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BUSINESS

Saving for kids' college? You have options

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When it comes to saving for college, you can never start too soon.

According to the College Board, students and their families can expect to pay, on average, between \$90 and \$1,238 more for this year's tuition and fees than last year, depending on the college.

Although the increase in tuition and fees at four-year public colleges slowed for the third year in a row, prices are still up 35 percent from five years ago, after adjusting for inflation.

"College prices continue to grow at about twice the inflation rate," said Mark Kantrowitz, publisher of FinAid.org, a Web site that gives information on paying for college.

Although grants and student loans are available, saving more on your own means your child will have less of a chance of starting his or her career with student loans to pay off.

"Parents should expect to pay at least half to two-thirds of their children's college costs through a combination of savings, current income and loans," Mr. Kantrowitz said. "Gift aid from the government, the colleges and universities, and private scholarships accounts for only about a third of total college costs."



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529 tuition plans

The most popular is a 529 plan, which is a tax-advantaged investment plan designed to encourage saving for college. The plans are named after Section 529 of the Internal Revenue Code and are administered by the states.

There are two types of 529 plans: prepaid tuition plans and state-sponsored college savings plans.

In prepaid plans, you can lock in the cost of tomorrow's college tuition and fees at today's prices.

Texas' plan, called the Texas Guaranteed Tuition Plan, was launched with much fanfare in 1996. But it was closed to newcomers in the summer of 2003 after the Legislature deregulated tuition at state colleges and universities.

Deregulation allowed college governing boards to set their own tuition levels rather than adhering to statewide rates set by the Legislature. It triggered a record surge in tuition rates.

The spiraling costs made it virtually impossible for the state board that oversees the Texas Tomorrow Fund to set prices for new contracts, so it voted to keep the program shuttered in each of the past four years.

Texas lawmakers are trying to resurrect the Tomorrow Fund in another form. The Senate passed a bill last week to create the Texas Tomorrow Fund II, which would enable families to invest by purchasing "units," each of which would be worth 1 percent of one year's tuition and required fees at current prices.

Once a child enters college, the fund would pay the school the money initially invested in the child's account, plus any returns made on that investment.

Rep. Geanie Morrison, R-Victoria, introduced the bill that passed the House.

"This legislation will give Texas families more predictability about the cost of higher education, while protecting the state from a shortfall," said Ms. Morrison, who chairs the House Higher Education Committee.

Families in Texas' existing prepaid tuition plan wouldn't be affected by the creation of Texas Tomorrow Fund II.

Also Online

www.savingforcollege.com

www.finaid.org

www.collegesavings.org

www.collegeboard.com/parents/

www.independent529plan.org

www.texastomorrowfunds.org

Mr. Kantrowitz of FinAid.org recommends prepaid tuition plans only in cases where you are "absolutely certain that the child is going to attend public college in the state, and you really need the peace of mind that you've got certain percentage paid for."

If you move out of state, you should roll over savings in the prepaid plan to the second form of a 529 plan: a state's 529 college savings plan, Mr. Kantrowitz said.

"It gives you more flexibility, and you will no longer be tied to a particular state's plan," he said.

529 savings plan

A state's 529 college savings plans differs from prepaid tuition plans in that earnings in your account are based on the market performance of the underlying investments, which typically consist of mutual funds. The money is yours to be used as you choose, as long as it goes toward higher education.

Contributions to 529 college savings plans grow tax-deferred, and earnings are tax-free if the money is used to pay for qualified education expenses.

The earnings portion of any withdrawal not used for college expenses would be taxed at the recipient's tax rate and subject to a 10 percent penalty. Accounts can be transferred to different recipients or even used by the parents for adult education courses.

When considering a 529 college savings plan, pay close attention to fees, because they come out of your investment return. Fees are usually lower if you're a resident of the state operating the 529 plan. But they can still be higher than those of other investment vehicles.

"Despite a general industry trend toward lower fees the past couple of years, the overall costs of 529 plans remain high relative to retail options, and at a number of plans excessively so," Kerry O'Boyle, a mutual fund analyst at Morningstar.com, wrote in a recent article.

When you buy a no-load mutual fund, you pay fees related to the cost of running and administering the fund.

"Fees for 529 plans, by contrast, are much more complex," Mr. O'Boyle said. "Investors potentially face enrollment fees, account-maintenance fees, administrative fees, management fees and distribution fees on top of the costs of the underlying investment options."

Independent 529

The Independent 529 Plan is a national prepaid tuition plan for private and independent colleges.

The plan was launched in fall 2003 by the Tuition Plan Consortium, a group of several hundred independent colleges and universities, including Southern Methodist University.

The plan allows parents to buy discounted certificates guaranteed to pay a fixed percentage of tuition at any of the schools in the consortium.

The percentage varies depending on the current cost of tuition at the school. Contributions to the plan are capped at five years' worth of tuition and mandatory fees at the most expensive college in the group.

When a student enrolls at a participating college, the college will provide the promised percentage of tuition and in exchange will receive the actual return on investment.

The colleges bear both the risks and the potential rewards from the investments. They also pay all the fees.

Coverdell accounts

Previously known as Education IRAs, Coverdell Education Savings Accounts are trusts created to pay the qualified education expenses of your child.

The contributions aren't tax-deductible, but they and their earnings can be withdrawn tax-free as long as they are used to pay eligible schooling costs.

You can open a Coverdell at a bank or investment firm that offers the accounts.

Generally, you can contribute up to \$2,000 per beneficiary per year. You can't invest in life insurance contracts, but otherwise, investment options are not as limited as those offered by 529 plans.

"The main drawback is that it's limited to \$2,000 in contributions from all sources per year, but you can invest in any equity offered by the sponsor of the plan," said Mr. Kantrowitz of FinAid.org.

The other drawback is that unless Congress acts, the contribution limit will drop from \$2,000 to \$500 on Dec. 31, 2010.

Also, the money must be used by the time the child reaches age 30 or the earnings will be taxed as ordinary income plus a 10 percent penalty.

Individual savings

You can save for college in a taxable account in your name.

You maintain control over the assets and have flexibility in choosing the investments, and you can use the money for another purpose if your child decides not to go to college. There are no limits on the amount you can invest.

However, your earnings are subject to income or capital gains taxes, unlike money in a 529 plan. So your after-tax return on investment may be lower.

"If you decide to invest in the parents' names, you should consider taking steps to minimize your taxes, such as investing in mutual funds that are managed to minimize the tax bite," Mr. Kantrowitz said.

Custodial accounts

A custodial account is an account established at a financial institution for the benefit of a minor child and managed by the parent or another designated custodian.

In Texas, a custodial account is established under the Texas Uniform Transfers to Minor Act.

The catch with a custodial account is that when the child turns 21, "it's the kid's money to do anything they want with it," said Alan Goldfarb, a certified financial planner at Weaver and Tidwell Financial Advisors Ltd. in Dallas.

Also, custodial accounts can reduce how much financial aid your child can get because they're considered assets of the child rather than assets of the parents.

IRAs

Retirement funds also may help you pay for college expenses. You can withdraw funds from your Individual Retirement Account without penalty to pay higher education expenses.

In a traditional IRA, you put in pretax money while you're working, and the principal and earnings are taxed when you withdraw them in retirement. With a Roth IRA, you put in after-tax money and are taxed later for only the investment-growth portion of your withdrawals.

Normally, if you withdraw money from a traditional or Roth IRA before you reach age 59 ½, you would pay a 10 percent early-withdrawal penalty on the funds, in addition to any regular income tax due.

"There is, however, an exception for distributions used to pay qualified higher education expenses," Mr. Kantrowitz said. "The portion of the distribution used for qualified higher education expenses is exempt from the 10 percent early-distribution penalty. You will still pay income tax on the portion of the distribution that would otherwise have been subject to income tax."

But remember this – when you take money from an IRA to pay for college, you're interrupting the tax-free compounding growth that makes them so valuable.

"The longer it lasts and the less it's disturbed, the better off you are," Mr. Goldfarb said. "Taking it out of the Roth would be the last resort."



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