GETTING FI$CALLY FIT

Saving for College

Paying for a college education, or perhaps two or three, will be among the biggest financial challenges that many families face. Increases in college costs have dramatically outpaced inflation over the last forty years. What was once an expensive, big-ticket item for most families' budgets, has now grown to an overwhelming expense for many. As families plan for college expenses, it's important to consider where these costs fit into their lifetime financial plan. A set of lifetime financial goals can help families allocate resources among long-term needs and wants. It's important not to delay planning and saving for retirement and other goals just because college expenses occur first.

Develop a Strategy to Save for College

First, estimate what the costs of a college education will be for your children. Costs will vary widely depending on whether a public, private or elite private college is chosen. Contact colleges that your child might be likely to attend and ask for an estimate of the costs for the years your child would be there. Another way to estimate college costs in the future is by logging on to several internet web sites from commercial sources that contain on-line, interactive cost calculators.

Then, considering your other lifetime financial goals, decide on a realistic sum that you plan to spend on college education. Few families have 100 percent of the costs set aside on the first day of college. If your plan is to save only part of the total cost in advance, there are several options for funding the remainder. Some families may have the resources to pay for the unsaved balance out of current income. Some will chose to borrow from the low-interest college loan programs available or take out a home equity loan. In others, children may use savings, obtain scholarships, receive gifts or take out financial aid loans in their own names. For some families, additional income from a parent's second job or the child's earnings will supplement the family's financial resources for college. What is important is to have a clearly defined goal of how much of the total college bill you would like to have available when your child is ready to start.

After estimating how much you plan to save, decide on the kinds of investments where these funds will grow. How you allocate your funds among different types of investments will depend on your attitude toward risk and how much time you have to invest. Over time, stocks have outperformed all other types of investments, although they have greater risk than other investments. With many years to invest, you may be able to assume more risk and be willing to invest in stocks and stock mutual funds. With fewer years, you may want

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to use a more conservative strategy that focuses on investments with guaranteed rates of return.

If your child is newborn to age 8, the most important practice is to start saving regularly, even if it's not as much as you would like it to be. With time on your side, you might consider taking on the higher risks of the stock market in exchange for the chance for greater returns.

Investments for children age 8 to 13 have less time for market fluctuations to average out. This means taking less risk than families with younger children and building or changing to a balanced portfolio of stocks, bonds and fixed income securities.

If your child is older than 13, this may be the time to shift some of the money saved out of stock-oriented investments and into more conservative investments. Short-term securities with guaranteed return rates, such as treasury bills or bank certificates of deposit, offer predictable, consistent returns for the cash you'll need in the near future.

Criteria for Choosing a College Savings Plan

Many tax-advantaged saving and investing programs are available to save for college. Keep the following criteria in mind as you evaluate college savings plans and choose those that best meet your needs.

- Investment risk: how safe is the principal of your initial investment?
- Growth potential: will the earnings be adequate for you to carry out your plan?
- Income tax benefits: some plans provide earnings that are tax-free upon withdrawal; some are allowed to grow tax-free; some are taxed at the child's rate; and some have no tax advantages in certain situations.
- Control of the money: does the child or parent have control of the money?
- Effects on financial aid eligibility: if financial aid is to be part of your plan, consider whether the investment will reduce the child's chances of qualifying for financial aid. At present, under some financial aid formulas, 35 percent of the money in a child's name is considered available to pay for college expenses, while 5.6 percent of non-retirement account money held in the parents' names is considered available for college expenses. This means that more financial aid will be granted if money is held in the parents' names compared to that same money being held in the child's name.
- Cost of administrative fees: how much will it cost to set-up and administer the account?
- Residency restrictions: are there requirements to use the college fund in your state? Are plans from other states available?
- Estate planning benefits: some plans offer wealthy families special tax advantages under the unified gift and estate tax laws for funding educational expenses.

Six Ways to Save and Invest for College

State College-Savings Plans - These plans, a type of 529 account, are state-sponsored trusts that encourage saving for higher education. Investment professionals manage the plan funds. However, among different states, the fund managers' investment styles and objectives differ greatly. Choose a plan that has an investment strategy with which you are comfortable. The fees for administering the plans also vary by state. Some have high fees, while others are more reasonable. Most plans allow investors to defer state income taxes on the earnings of accounts up to $100,000, or in some states, up to $150,000, per child. When the money is withdrawn and used to pay college expenses, the earnings on the tax-deferred growth are taxed as ordinary income at the student's rate. Some state plans accept only in-state residents, in other states anyone

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can join. Depending on the rules of the state plan, if the child goes to an out-of-state school, state taxes may be due when the money is withdrawn; there are no federal income taxes on earnings.

A recent change in the tax laws now considers assets in both types of 529 plans to belong to the parents (assuming the parents are the owners of the account), rather than the student. These plans now have no impact on federal aid eligibility, however, college-sponsored aid may take these assets into account.

Another disadvantage to consider is the restriction against withdrawals. If you move to another state and want to move your money to that state's plan, there may be a penalty if the account is not reinvested within 60 days. Some states' plans offer a direct rollover. In most states, you have no control over how your savings are invested once you have enrolled. However, as more plans become available, investors may find that fund managers will offer more investment choices to attract more investors. Contributions to both a 529 plan and a Coverdell education savings account in the same year for the same child are allowed.

Pre-Paid Tuition Contracts - In these plans, a second type of 529 account, in-state residents invest the equivalent of current college charges with a guarantee that the amount will cover future tuition costs at the state colleges and universities in that state. Check the plan to be sure it covers both tuition and fees, not all of them do. If the plan only covers tuition, all cost increases may not be fully covered. A few plans also cover room and board. If the student chooses to attend college at a private institution or out-of-state, the benefit of guaranteed full tuition will be lost. However, under most plans, an amount similar to what would have been paid for in-state tuition can usually be transferred to a private college or an out-or-state school. A pre-paid tuition program is also available at a number of private colleges and universities that participate in the Independent 529 plan.

Coverdell Education Savings Account – A third type of savings plan is the Coverdell education savings account, formerly known as the Education IRA. For those who meet income guidelines[1], up to $2,000 per year can be invested for each child under age 18. Earnings and withdrawals, if used for college expenses, are both free of federal income tax. Just as with a Roth IRA, contributions to a Coverdell education savings account are not deductible on your federal income tax return in the year you make them. The advantage comes when you withdraw the money tax-free. Also similar to IRAs, a Coverdell education savings account offers control over where the funds are invested.

As with the 529 plans, these accounts are not considered the student's assets and do not reduce financial aid eligibility. Colleges may include assets in Coverdell education savings accounts when college-sponsored aid is awarded.

The main disadvantage to this college savings plan is that contributions are limited to $2,000 per year. This sum, in spite of being invested annually for long periods of time, may still be inadequate to cover expenses at even a low-cost college.

Roth IRA - Although not designed for college savings, the Roth Individual Retirement Account (IRA) offers some distinct advantages for funding a college education, if saving for college in this account does not endanger retirement savings. To open a Roth IRA, the investor must meet certain income guidelines[2]. As with a Coverdell education savings account, the investor has control over the selection and management of the funds that can be put in any type of investment. Although there is no tax deduction, the contribution limits are $3,000 per year or $6,000 for joint filers. While your investment grows, earnings are tax-deferred. Normally, withdrawals before age 59½ are not permitted without penalty. However, withdrawals for college expenses are an exception. They may be withdrawn early penalty-free and tax-free as long as the money has been in the Roth IRA for five years. Another advantage is that if your child decides not to go to college, there will be no penalty, as there is with some other plans.

Custodial Accounts - UGMA and UTMA (Uniform Gifts to Minors Act and Uniform Transfers to Minors Act) accounts are owned by

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a child. Parents act as custodians of the account making decisions about how to invest the funds for the child's benefit. Custodial accounts allow funds to be placed in any type of investment. If growth stocks or stock mutual funds are chosen, there will be very little current income compared to investing in an interest-bearing asset, such as a certificate of deposit. With growth stocks or stock mutual funds, most of the earnings come from increases in the prices of shares, not from interest or dividends. Gains will not be realized until the holdings are sold.

The advantage of using custodial accounts is being able to move taxable earnings out of the parents' tax bracket that is usually substantially higher than their child's. Some financial planners discourage parents from putting savings in their child's name if they plan to apply for financial aid. Under the current financial aid formula, a greater percentage of money held by the child is expected to be used for college expenses than money held in the parents' names. Depending on the parents' tax bracket, the tax savings may be small compared to the flexibility given up to use the money for other purposes. Another consideration is that children have complete access to an account in their names after they reach the age of majority. This means the child can use the money in any way he or she chooses.

U.S. Savings Bonds - Series EE and Series I savings bonds offer tax advantages when used to pay for college. If all requirements are met, no local, state, or federal income tax is due on the interest earned. However, there are some income restrictions[3] on who can take advantage of this benefit. In addition, the interest is not deductible in the same year that a Coverdell education savings account withdrawal is made. So, timing of withdrawals is important if savings bonds are being combined with a Coverdell education savings account to fund a college education.

The Series EE bonds are sold at half their face value. For example, a $50 bond is purchased for $25. The face values of Series EE bonds range from $50 to $10,000. The interest rate earned on these bonds varies. EE bonds purchased before May 1, 1997 reach face value in a maximum of 17 years. Bonds, bought after this date, earn interest based on market yields for Treasury securities. The new Series EE bonds will increase in value every month and compound semiannually. Because bond interest is pegged to market rates that change every six months, there is no way to predict when a bond will reach its face value.

The "I" in Series I bonds means "inflation indexed." The unique aspect of the I bond is a rate of return that combines a base rate with an adjustment fixed to the rate of inflation for the previous six months. This means that bond buyers will always earn more than the rate of inflation. I bonds are bought for full value. In this case, a $50 bond sells for $50 and increases in value by earning interest.

Summary

Knowing your goals and needs will help you compare the alternatives available for saving and investing for higher education. As you develop a strategy for funding your children's college education, keep all of your lifetime financial needs and goals in mind.

[1] You are eligible to open a Coverdell education savings account if adjusted gross income is $110,000 or less if single; $220,000 or less if married and filing jointly. The ability to contribute to a Coverdell education savings account begins to phase out for singles once adjusted gross income exceeds $95,000 and for couples at $190,000.

[2] You are eligible to open a Roth IRA if your adjusted gross income was $95,000 or less if single; $150,000 or less if married and filing jointly. The deduction is phased out for singles once the adjusted gross income exceeds $110,000 and for couples at $160,000.

[3] If the parent's adjusted gross income is above $59,850 for singles, or $87,750 for those filing jointly, the tax benefit is reduced. Interest is fully taxable when income exceeds $74, 850 for singles or $117,750 for married couples filing jointly.

The Center for Personal Financial Education is an educational resource and research center whose mission is to advance the adoption of sound personal financial practices by developing and delivering personal financial education programs and conducting related research. The Center, established in 1996, is a joint venture between the University of Rhode Island and the Consumer Credit Counseling Service of Southern New England.

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