louisiana to $315,270 in Rhode Island), donors retain control over the assets, and significant federal and state tax benefits exist. Specifically, §529 plan earnings and qualified withdrawals are tax-exempt for federal income tax purposes and 25 states currently provide tax deductions to taxpayers choosing in-state plans. This is the first study to examine §529 plan inflows and the choices investors make for these investments. Our preliminary results demonstrate that §529 plans with HIGH Fees have more investors and that plans in states offering tax deductions have FEWER investors. Thus, it appears that investors appear to be choosing based upon marketing information, rather than favorable state tax treatments.

**Why should taxpayers and investor be concerned about §529 plans?**

Section 529 plans are not regulated the Securities and Exchanges Commission (SEC). Therefore, §529 plan do not include a standardized fee and historical return disclosure, similar to mutual funds. Furthermore, Morningstar did not begin coverage of §529 plans until late in 2003. Although direct investment is often less expensive, 68 percent of the §529 plans were sold through brokers in 2002 and is predicted to exceed 85 percent. Thus, there is indication that the absence of §529 historical return data and independent assessments may have caused investors to rely extensively upon securities dealers for fund recommendations.

Section 529 plans are criticized because they often incur unusually high management fees and loads which reduce investment returns. Both houses of Congress have held hearings to investigate whether financial advisors recommend out-of-state §529 plans with high commission payments while ignoring available state tax benefits. A Securities and Exchange Commission (SEC) task force is examining §529 plan fee structures and investor disclosures, and the National Association of Securities Dealers (NASD) is investigating 20 funds sold by compensated brokers that have unusually high amounts of non-resident sales and high expenses. For example, the Rhode Island CollegeBound Fund is the second largest fund with over $3,665,000,000 in plan assets during our time period yet 97.5 percent of investors are non-residents who do not receive a state tax benefit for contributions.

**How did we study the problem about investor choice in §529 plans?**

Using proprietary panel data for 77 plans in 50 states for quarters ending 12/31/01 through 9/30/03, this paper compares tax and non-tax factors that drive §529 investment choices. We examine state tax deductions, state tax exemption, annual fund fees, load expenses, plan length, number of investment options, and public awareness of the plan and the plan distributor.

**What do we find?**

During the eight quarter time period, notable changes occur. The number of accounts per plan and the amount invested increasing over time. Importantly, all fees increase steadily during this short time and the percentage of funds that can only be purchased through a broker nearly doubled from 17 percent to 32 percent. On average, the funds with the most accounts have more assets, have been in existence longer and are part of the largest fund families.

When we perform regression analysis, our findings demonstrate that the amount of state tax deductions from plan contributions is *negatively* related to the number of accounts, meaning that the states providing the largest state income tax deduction for residents' contributions are likely to have the *smallest* number of accounts. In addition, our results demonstrate that §529 plans with *higher* fees have *more* accounts and *more* assets. In this study, investors are choosing out-of-state plans with higher fees and forgoing significant state tax benefits. These findings are consistent with prior research that investors are willing to use brokers because they reduce investors' information search costs. We find no support for the theory that investors choose plans based upon low fees and state tax subsidies.

**What are the implications of this study?**

During this start-up phase with limited investment choices, few plan administrators, and incomplete financial disclosures, §529 markets may be inefficient. Investors may not be aware of state tax deductions available through an in-state plan. In addition, investors may not be told about the direct-invest plans that have lower fees. Therefore, to the extent that §529 plan contributors are sold high fee funds, policy makers should be aware that the federal and state tax subsidies may be accruing to the mutual fund distributor and the brokers, rather than to the taxpayers.

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This paper was accepted for the National Tax Association Conference and will be presented on November 14, 2004. Drs. Alexander and Luna were one of six comment letter writers to the Municipal Securities Rulemaking Board (MSRB) about proposed changes to §529 plan fees and disclosures. This paper has been requested by the MSRB and by Sen. Fitzgerald (R-Ill), Chair- Subcommittee on Financial Management, the Budget, and International Security. This subcommittee held a hearing "Oversight Hearing on Section 529 College Savings Plans: High Fees, Inadequate Disclosure, Disparate State Tax Treatment and Questionable Broker Sales Practices" on Sept. 30, 2004.

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