

# Paying for College: It Can Be Clearer than You Think

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## You Don't Need a Crystal Ball

For your third grader, college probably seems light years away. Most likely you are more focused on the three “Rs” rather than life after high school. Why worry now? There will be plenty of time to think about college later, right?

Now, fast-forward nine years into the future when your 17-year-old is ready to take that first big step toward adulthood—college. You, too, are nine years older and hopefully much wiser.

You may have done plenty to ensure your child's education is financed. However, after learning more about your child's college choice, the cold, hard slap of reality hits you square on the face. You haven't done enough—there is no way you can afford to send your child to this school; it's just too expensive.

The full cost of tuition, room and board, and fees alone would wipe out your personal savings and most likely begin eating into your retirement nest egg. Scholarships are out of the question and your family income is probably too high to qualify for any meaningful financial aid. You could always turn to student loans as you did to finance your college education, but you and your spouse swore that you would do whatever it takes to avoid straddling your children with unmanageable levels of debt. You ask yourself—where has time gone? Why didn't we do more?

Stop, take a deep breath and rewind back to 2004. This doesn't have to be your future.

## A Dose of Reality

College is expensive, there's no denying it. For the past 20 years the cost of education at America's public and private colleges and universities has grown at more than twice the rate of inflation. According to the College Board, the average cost of attending a four-year private or public college in 2020 (based on 2002 costs) may approach \$266,432 and \$123,614 respectively.<sup>1</sup> The average cost of attending

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<sup>1</sup> Costs represent current estimates of average tuition and room and board for four-year public and private universities according to the “2002 Trends in College Pricing” published by the College Board. Projected 2020 costs assume a five percent annual increase, a growth rate used by the College Board in the same publication.

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a four-year public or private school increased by 9.8 percent and 5.7 percent from 2002/2003 to 2003/2004 respectively.

Some experts argue that these costs are balanced by financial aid. Federal aid has surged to historical levels, but these rate increases have failed to keep pace with college inflation. As a result, the gap between the cost of college and families' ability to pay for it continues to grow. To fill the gap, families may be forced to take on more debt, draw from retirement savings accounts or hope for additional aid. However, those who take a more proactive role and start planning early and often may help offset the widening gap.

Federal and state governments provide most financial aid, although colleges, scholarship organizations and employers are also important sources. The amount and type of financial aid is based on two factors: the student's merit and financial need.

Almost 60 percent of respondents in a recent Investment Company Institute survey expect their children to receive some type of financial aid.<sup>2</sup> If you are fortunate enough to qualify, financial aid may be the best way to fund a college education. The problem is, many families do not qualify for financial aid, and most students do not receive scholarships or grants. Relying only on financial aid is a roll of the dice. If you lose that bet, you could be forced into raiding your retirement nest egg, postponing your retirement or straddling yourself or your child with debt. Today an estimated 42 percent of student borrowers graduate with unmanageable levels of debt<sup>3</sup>—a further reason for establishing a sound education savings plan.

### **Putting Yourself in the Driver's Seat**

Saving now may be the best way to plug the gap and ensure that you have options later. Luckily, there are many strategies and investment vehicles available to help maximize your college savings, but selecting a suitable strategy and the best combination of investments is critical. For each option, you need to evaluate key characteristics, including:

- ✓ Potential for growth
- ✓ Risk of loss
- ✓ Tax implications
- ✓ Ownership and control
- ✓ Ease of management
- ✓ Fees and expenses

<sup>2</sup> 2003 Trends in college pricing: College Board

<sup>3</sup> ICI: Fall 2003 Profile of Households Saving for College

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You'll also want to cover the fundamentals of planning to ensure that your fiscal responsibilities and personal preferences have been considered. This includes anticipating additional funding sources such as financial aid, loans and scholarships. You and your college-bound children should also ask yourselves the following questions: Are you planning for a public or private education? A two- or four-year college or university? On- or off-campus living? You may also want to take graduate school into account. When you begin this process it's important not to think of college savings in a vacuum but to think of it as a crucial element of your family's overall financial plan.

### **The New Breed**

A whole new breed of federal tax incentives targeted for education has arrived on the education planning scene. When coupled with some of the more traditional programs already in place, families now have a dizzying array of programs and special tax incentives to choose from, including:

- ✓ Custodial accounts (UGMA/UTMA<sup>4</sup>)
- ✓ Qualified tuition programs (529 plans)
- ✓ Coverdell Education Savings Account
- ✓ U.S. savings bonds
- ✓ Whole life insurance
- ✓ Hope Scholarship and Lifetime Learning credit
- ✓ Section 222 deduction
- ✓ Tax-free scholarships
- ✓ Tax-free educational assistance

Which program is best? They all have their merits. Take the Coverdell Education Savings Account, for example. In a Coverdell, your earnings grow free from federal income taxes and when withdrawn for qualified expenses—including both college and grades K-12—they are tax-exempt. While a Coverdell is very flexible, under current tax law you can only contribute \$2,000 per child annually to a Coverdell. Given the cost of college today, this can be a serious limitation for some. The key is to do your homework—make comparisons and narrow the field down to a handful of programs that may work best for you.

The accompanying table is current as of August 1, 2004, and provides information on some of the key benefits of a few of the more popular plans available today.

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<sup>4</sup> Uniform Gifts to Minors Act; Uniform Transfers to Minors Act

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| Benefit  | Coverdell IRA | 529 College Savings Plan | UGMA/UTMA Account |
|--|---------------|--------------------------|-------------------|
| Tax-deferred earnings                          | ✓             | ✓                        | <sup>5</sup>      |
| Tax-exempt earnings on qualified withdrawals   | ✓             | ✓                        |                   |
| High contribution limits                       |               | ✓                        | no limits         |
| No income limits <sup>6</sup>                  |               | ✓                        | ✓                 |
| No time/age restrictions <sup>7</sup>          |               | ✓                        |                   |
| Significant tax and estate planning advantages |               | ✓                        | ✓                 |
| Ownership of assets for financial aid purposes |               | ✓                        |                   |
| Control of assets in the account               |               | ✓                        |                   |

### What Makes 529 College Savings Plans (CSPs) Tick?

For parents and grandparents across the country, 529 CSPs are increasingly becoming a vehicle of choice for college planning. Created by federal legislation in 1996 and sweetened by Congress in 2001, the 529 CSPs offer families a tax-advantaged way to invest for college.

#### Significant tax advantages

Because all contributions and earnings grow exempt from federal taxes,<sup>8</sup> the 529 CSPs have the potential to accumulate faster than they would in comparable taxable investments. When money is used to pay for qualified higher education expenses (typically tuition, room and board, supplies and fees) withdrawals are

<sup>5</sup> Earnings and gains taxed to minor. First \$750 of unearned income is tax exempt. Unearned income over \$1,500 for minors below 14 are taxed at parents' rate.

<sup>6</sup> The ability to contribute to a Coverdell phases out for incomes between \$190,000 and \$220,000 (joint filers). No income limits exist for 529 CSPs and UGMA/UTMA accounts.

<sup>7</sup> Contributions for Coverdell must be made before the child reaches 18 years of age. Assets must be used by age 30. At age of majority (depending on state where beneficiary resides) assets in UGMA/UTMA account become legal property of the beneficiary.

<sup>8</sup> Under a "sunset provision" the federal tax exemption for earnings on qualified withdrawals is scheduled to expire on December 31, 2010, unless extended by Congress.

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exempt from federal taxes. This can mean more money for college because taxes won't take a significant portion of what you've accumulated over the years.

### **Gift and estate tax benefits**

Due to special provisions available only with 529 CSPs, you can make contributions without incurring gift taxes while at the same time reducing your taxable estate. Through a 529 CSP, parents, grandparents and other relatives can contribute up to \$11,000 per year (\$22,000 for married couples) per beneficiary without triggering federal gift taxes. You can also take advantage of a special forward-gifting provision only available in 529 plans.

These advantages can be attractive if you have multiple children or grandchildren. By making multiple gifts you can remove significant assets from your taxable estate while helping pay education costs for your loved ones.

### **Flexibility and control**

Anyone can open a 529 CSP, regardless of income level, and anyone can be a beneficiary, regardless of age. And, unlike many other college savings vehicles, high contribution maximums in 529 CSPs allow parents or grandparents to contribute as much as \$300,000. In addition, many 529 CSPs permit account owners to contribute to accounts over time through a systematic investment plan, which allows for automatic transfers from checking or savings accounts.

Money can be used to pay tuition, room and board, books, computers and other required supplies at accredited schools nationwide. This includes public and private colleges, public universities, graduate schools, two-year community colleges and most vocational and technical schools.

One other significant feature of the 529 CSP is that the account owner has control over the assets. With traditional custodial accounts—UGMA accounts and UTMA accounts—assets are legally transferred to the beneficiary's control upon reaching age of majority. In contrast, assets in a 529 CSP remain in the account owner's control for the life of the account. This important benefit helps ensure that your investment will be used as intended.

### **Professional investment management**

529 CSP programs are primarily managed by financial firms like mutual fund companies, banks and registered broker dealers. These managers typically invest contributions in a variety of investment options ranging from conservative fixed income to aggressive equity portfolios. One of the most popular investment options offered today is the life cycle portfolio. This option allows investors to

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follow an investment strategy that varies based on the age of the child. As the child grows older, the mix of investments automatically shifts from more aggressive equities to more conservative fixed-income money market investments.

Although a 529 CSP offers tax advantages, flexibility and control, it's important to remember that contributions to 529 CSPs may be invested in stocks and bonds; therefore they are subject to the rise and fall of the securities in which they invest. As a result, investments in 529 CSPs have the potential to appreciate in up markets and depreciate in down markets.

### **Homework Required**

The marketplace for college savings vehicles has become more complex and difficult to navigate. As a result, it is even more important today to take your time, do your homework and seek professional investment guidance before making any decisions.

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