BEST WAYS TO SAVE FOR COLLEGE

With the cost of higher education rising annually, saving for college is on every parent's mind. There are several vehicles designed specifically for this, including state savings plans, prepared tuition plans, Coverdell education savings accounts, and custodial accounts. Each option offers different advantages and presents potential disadvantages.

529 plans: state savings plans

The 529 state savings plan is a tax-advantaged college savings vehicle governed under Section 529 of the Internal Revenue Code (IRC)—hence the name "529" plans. A state savings plan lets you save money for college in an individual investment account. Some plans let you enroll directly, while others require that you go through a financial professional. The details of these plans vary by state, but the basics are the same:

1. **Apply**. You begin by filling out an application on which you (the account owner or participant) name a beneficiary and a successor participant (who would assume control of the account at your death). You also choose one or more of the plan's preestablished investment portfolios for your contributions. Most plans offer a range of investment portfolios that vary in risk.
2. **Contribute**. You (or someone else) contribute money to the account as often as you wish, subject to plan limitations.
3. **Invest**. Your contributions go into the investment portfolios you've chosen. Portfolios typically consist of groups of mutual funds. **Please note:** The financial institution that the state has designated to run its plan is solely responsible for managing the plan's investment portfolios. You have no control over how these portfolios are managed.
4. **Taxation**. Your contributions grow tax-deferred, which means you don't pay income tax on the account's earnings each year. In addition, some states (but not the federal government) allow you to deduct your contributions.
5. **Withdraw**. Money withdrawn to pay college expenses (a qualified withdrawal) is tax-free at the federal level and may also be tax-free at the state level. If the money is not used for college (a nonqualified withdrawal), you will owe income tax and a 10-percent federal penalty on the earnings portion of the withdrawal.

Advantages. Anyone can open a state savings plan account. Your ability to contribute doesn't depend on your income or on your status as a parent. Money in the plan can be used at any college in the United States or abroad that is accredited by the U.S. Department of Education. And, if your child decides not to go to college or gets a scholarship, the account can be transferred to a sibling or other qualified family member without penalty. Plus, if you are unhappy with your plan for any reason, you can switch (roll over) your funds to a different 529 plan (a different state savings or prepaid tuition plan) once every 12 months without penalty. Your state may even offer tax breaks, such as a deduction for contributions or tax-free withdrawals.

Drawbacks. You relinquish some control of your money, returns aren't guaranteed (you roll the dice with the investment portfolios you've chosen), and your account may gain or lose money. Also, there are usually fees associated with opening and maintaining an account (e.g., an annual maintenance fee, administrative fees, and investment expenses based on a percentage of total account value).

529 plans: prepaid tuition plans

Although prepaid tuition plans are similar to state savings plans in that they are governed under Section 529 of the IRC, the two plans are different. A prepaid tuition plan is a tax-advantaged college savings vehicle that lets you prepay tuition expenses now for use in the future.

Prepaid tuition plans can be run by states or colleges. For state-run plans, you prepay tuition at one or more state colleges; for college-run plans, you prepay tuition at the participating college(s). Although the details of prepaid tuition plans vary according to state, the basics are the same:

1. **Apply**. When you fill out the application, you (the account owner or participant) name a beneficiary and a successor participant (who would assume control of the account at your death).

2. **Contribute**. You (or someone else) purchase a number of tuition credits or units in a lump sum, or periodically, subject to plan rules and limitations. Typically, the tuition credits or units are guaranteed to be worth a certain dollar amount or percentage of tuition in the future, no matter how much college costs increase.
3. **Invest**. Your contributions are pooled with those of other participants in a general fund, and the money is invested. At a minimum, the plan hopes to earn an annual return equal to the annual rate of college inflation for participating colleges.
4. **Taxation**. Your contributions grow tax-deferred, which means you don't pay income tax on the account's earnings annually. Some states (but not the federal government) also allow you to deduct your contributions.
5. **Withdraw**. Money you withdraw to pay college expenses (a qualified withdrawal) is tax-free at the federal level and may also be tax-free at the state level. If the money isn't used for college (a nonqualified withdrawal), you will owe income tax and a 10-percent federal penalty on the earnings portion of the withdrawal.

Drawbacks. One major disadvantage is that your child is limited to the participating colleges (if your child attends a different college, plans differ on how much money you will get back). Also, if the plan earns more than the relevant college inflation rate, you are not necessarily entitled to the difference. Keep in mind, too, that fees are associated with opening and maintaining the account (e.g., an enrollment fee and administrative fees).

Coverdell education savings accounts

A Coverdell education savings account (Coverdell ESA) is a tax-advantaged education savings vehicle that lets you save money for college, as well as for elementary and secondary education (K through 12) at public, private, or religious schools. Here's how it works:

1. **Apply**. You fill out an application at a participating financial institution and name a beneficiary. Depending on the institution, there may be fees associated with opening and maintaining the account. Keep in mind that the beneficiary of a Coverdell ESA must be under age 18 when the account is established (unless the beneficiary is a child with special needs).
2. **Contribute**. You (or someone else) make contributions to the account, subject to the maximum annual limit of $2,000. This means that the total amount contributed for a particular beneficiary in a given year cannot exceed $2,000, even if the money comes from different people.
3. **Invest**. You invest your contributions as you wish (e.g., in stocks, bonds, mutual funds, certificates of deposit). You have sole control over your investments.
4. **Taxation**. Contributions to your account grow tax-deferred, which means you don't pay income taxes on the account's earnings each year.
5. **Withdraw**. Money withdrawn to pay college or K through 12 expenses is tax-free at the federal level and typically at the state level, too. If the money isn't used for college or for K through 12 expenses, you'll owe income tax (at the beneficiary's tax rate) and a 10-percent federal penalty on the earnings portion of the withdrawal. Any funds remaining in a Coverdell ESA must be distributed to the beneficiary when he or she reaches age 30 (unless the beneficiary is a person with special needs).

Drawbacks. Not everyone can open a Coverdell ESA. Your ability to contribute depends upon your income. To make a full contribution, single filers must have a modified adjusted gross income (AGI) of $95,000 or less, and joint filers must have a modified AGI of $190,000 or less.

Custodial accounts

Before 529 plans and Coverdell ESAs, there were custodial accounts. A custodial account allows your child to hold assets that he or she ordinarily wouldn't be allowed to hold in his or her own name. The assets can then be used to pay for college or for anything else

The fees, expenses, and features of 529 plans can vary from state to state. 529 plans involve investment risk, including the possible loss of funds. There is no guarantee a college-funding goal will be met. Earnings must be used to pay for qualified higher education expenses to be federally tax-free. The earnings portion of a nonqualified withdrawal will be subject to ordinary income tax at the recipient's marginal rate and subject to a 10-percent penalty. By investing in a plan outside your state of residence, you may lose any state tax benefits. 529 plans are subject to enrollment, maintenance, and administration/management fees and expenses.

that benefits your child (e.g., summer camp, braces, hockey lessons, or a computer). A custodial account follows the subsequent process:

1. **Apply**. You begin by filling out an application at a participating financial institution and naming a beneficiary. Depending on the institution, fees may be associated with opening and maintaining the account. You also designate a custodian to manage and invest the account's assets. The custodian can be you, a friend, a relative, or a financial institution. Remember, though, if a parent serves as custodian, the entire value of the account will be included in the parent's gross estate if the parent dies while serving as custodian.
2. **Contribute**. You (or someone else) contribute assets to the account. Whether your state has enacted the Uniform Gifts to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA) will determine the type of assets you are allowed to contribute. (The UTMA allows more types of property than the UGMA, and most states have enacted the UTMA.)
3. **Taxation**. The account earnings are taxed every year at your child's tax rate. Assuming your child is in a lower tax bracket than you, this means that you will reap greater tax savings than if you had held the assets in your name.

Drawbacks. Despite the potential tax savings, custodial accounts have a serious drawback—all gifts to a custodial account are irrevocable. When your child reaches the age of majority (as defined by state law, typically 18 or 21), the account terminates and your child receives the money free and clear of parental influence. Some children may not be able to handle this responsibility or might decide not to spend the money for college.

Impact on financial aid

Your decisions on how to save for college expenses impact the financial aid process. When the time comes to apply for financial aid, your family's income and assets are run through a formula at both the federal and the college (institutional) levels to determine how much money you are expected to contribute to college costs before you receive aid. This number is referred to as the expected family contribution or EFC.

In the federal calculation, your child's assets are treated differently than your assets. Your child must contribute 20 percent of his or her assets each year, while you must contribute 5.6 percent of your assets. For example, $10,000 in your child's bank account would equal an expected contribution of $2,000 from your child ($10,000 x 0.20), but the same $10,000 in your bank account would equal an expected $560 contribution from you ($10,000 x 0.056).

A custodial account is classified as a student asset. In contrast, Coverdell ESAs, 529 state savings plans, and 529 prepaid plans are considered parental assets if the parent is the account owner (accounts owned by grandparents or other relatives or friends don't count). Custodial versions of 529 plans and Coverdell ESAs are treated as parental assets. In addition, withdrawals from Coverdell ESAs and state savings plans used to pay the beneficiary's qualified education expenses are not classified as parent or student income on the federal government's aid form. This means that some or all of the money is not counted again when it is withdrawn; however, withdrawals from prepaid tuition plans are counted. Specifically, any distributions from a prepaid tuition plan reduce your child's cost of attendance. As a result, every dollar that comes out of your prepaid tuition plan will reduce your child's potential aid award by one dollar.

We are here to help

Trying to decipher which college savings plan is right for you can be enormously challenging. We are here to help you determine which savings vehicle best fits your financial situation—and, most important, your family's needs. We know that family members play a primary role in your life and in your financial decisions. That's why we always keep them in mind when we work with you to manage your wealth.

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