Before you put your money in a special tax favored account for college or retirement, make sure your tax savings won’t be stolen away by excess fees—and be ready to walk away from a tax break if they will. Those are two of the tough lessons to be drawn from a new study of 529 state college savings plans by Cornell University economist Vicki Bogan. The money in these accounts—now more than $180 billion—grows tax free provided withdrawals are for higher education. While there’s no federal deduction for contributing to a 529 account, 34 states and the District of Columbia offer residents a deduction or credit for their contributions to the state’s plan.

A great deal? Not necessarily. Bogan shows, as others have, how high 529 fees can eat up tax savings. In addition, she uncovers this disturbing correlation: the more valuable the state tax break, the higher the fees in a state’s plan. “This suggests that government policies
designated to make college more affordable could enable investment firms to charge excess fees,” she concludes.

Bogan’s paper, which will be published in Contemporary Economic Policy, only covers plan data through 2006 and Joe Hurley, a CPA and 529 expert who runs savingforcollege.com, notes that costs (or at least those for plans sold directly to consumers and not through brokers) have dropped a lot since then. Nevertheless, the fees charged for mutual funds in 529s remain generally higher than for comparable direct or broker sold funds held in regular old taxable accounts. Indeed, recent developments in both the 401(k) and 529 markets, suggest some lessons for individual investors and for Congress—assuming, that is, the politicians create savings tax incentives to help families and not the financial industry lobbyists who fill campaign coffers.

Here are 10 points that will help you make sure the tax savings from your 529 or 401(k) fatten your bottom line, and not Wall Street’s.

1. Tax complexity creates hidden costs. We all know that Americans spend an obscene amount of time and money complying with the 3.8 million words in the tax code. Yet some of the ancillary costs aren’t as well understood. There are 11 different and sometimes overlapping federal tax breaks for education and Bogan theorizes that the time and effort an investor must put into understanding college breaks helps explain why half of 529 money is currently held in expensive broker sold plans. “You have information
costs and that’s why people might rely on brokers more even though the brokers’ fees are very exorbitant and it’s not clear how much value added they’re getting,” the economist says. As evidence, she points to the cost of 529s invested only in index funds, with their asset allocation set automatically based on a child’s age—meaning, the broker isn’t making allocation decisions every year. Such funds sold directly cost an average of 0.42% of assets a year, compared to 1.53% for broker-sold C shares (with no upfront sales charge) and 0.78% for broker sold A shares (with an upfront sales charge), according to the most recent 529 report from Morningstar, Inc. (I’d argue that coordinating the use of 529s with college financial aid and the $2,500 American Opportunity Tax Credit is so complicated, most of the brokers collecting those hefty fees for their information probably don’t know all the tax angles and traps anyway.)

2. **Complexity costs the little guy the most.** It’s no accident that smaller 401(k) and 529 plans tend to have higher costs. Administrative costs get spread over fewer participants and financial companies don’t compete as aggressively (on cost that is) for their business. And then there are those pesky information costs: a small business owner doesn’t have time to master the legal ins and outs of retirement plans (say, the nondiscrimination rules) or to shop around. “Your insurance agent is going to make it really easy for you and you can spend your time doing 100 other things for your business. But GE has a whole department of people dedicated to putting their 401(k) out for proposal and getting the best program and lowest fees,”
observes Brooks Herman, BrightScope.com’s director of research. BrightScope, which compiles audited financials that must be filed with the Department of Labor for 401(k) plans with more than 100 participants, finds costs average 0.51% of assets a year in plans with 10,000 or more participants and 0.91% at firms with 100 to 500 participants. What about even smaller plans? The Society of Human Resource Management reports those with just 50 participants had average total expenses of 1.46% of assets in 2012—nearly triple what big company workers paid. Perhaps one of the most telling moments in The Retirement Gamble, the recent controversial PBS/Frontline take-down of 401(k)s, occurred when the show’s correspondent, Martin Smith, discovered high and hidden fees in the plan he offers workers at his tiny film company. Smith is a veteran, award winning investigative reporter who went Hunting Bin Laden in a prescient 1998 documentary, yet he didn’t chase down the fees in his own 401(k) until it was part of a story.

3. High costs compound, just as returns do. Vanguard founder Jack Bogle calls this the “tyranny of compounding costs.” Invest $10,000 in a 529 when your child or grandchild is born, and, assuming 6% returns a year (before fees), you’ll have $27,682 when he’s 18, if you’re paying the flat 0.17% of assets (with no annual fees) charged by New York’s direct sold 529, which uses Vanguard Group index funds. Fees over that period: $582. In Montana’s direct sold 529 you’ll pay 0.89% a year for the Vanguard LifeStrategy Growth Portfolio for your newborn – the same 0.17% for
the Vanguard fund, plus 0.72% a year in administrative fees. Over 18 years, you’d pay $2668 in total fees and end up with only $24,301—$3,381 less. (Your losses are greater than your actual out-of-pocket fees, because the money you shell out in fees in early years reduces what’s left to grow for you, i.e. fees compound.) Use a mutual expense cost calculator like this one at Dinkytown to do your own calculations. Excessive fees have an even more pernicious effect over the 30 or 40 years you’ll be saving for retirement.

4. **Disclosure helps reduce costs.** When 529s were first widely offered in 2001, their charges were often difficult, if not impossible, to ferret out. But in 2004, state treasurers (operating through the College Savings Plan Network) moved to head off regulation and quiet the critics by developing voluntary disclosure standards, including the use of fee tables. Hurley credits that disclosure, along with increased competition, with driving down average costs in directly sold plans. Similarly, in 2012, the Department of Labor began requiring 401(k) sponsors to provide better disclosure to participants, including of investment and administrative expenses, the performance of investments and benchmarks each fund’s performance could be compared to.

5. **But investors must use that disclosure.** “You need to be proactive and educate yourself not just about the different investments, but about the fees,” says Bogan, who happily saves in the New York plan for her own kids. On the Internet, you’ll find a lot of the spade work has been done for you. Hurley compares the fees and 10 year cost of all
direct sold plans [here](http://www.forbes.com/sites/janetnovack/2013/09/10/10-tough-lessons-for-retirement-and-college-savers/print/). Morningstar produces an even more detailed (but arguably less user friendly) report [here](http://www.forbes.com/sites/janetnovack/2013/09/10/10-tough-lessons-for-retirement-and-college-savers/print/) that lists fees (although not 10 year cost comparisons) for all plans, both broker and directly sold. What about 401(k)s? A recent survey from the Employee Benefit Research Institute found just 7% of workers had made changes in the funds they hold as a result of the newly required disclosure. Here’s a quickie check, if there are 100 or more participants in your plan: see how your 401(k) compares to those offered by similar firms at BrightScope.com.

**6. Tax breaks hold investors hostage.** Most states allow 529 deductions only for contributions to their own plans. Meanwhile, the U.S. tax code tethers regular employees to the workplace for the biggest retirement tax breaks. For 2013, a worker is allowed to make $17,500 in employee contributions to a 401(k) ($23,000 for those 50 or older), but can put only $5,500 ($6,500 for those 50 plus) in an individual retirement account. Moreover, higher income workers eligible for a 401(k) plan can’t deduct IRA contributions from their currently taxable income, as they can 401(k) contributions. *(With a little fancy footwork, however, even the well paid can contribute to a Roth IRA. There’s no upfront tax break for a Roth, but the money grows tax free.) Yes, there are some good policy reasons for linking tax breaks to the workplace: it encourages bosses to offer 401(k)s and to make matching contributions, if they want to grab maximum breaks for themselves. Moreover, given both human nature (saving is hard) and the complexity of
using retirement breaks (those pesky information costs again), people are more likely to save when money is automatically deducted from their paychecks. But they also have less ability to fight excessive fees.

7. **Automatic saving can induce somnolence.** In 2006, Congress made “automatic enrollment” in 401(k)s more attractive to employers and designated target-date funds (which adjust the asset allocation based on a worker’s years to retirement) a default option for workers who don’t bother to choose their own investments. Today, a stunning $500 billion in 401(k) money is invested in target date funds and an SEC study found nearly half of workers wrongly believe target-dates provide a guaranteed income in retirement. But are robo-savers being well served, particularly if automatic everything means they aren’t regularly scrutinizing their investments? According to Morningstar’s most recent report, the average asset weighted fee for a target date fund was a hefty 0.91% in 2012. Granted, that was down from 0.99% in 2011—largely because two of the priciest target-date providers, the Goldman Sachs Group and Oppenheimer Holdings, pulled out of the business and more dollars moved to low cost providers. As in the 529 market, there are huge cost differences, even among target date funds using exclusively what should be low cost index funds. While Vanguard charges an average of 0.15% of assets and Fidelity’s Freedom Index Series 0.19%, ING Inc.’s Index Solution Series costs 0.90% and Nationwide’s Target Destination Series charges 0.93%. The most expensive actively managed target funds: Legg
Mason’s at 1.47% a year and Franklin Templeton’s at 1.36%. (The free Morningstar report also provides extensive comparison on asset allocation by age—glide path it’s called—and performance.)

8. Even hostage investors can lobby for change. When it comes to 529s, investors are also voters who can demand change when government policies promote excessive fees. After complaints from residents about high 529 costs, Montana first replaced the investment manager (yep, it used to be even more expensive) and this past May, Gov. Steve Bullock signed a parity law extending the state’s $3,000 per individual/$6,000 per couple tax deduction for contributions to its own plan to contributions made to other states’ 529s too, retroactive to Jan. 1, 2013. That made Montana the sixth state to extend parity, Hurley says. (The others are Arizona, Kansas, Maine, Missouri and Pennsylvania.) What if you’re stuck in a 401(k) with only high cost funds? Use newly available disclosure to lobby your boss for a better plan and/or a brokerage window that allows you to buy outside funds and ETFs. Offer to do some of the leg work for him. If need be, remind your boss of his “fiduciary duty” as a plan sponsor.

9. If fees remain excessive, weigh them against the savings. If the fees look high, do the math. On Hurley’s site, he has already calculated the annualized value of each state tax break based on your time horizon. North Dakota’s direct sold plan, like Montana’s, uses cheap Vanguard funds but then tacks on stiff administrative fees, for a 0.85% total
charge each year. But unlike Montana, North Dakota still restricts its $10,000 per couple deduction to investments in its own plan. Over 18 years the state tax deduction adds just 0.17% a year to returns, but over two years it’s worth 1.57% a year, his calculation shows. (Note, however, that according to Hurley, the state doesn’t claw back its deduction if a resident moves his money to a 529 in another state. So a North Dakotan with a high tolerance for paperwork could theoretically claim the tax break one year and roll the money over to New York in a later year.)

10. Finally, be ready to say no to a tax break. “Don’t let the tax tail wag the investment dog,” is the operative cliche here. Usually, that’s taken to mean don’t buy a specific investment, refuse to buy a good one, or hold onto one you really should sell, based primarily on tax consequences. But it applies as well to accounts you use to hold your investments. “Just going after the tax break may not be the smart thing,” says Bogan. Skip your state’s 529 if you’re giving back your tax savings in excess fees or lousy returns. If the costs are too high or investments unsuitable in your 401(k), and your lobbying doesn’t sway your boss, limit your contributions to those necessary to earn your employer’s match (assuming there is one) and do the rest of your savings in IRAs and taxable accounts. And next time you switch jobs, roll that 401(k) balance into an IRA. If you’re old enough, you may even be able to roll over your money without switching jobs.
Remember, there are other gotchas (besides fees) in tax favored accounts—including tax penalties on most early withdrawals from retirement accounts and on earnings in a 529 that aren't used for college.

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