Ask the Advisor

What's the best way to save for college?

Randy in Exeter

College costs continue to rise at a rate double that of inflation and New England colleges and universities continue to rank among the most expensive.

The outlook is not good and parental help is more critical than ever. Forget about junior putting himself through school as you perhaps did. The days of paying a good part of tuition with a summer job and part time work are long gone.

Making matters worse, schools and governments have intentionally shifted the burden to parents. On average, affluent parents pay 100% of published tuition rates and aid assisted parents still pay 70%, remember, most aid comes in the form of loans that have to be paid back, not grants or tuition reductions.

There are plenty of schemes that promise to help reposition assets and make other changes to help qualify for financial aid, but be careful – many of the loopholes on which these strategies are based are tenuous at best, and as schools & the government catch on, many loopholes are closed tight without warning.

The best way to plan for college is to save early and save regularly. The idea that saving for college will hurt your financial aid package is dangerous thinking.

Not saving for college is the real danger. Would you rather be paid interest now on money that you have saved or pay interest to someone else later to borrow money?

Don't forget; you can spend the interest you earn to pay for school, the interest you pay on a loan belongs to someone else.

Federal financial aid is based predominately on income and the number of children in college at the same time.

Primary residences and retirement plans are excluded from the federal financial aid formula and most college savings plans are included only as a parental asset at the more favorable parental rate (the amount the government will require you to withdraw each year from the plan if receiving federal aid).

Grandparent or non-parent owned plans are completely excluded from the federal aid formula.

The savings options are many.

US Savings Bonds are very safe but also offer a lower rate of return. The lower rate of return is a major drawback when school is still far off, but less of a factor when enrollment is closer.

Interest earned by Series EE and Series I Savings Bonds is free from state income tax and all or some of the interest may also be free from federal taxes if the bonds are used for qualified higher education expenses.

The exclusion from federal tax is subject to an income phase-out – how much you earn. To qualify, the bond must be registered in the parent's name and redeemed in the same year the qualified expenses are paid.

Qualified expenses are reduced by any financial aid or other education tax breaks or credits received. The parent retains control of the funds and purchases are limited to $30,000 of face value per year per parent.

The Uniform Transfer to Minors Act (UTMA) allows a parent to place up to $13,000 per year ($26,000 for a couple) for 2011 in an account under the annual exclusion from federal gift tax, or an unlimited amount otherwise, of cash, stocks, mutual funds, real estate or other approved assets into a custodial account for the benefit of a child.

The funds may be used at any time for any purpose that benefits the child, including education. The account has limited tax benefits and is counted less favorably in the federal financial aid formula as a child's asset.

Perhaps the biggest potential drawback is that the child will have full control over the money at the age of majority.

That may be good news for junior, he can now buy that fast car he's always wanted instead of paying the tuition bill!

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The Coverdell Education Savings Account, formerly the Education IRA, allows parents and anyone else to contribute to a single account for a child's benefit, as long as the combined contributions don't exceed $2,000 per year (2011).

Growth and distributions can be used for qualified education expenses and not just college, but also kindergarten through grade 12. The beneficiary can be changed to certain approved family members.

Contributions can be limited by parental income phase-outs.

If not used for education, the funds can be withdrawn subject to a 10% penalty and tax on the growth.

A Coverdell Education Savings Account is included for federal financial aid only as a parental asset at the favorable 5.6% annual distribution rate.

The 529 plan, named for the IRS Code Section 529 that provides for the plan, comes in two flavors: the prepaid tuition plan and the savings plan.

The prepaid tuition plan allows parents to buy future tuition at current discounted rates. NH has no prepaid tuition plan but does have a savings plan. The 529 savings plan allows parents, grandparents, or anyone who wants to benefit a child to put after-tax dollars away which then grow tax free and can be taken out tax free if used for qualified education expenses. The 529 plan cannot be used for kindergarten through grade 12.

The 529 savings plans are administered by financial institutions and just like the institutions that run the plans, there are good and bad plans.

Anyone can fund anyone else's 529 plan to the tune of $13,000 in contributions per donor per year under the annual exclusion from federal gift tax, or more than $13,000 subject to tax and plan contribution limits.

Anyone can set up a 529 plan in their own name to benefit anyone else. If Grandma isn't comfortable funding Mom or Dad's plan she can set up her own plan to benefit junior.

Each plan is subject to a state specific maximum contribution limit and/or contribution and growth limit; the limits vary, with some in excess of $300,000.

The plan also has the added benefit of allowing one to front load five years worth of annual gifts, $65,000 ($130,000 for a couple), into the plan in a single year (2011); some restrictions apply and you will need to wait for the five-year clock to run out before making any additional contributions.

However, don't let the generous contribution caps mislead you. Most 529 plans are very reasonable to start, offering very low minimums, some as low as $25 to start, with additional contribution limits as low as $15.

Assets placed in a 529 are removed from the owner's taxable estate but the owner retains control of the assets – junior can't use the money to buy a plasma TV when he reaches the age of majority. Beneficiaries can be changed and accounts can be divided among multiple beneficiaries. If the funds are not used for qualified higher education expenses they can be withdrawn subject to a 10% penalty and tax on the growth.

Most 529 plans offer an age-based investment option that automatically invests the funds based on the beneficiary's age. The investments start out more aggressive closer to birth and become increasingly conservative closer to enrollment.

Last but not least, for those with wealthy friends and family, anyone can pay anyone else's approved education expenses without tax or gifting implications as long as the educational institution is paid direct – the check must be made payable to the school in question.

A great resource for checking out all of the various college savings options is www.savingforcollege.com and Morningstar also provides reviews at www.morningstar.com. A great resource for financial aid information is www.finaid.org.

Save early and save regularly, most plans offer contribution arrangements where funds, even very small amounts, can automatically come right out of your bank account each month and go into your plan. Don't forget to fund your own retirement too though – a financially destitute parent can still cost a child far more than college. Saving ahead now for college and retirement can help assure your family's financial future for generations to come.

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