

College Savings Plans

When is the right time to start saving for your children's or grandchildren's college education? Decide when and then decide how.

WHEN

When can be impacted by several factors, including the number of children for which you are saving, where they may attend college, when they plan to begin and how much you can contribute. Usually, the sooner the better. Depending on what plan you choose and how often you choose to contribute will also impact the when, as in "How long?" Different investment vehicles may provide larger contributions, dollar-cost averaging, and discretion on investment choices. All of these options will impact the potential growth of the saving plan and therefore, how long you will have to contribute.

For example, current year education costs of \$10,000 per year for 4 years will require investment strategies and savings to accumulate \$124,000 in 18 years. At 8%, this will require approximate savings of \$260 per month. At 4%, the monthly savings would increase to \$400 per month. Finally, with only 10 years to invest at 8%, the monthly savings requirement would increase to \$650. This also assumes the savings are in a tax-free investment vehicle. Now, you know the answer to the question "When?" is the sooner the better.

HOW

The question of how gets a little tricky. How you save depends on your goals. Some of the savings vehicles available today are:

- Coverdell Education Savings Plan (formerly Education IRAs)
- Professionally managed Section 529 plans.
- State sponsored Section 529 plans.
- UGMA or UTMA accounts
- Mutual Funds

The Coverdell Education Savings Plan contributions are limited to \$500 in 2001 and increase to \$2,000 in 2002, per child up to age 18. With the new tax law changes, AGI limitations have been raised and the use of the funds expanded. Previously, distributions were only available for secondary education. Now, the funds may be used for Kindergarten through Grade 12. Covered expenses include tuition, tutoring, computer equipment and uniforms. With the limited contributions and AGI limitations, you may never accumulate the funds you need.

Professionally managed Section 529 plans are abounding. These plans refer to the Internal Revenue Code that details the rules. Typically, a state works with an institution that professionally manages money, such as Alliance, Merrill Lynch, or American Funds, to name a few. They develop a 529 plan that offers various investment options and

contributions. Once a particular investment option is selected, it may be changed only annually. So, you may initially select a conservative portfolio with bonds and later want to change to more growth with stocks. You must wait a year before making this change. Contributions are made from after-tax dollars and the growth is tax deferred. After 2001, distributions for qualified education expenses are no longer taxed at the beneficiary's tax rate BUT are now tax free. Different state's plans may better fit your needs for management, contributions or fees. Some plans allow out of state residents to participate but may not offer the same state tax advantages. There are no income limits and usually the set-up fees are minimal. Ownership remains with the contributor but these assets do not count toward the family contribution factor in calculating financial aid and they are not included in the value of the estate of the owner. A beneficiary, once named, may be changed. If the beneficiary chooses not to attend college and you choose not to name a new beneficiary, any earnings are taxed and a 10% penalty applies.

Pennsylvania's plan has hit a snag. Dreyfus and its parent company, Mellon Financial, Corp., were developing the Pennsylvania plan when businesses owned by Mellon, and instrumental to the plan, were sold. This has put the brakes on the plan until contingencies are formed.

Other state sponsored 529 plans include the Pennsylvania TAP program. These traditional plans are typically referred to as prepaid tuition plans. There is no owner control on these plans but the returns are guaranteed unlike the new professionally managed plans.

Uniform Gifts to Minors Act or Uniform Transfer to Minors Act (UGMA or UTMA) accounts may still provide some benefits but few that the 529 plans provide. Earnings are reportable by the minor and to the extent they have an unused standard deduction, some income may be sheltered from tax. The negative aspects as compared to the 529 plans follow. These accounts count toward family contributions in calculating financial aid. The earnings in excess of the standard deduction are taxable. They are included in the custodian's estate.

The difference lies in the use of the funds. The 529 plans distributions must be used for qualified education expenses to avoid a penalty. The UGMA or UTMA, once the child reaches majority, has no restrictions.

Investing on your own or with an investment advisor in mutual funds is always another option. Some investors may feel they may outperform a professionally managed 529 plan that has to adhere to investment restrictions and oversight from the state. The necessary return to attain this has increased significantly with the tax law change allowing tax-free distributions for qualified expenses. Investing on your own may give better returns but there will be a tax consequence on growth and earnings. In addition, these assets remain in your estate. You may want this strategy if you're not sure your children or grandchildren will attend college and you do not want to risk the penalty.

So, when is the right time to plan? NOW. When is the right time to save? Now, but many “what-if” calculations and scenarios may be illustrated to suit your needs. Call your financial planner.

Tax Quick Notes

College Tuition Deduction:

For 2002-2003, a single taxpayer with adjusted gross income below \$65,000 (\$130,000 MFJ) will be entitled to an above-the-line tuition deduction of \$3,000 each year.

This deduction cannot be claimed in the same year as HOPE or Lifetime Learning Credit for the same student.

Coverdell Education Savings Accounts (formerly Education IRAs):

Beginning in 2002, the new contribution limit is \$2,000 and the AGI limitations have been raised to \$190,000 - \$220,000 for MFJ, double that of single filers. Some education expenses for Grades Kindergarten through 12 are also now covered.

Student Loan interest deduction:

\$2,500 of student loan interest is currently deductible as an above-the-line deduction but previous AGI limitations limited the times the deduction qualified. Now, the AGI limitations have been raised to \$55,000 - \$65,000 for singles and \$100,000 - \$130,000 for MFJ, making the deduction available for more people. In addition, previously the loans had a 60-month limitation. This no longer applies.