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# College Planning: **Easing the Financial Burden**

Advice from CPAs

## College Planning

For many Americans with children, paying for college may be their greatest financial worry. According to the College Board, tuition and fees average almost $20,000 at private colleges and $5,000 at public institutions. Those figures do not include books, room and board and other expenses that make up the college experience.

In recent years, tuition has increased between six and seven percent annually. When you factor in the number of years until your kids will be in college, the figures can be daunting. But don't let the numbers overwhelm you. A college education is within reach for almost any family willing to plan ahead, tighten its belt and assume at least some debt.

## When Time is On Your Side

Starting a college savings plan early is the key, CPAs stress. Make deposits regularly and benefit from the power of compounding. Asset allocation is another critical component of your college savings plan. Choose growth-oriented investments when your children are young. As they reach their teen years, transfer funds to more conservative investments so they are available when you need them.

## College Savings Plans

You'll find a variety of investment vehicles available for your college savings plan, including:

**529 Plans.** These state-sponsored plans have become one of the most popular college-funding vehicles with good reason:

- Earnings grow tax free and distributions are free from federal tax as long as the funds are used for qualified higher educational expenses.
- There are no income limits, meaning any family can participate.
- Investment minimums are low.
- One child can be the beneficiary of numerous accounts. If there are grandparents or other generous relatives who would like to help fund your child's education, they can open their own 529 accounts with your child named as the beneficiary.
- If the plan beneficiary chooses not to go to college, plan assets can be transferred to another close relative without penalty.
- Many states do not cap annual contributions. However, to avoid paying gift tax, limit annual contributions to each recipient to $22,000 for married couples, or $11,000 for single taxpayers.

While most states have 529 plans, their specifics vary widely. Some plans allow you to choose investment vehicles, while others offer age-based portfolios that become more conservative as the child gets closer to college age. Some states offer income tax breaks to state residents or for those who choose in-state schools. Furthermore, each state has its own lifetime contribution limit, investment managers, investment choices and expenses. Since you are free to invest in any state's plan, it pays to shop around for the plan that best meets your needs.

**Prepaid Tuition Plans.** State-sponsored prepaid tuition plans allow you to pay future tuition at a state college at today's lower rates. Some plans may even pay expenses at an out-of-state school or private university, though you may forfeit some of the account's value by opting for such a school. Recently, a group of private institutions joined together to form their own prepaid plan known as the Independent 529. Prepaid tuition in this plan can be used at more than 200 colleges across the country.

Since returns are not tied to the ups and downs of the stock market, prepaid plans may be attractive to those who are especially risk averse. On the downside, prepaid tuition plans lack flexibility and in most cases, if a child decides not to go to a covered college, or not to go to college at all, plan contributions will be refunded without any interest that has accrued over the years. A cancellation fee may also apply.

**Coverdell Education Savings Accounts.** Formerly known as Education IRAs, these plans were created by Congress to encourage people to save for educational expenses the same way they save for their own retirements. Taxpayers can contribute up to $2,000 a year to a Coverdell account and invest it in any manner. There is no tax deduction for contributions, but funds may be withdrawn tax free if used for qualified educational expenses.

Unfortunately, the ability to contribute to a Coverdell account is phased out as income level rises. The tax break is completely phased out once Adjusted Gross Income (AGI) exceeds $220,000 if married, filing jointly, or $110,000 if single or head of household.

**UGMA.** Under the Uniform Gift to Minors Act, individuals can make a gift each year to each child and deposit it in one of these custodial accounts. Your investment options are unlimited. Keep in mind that once you transfer assets to your children, they may become subject to the "kiddie tax." Under these rules, if your child is under the age of 14 at the end of the tax year with investment income of $1,600 or below, the kiddie tax will not apply and the income will be taxed at the child's tax rate. Any investment income above $1,600, however, is taxed at the parents' tax rate. Once a child reaches age 14, investment income is taxed at the child's tax rate.

UGMA accounts allow parents to control the funds until the child reaches age 18 or 21, depending on the state. After that, however, the money in the account belongs to the child.

**Series EE and I Bonds.** Bonds can be a valuable part of any college savings plan. Interest from these bonds is free from state tax. Federal taxes can be deferred until the bonds are redeemed or reach maturity. For some taxpayers, interest may be completely free of federal tax if proceeds are used to pay higher education or vocational school expenses. Keep in mind, this tax break phases out once income exceeds certain levels.

## When Savings Come Up Short

If your children are fast approaching college age, but your savings hasn't grown as quickly, don't despair. A college education may still be within reach. Now is the time to look at financial aid, loans and the use of tax credits and deductions to help you foot the bill.

**Financial Aid.** Billions of dollars in financial aid are awarded each year. Your first step in getting a share is completing the Free Application for Federal Student Aid (FAFSA) in January of the year your child will begin college. Keep in mind that financial aid is given out on a first-come, first-served basis. Complete the paperwork as early as possible.

**Grants and Scholarships.** Grants are awarded by federal and state governments and individual colleges. There are two federal grants you should know about. The first is the Pell Grant, which provides up to $4,050 toward annual tuition. The second is the Supplemental Opportunity Grant, which awards up to $4,000 a year. Both are given on the basis of financial need. College-sponsored grants and scholarships can be based on any number of criteria, from academic or athletic achievement to ethnicity.

Grants and scholarships don't have to be repaid and are great if you get them. But it's likely that a majority of your financial aid package will consist of loans.

**Loans.** Many loan programs are available through individual schools, as well as the federal government. Rates are low, terms are generally long and repayment doesn't begin until schooling is completed. Students in greatest financial need may qualify for a subsidized loan on which the government pays the interest while the student is in school. Interest on unsubsidized loans starts accruing immediately.

Also available are Parent Loans for Undergraduates (PLUS). The terms are comparable to student loans but the funds are loaned to the parents who are also responsible for repaying them.

## Tax Credits and Deductions

The federal government also helps to ease the tuition burden for some families through tax credits, which directly reduce tax liability dollar-for-dollar. The Hope Credit allows taxpayers a maximum credit of up to $1,500 for qualified tuition and related expenses for each of the first two years of undergraduate study.

The Lifetime Learning Credit, however, can be used for graduate or undergraduate expenses and for nondegree courses. The credit can be claimed only once per taxpayer each year for all eligible students in the family and there is no limit on the number of years the credit can be claimed. The maximum credit allowed per year is $2,000. Keep in mind that you cannot claim both the Hope and the Lifetime Learning Credits for the same student in the same tax year. The ability to claim the credits phases out completely once AGI exceeds $53,000 for single filers and $107,000 if married, filing jointly.

A tax deduction of up to $4,000 is available for qualifying college tuition and fees of a student for whom the Hope or Lifetime Credit is not claimed. Again, this benefit phases out completely once AGI exceeds $80,000 for single filers and $160,000 for married filers. Unless new legislation extends this benefit, the deduction will not be available after 2005.

## Start Early and Get Advice

Saving and paying for a college education may seem like an impossible task. But it can be done. Start saving early and aggressively. Keep abreast of changing investment options and tax laws. And get expert advice if you need it. A CPA financial planner can help you analyze your investment choices as well as the tax implications of your decisions.

CPA financial planners urge you not to fund a college plan at the expense of your own retirement savings. A great deal of assistance exists if your college savings come up short, but little help is available to you if your retirement reserves are inadequate.

## In Whose Name to Save

*When starting a college savings plan, one of the most important considerations is whether to save in your own name or that of your child.*

### Savings in a Child's Name

***Advantage***

- Favorable tax treatment for a child above the age of 14. If below the age of 14, there is favorable tax treatment on the first $1,600 of investment income.

***Disadvantages***

- Parents lose control of the money once the child reaches age 18 or 21.
- A higher percentage of a child's savings is included in the Expected Family Contribution (EFC) when applying for financial aid.
- Savings beyond the annual gift limits will incur gift tax liability.

### Saving in Parents' Name

***Advantages***

- Parents never lose control of assets.
- A lower percentage of savings is included in the EFC when applying for financial aid.
- No limit on the amount you can save in any year.

***Disadvantage***

- Larger tax bite if funds are not in tax-advantaged plan.