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The Best Ways to Save for College

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In the college savings game, all strategies aren't created equal. The best savings vehicles offer special tax advantages if the funds are used to pay for college. Tax-advantaged strategies are important because over time, you can potentially accumulate more money with a tax-advantaged investment compared to a taxable investment. Ideally, though, you'll want to choose a savings vehicle that offers you the best combination of tax advantages, financial aid benefits, and flexibility, while meeting your overall investment needs.

529 plans

Since their creation in 1996, 529 plans have become to college savings what 401(k) plans are to retirement savings--an indispensable tool for helping you amass money for your child's or grandchild's college education. That's because 529 plans offer a unique combination of benefits unmatched in the college savings world.

There are two types of 529 plans--college savings plans and prepaid tuition plans. Though each is governed under Section 529 of the Internal Revenue Code (hence the name "529" plans), college savings plans and prepaid tuition plans are very different college savings vehicles. There are typically fees associated with opening and maintaining each type of account.

Note: *Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing. More information about specific 529 plans is available in each issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.*

529 plans: college savings plans

A 529 college savings plan is a tax-advantaged college savings vehicle that 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 college savings plans vary by state, but the basics are the same. You'll need to fill out an application, where you'll name a beneficiary and select one or more of the plan's investment portfolios to which your contributions will be allocated. Also, you'll typically be required to make an initial minimum contribution, which must be in cash.

529 college savings plans offer a unique combination of features that no other college savings vehicle can match:

- **Federal tax advantages:** Contributions to your account grow tax deferred and are completely tax free if the money is used to pay the beneficiary's qualified education expenses. The earnings portion of any withdrawal not used for college expenses is taxed at the recipient's rate and subject to a 10 percent federal penalty.
- **State tax advantages:** Many states offer income tax incentives for state residents, such as a tax deduction for contributions or a tax exemption for qualified withdrawals. However, be aware that some states limit their tax deduction to contributions made to the in-state 529 plan only.
- **High contribution limits:** Most college savings plans have lifetime maximum contribution limits over \$300,000.
- **Unlimited participation:** Anyone can open a 529 college savings plan account, regardless of income level.
- **Professional money management:** College savings plans are managed by designated financial companies who are responsible for managing the plan's underlying investment portfolios.

- **Flexibility:** Under federal rules, you can change the beneficiary of your account to a qualified family member at any time without penalty. And you can rollover the money in your 529 plan account to a different 529 plan once per year without income tax or penalty implications.
- **Wide use of funds:** Money in a 529 college savings plan can be used at any college in the United States or abroad that's accredited by the U.S. Department of Education and, depending on the individual plan, for graduate school.
- **Accelerated gifting:** 529 plans offer an excellent estate planning advantage in the form of accelerated gifting. This can be a favorable way for grandparents to contribute to their grandchildren's college education. Individuals can make a lump-sum gift to a 529 plan in 2009 of up to \$65,000 (\$130,000 for married couples) and avoid federal gift tax, provided a special election is made to treat the gift as having been made in equal installments over a five-year period and no other gifts are made to that beneficiary during the five years.
- **Variety:** Currently, there are over 50 different college savings plans to choose from because many states offer more than one plan. You can join any state's college savings plan.

But college savings plans have drawbacks too. 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.

529 plans: prepaid tuition plans

Prepaid tuition plans are distant cousins to college savings plans--their federal tax treatment is the same, but just about everything else is different. A prepaid tuition plan is a tax-advantaged college savings vehicle that lets you pay tuition expenses at participating colleges at today's prices for use in the future. Prepaid tuition plans can be run either 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).

As with 529 college savings plans, you'll need to fill out an application and name a beneficiary. But instead of choosing an investment portfolio, you purchase an amount of tuition credits or units (which you can then do again periodically), subject to plan rules and limits. Typically, the tuition credits or units are guaranteed to be worth a certain amount of tuition in the future, no matter how much college costs may increase between now and then. As such, prepaid tuition plans provide some measure of security over rising college prices.

- **Federal and state tax advantages:** The federal and state tax advantages given to prepaid tuition plans are the same as for college savings plans.
- **Other similarities to college savings plans:** Prepaid tuition plans are open to people of all income levels, and they offer flexibility in terms of changing the beneficiary or rolling over to another 529 plan once per year, as well as accelerated gifting.

Prepaid tuition plans have some limitations, though, compared to college savings plans. One major drawback is that your child is generally limited to your own state's prepaid tuition plan, and then your child is limited to the colleges that participate in that plan. If your child attends a different college, prepaid plans differ on how much money you'll get back. Also, some prepaid plans have been forced to reduce benefits after enrollment due to investment returns that have not kept pace with the plan's offered benefits. Even with these limitations, some college investors appreciate the peace of mind that comes with not worrying about college inflation each year by locking in college costs today.

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 school (K-12) at public, private, or religious

schools. Here's how it works:

- **Application process:** 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. The beneficiary must be under age 18 when the account is established (unless he or she is a child with special needs).
- **Contribution rules:** 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 can't exceed \$2,000, even if the money comes from different people. Contributions can be made up until April 15 of the year following the tax year for which the contribution is being made.
- **Investing contributions:** You invest your contributions as you wish (e.g., stocks, bonds, mutual funds, certificates of deposit)--you have sole control over your investments.
- **Tax treatment:** Contributions to your account grow tax deferred, which means you don't pay income taxes on the account's earnings (if any) each year. Money withdrawn to pay college or K-12 expenses (called a qualified withdrawal) is completely tax free at the federal level (and typically at the state level too). If the money isn't used for college or K-12 expenses (called a nonqualified withdrawal), the earnings portion of the withdrawal will be taxed at the beneficiary's tax rate and subject to a 10 percent federal penalty.
- **Rollovers and termination of account:** Funds in a Coverdell ESA can be rolled over without penalty into another Coverdell ESA for a qualifying family member. Also, 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).

Unfortunately, not everyone can open a Coverdell ESA--your ability to contribute depends on your income. To make a full contribution, single filers must have a modified adjusted gross income (MAGI) of \$95,000 or less, and joint filers must have a MAGI of \$190,000 or less. And with an annual maximum contribution limit of \$2,000, a Coverdell ESA probably can't go it alone in meeting today's college costs.

Note: The provision of the Economic Growth and Tax Relief Reconciliation Act of 2001 that increased the annual contribution limit for Coverdell ESAs to \$2,000 is scheduled to expire on December 31, 2010. Unless Congress acts, after this date, the annual contribution limit for Coverdell ESAs will revert to \$500, its status prior to January 1, 2002.

Custodial accounts

Before 529 plans and Coverdell ESAs, there were custodial accounts. A custodial account allows your child to hold assets--under the watchful eye of a designated custodian--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 anything else that benefits your child (e.g., summer camp, braces, hockey lessons, a computer). Here's how a custodial account works:

- **Application process:** 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.
- **Custodian:** 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. The assets in the account are controlled by the custodian.
- **Assets:** You (or someone else) contribute assets to the account. The type of assets you can contribute depends on whether your state has enacted the Uniform Gifts to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA). Examples of assets typically contributed are stocks, bonds, mutual funds, and real property.

- Tax treatment: Earnings, interest, and capital gains generated from assets in the account are taxed every year to your child. Assuming your child is in a lower tax bracket than you, you'll reap some tax savings compared to if you had held the assets in your name. But this opportunity is very limited because of special rules, called the "kiddie tax" rules, that apply when a child has unearned income. Under these rules, children are generally taxed at their parents' tax rate on any unearned income over a certain amount. For 2009, this amount is \$1,900 (the first \$950 is tax free and the next \$950 is taxed at the child's rate). The kiddie tax rules apply to: (1) those under age 18, (2) those age 18 whose earned income doesn't exceed one-half of their support, and (3) those ages 19 to 23 who are full-time students and whose earned income doesn't exceed one-half of their support.

A custodial account provides the opportunity for some tax savings, but the kiddie tax sharply reduces the overall effectiveness of custodial accounts as a tax-advantaged college savings strategy. And there are other drawbacks. All gifts to a custodial account are irrevocable. Also, when your child reaches the age of majority (as defined by state law, typically 18 or 21), the account terminates and your child gains full control of all the assets in the account. Some children may not be able to handle this responsibility, or might decide not to spend the money for college.

U.S. savings bonds

Series EE and Series I bonds are types of savings bonds issued by the federal government that offer a special tax benefit for college savers. The bonds can be easily purchased from most neighborhood banks and savings institutions, or directly from the federal government. They are available in face values ranging from \$50 to \$10,000. You may purchase the bond in electronic form at face value or in paper form at half its face value.

If the bond is used to pay qualified education expenses and you meet income limits (as well as a few other minor requirements), the bond's earnings are exempt from federal income tax. The bond's earnings are always exempt from state and local tax.

In 2009, to be able to exclude all of the bond interest from federal income tax, married couples must have a modified adjusted gross income of \$104,900 or less at the time the bonds are redeemed (cash in), and individuals must have an income of \$69,950 or less. A partial exemption of interest is allowed for people with incomes slightly above these levels.

The bonds are backed by the full faith and credit of the federal government, so they are a relatively safe investment. They offer a modest yield, and Series I bonds offer an added measure of protection against inflation by paying you both a fixed interest rate for the life of the bond (like a Series EE bond) and a variable interest rate that's adjusted twice a year for inflation. However, there is a limit on the amount of bonds you can buy in one year, as well as a minimum waiting period before you can redeem the bonds, with a penalty for early redemption.

Financial aid impact

Your college saving decisions impact the financial aid process. Come financial aid time, your family's income and assets are run through a formula at both the federal level and the college (institutional) level to determine how much money your family should be expected to contribute to college costs before you receive any financial 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 ($\$10,000 \times .20$), but the same \$10,000 in your bank account would equal an expected \$560 contribution from you ($\$10,000 \times .056$).

Under the federal rules, an UGMA/UTMA custodial account is classified as a student asset. By contrast, 529 plans and Coverdell ESAs are considered parental assets if the parent is the account owner (so accounts owned by grandparents or other relatives or friends don't count at all). And distributions (withdrawals) from 529 plans

and Coverdell ESAs that are used to pay the beneficiary's qualified education expenses are not classified as parent or student income on the federal government's aid form, which means that some or all of the money is not counted again when it's withdrawn. Other investments you may own in your name, such as mutual funds, stocks, U.S. savings bonds (e.g., Series EE and Series I), certificates of deposit, and real estate, are also classified as parental assets.

Regarding institutional aid, colleges are generally a bit stricter than the federal government in assessing a family's assets and their ability to pay college costs. Most use a standard financial aid application that considers assets the federal government does not, for example, home equity. Typically, though, colleges treat 529 plans, Coverdell accounts, and UTMA/UGMA custodial accounts the same as the federal government, with the caveat that distributions from 529 plans and Coverdell accounts are often counted again as available income.

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