A Guide to Saving and Investing for College

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Sending their children to college is a primary financial goal for millions of American families, but the challenge can be daunting.

The cost of a college education continues to rise with no end in sight. And with competing financial priorities like saving for retirement and perhaps also helping support aging parents, saving for college can seem like an impossible dream.

We've created this guide to help you devise a comprehensive college savings plan for your children. Inside, you'll find a detailed description of the most popular education savings vehicles available, as well as tips for reducing college costs and a hands-on worksheet to help you determine the amount of financial aid your child may qualify for.

If you have any questions about the material included in this guide, please feel free to contact us.

Saving for College: Still a Worthwhile Goal

The old saying that nothing in life is certain except death and taxes left out at least one certainty: the rising cost of a college education.

Even with general inflation relatively tame in recent years, college costs have continued to rise relentlessly, **soaring at an annualized rate about twice that of overall inflation**, or around six percent. As a result, the total cost of a single year of education (tuition and fees only) at a four-year, in-state public college now averages $7,020, up 6.5% from a year ago.

Does your child want to attend school out of state? If so, one year's tuition and fees at a four-year college will cost an average of $18,548, up 6.2%. How about a private school? Here, the average cost rises to $26,273, up 4.4%. At a public two-year college, the annual cost drops to $2,544, but this is up 7.3% from a year earlier.*

Statistics like these cause some parents to throw up their hands in frustration and wonder why even bother trying to save for their children's college educations. After all, between meeting current expenses, saving for retirement, and perhaps helping support aging parents, saving for college may seem like a relatively low priority. (See sidebar "The Sandwich Generation.")

But it's not hopeless. **The good news is that there are more options available today to help you** save and invest for college than ever before. These include Section 529 plans, Coverdell Education Savings Accounts, custodial accounts, and even Roth IRAs.

Despite the cost, obtaining a college degree is still a worthwhile goal. A recent study confirmed that college graduates do indeed earn more than those with just a high-school diploma: The median weekly wage for a college graduate with a bachelor's degree or higher is $978, but this drops by almost half for a high school graduate—to just $591.** In addition, the unemployment rate for those with at least a bachelor's degree was 4.7% in May 2010, **less than half the rate for the nation as a whole**.

The study revealed that the best college education value is derived from public schools attended by in-state students, which yielded a 9.7% average net annualized return on investment (ROI).*** Conversely, out-of-state public schools offered the least value, yielding an annualized net ROI of just 8.4%. The net annualized ROI for private schools was 9.1%.

The average amount of student loan debt among graduating seniors in 2008 was $23,200, the study reported. By devising a comprehensive education savings plan for your children as soon as possible, you can help ensure that the funds will be there to enable them to attend college when the time comes—and finish school without a crushing student loan debt that will saddle them financially for years after they graduate.

** Source: The College Board, Trends in College Pricing 2009*
*** Source: U.S. Department of Labor, Bureau of Labor Statistics 2008 Survey*
**** ROIs were calculated based on the total cost of college (including tuition and fees, room and board, and books and supplies) and the estimated median pay for that graduate plus four-to-six years to compensate for time spent in school.*

Creating a Comprehensive Education Savings Plan

The good news when it comes to saving for your children's college education is that there are more options available to help than ever before. Following is a detailed look at the most popular education savings vehicles available to families today:

Section 529 College Savings Plans

Named after the section of the Internal Revenue Code that created them in 1996, Section 529 college savings plans have become the college savings plan of choice for many American families. They are operated by states or educational institutions and come in two forms:

- *Prepaid tuition plans*—These lock in today's tuition costs for a future student, avoiding tuition increases that could come later. As long as the money stays in the plan, earnings accumulate on a tax-deferred basis, and distributions for tuition and other qualified expenses are tax-free.
- *Investment savings plans*—Similar to retirement savings plans like IRAs, these plans seek to provide market returns on contributions, as opposed to locking in a specified tuition cost. Contributions can be invested in stocks and stock mutual funds, which can potentially generate higher returns, but also bear more risk.

All states now offer at least one 529 plan to choose from. You can participate in plans outside of your state (although tax benefits may be minimized if you do) and your children can attend out-of-state colleges with 529 funds, both public and private. Potential state tax benefits should be considered as one of the factors in making an informed investment decision.

529 plans allow tax-deferred growth *and* tax-free distributions if funds are used for qualified education expenses. Contributions are not deductible at the federal level, but some states do allow deductions to offset state tax liability. There are no income or

THE SANDWICH GENERATION

A growing number of American families are finding themselves squeezed between multiple competing financial priorities.

Not only do they face the challenges of meeting everyday living expenses, but they're also trying to save for retirement, save for their children's college educations, and perhaps even help care for and support aging parents. **Such families have been dubbed the "sandwich generation."**

The Pew Research Center reports that **13% of Americans between the ages of 40 and 60 (or nearly one in eight) are raising a child while providing financial support to a parent.*** Given that an estimated 44% of all baby boomers have a child under 21 and at least one living parent, this number will likely rise in the future.

The key to dealing with these conflicting financial goals is to **set priorities and be prepared to make some sacrifices.** Perhaps you can scale down your expectations for the kind of college your children will attend—a public or community college instead of a private school, for example (see sidebar "College Cost Busters"). Or maybe you'll need to plan on working a few extra years before you retire, or scale back your retirement lifestyle expectations.

A common mistake in prioritizing is to let the most immediate concerns carry the most urgency. For many sandwich generation families, helping aging parents tops the list, followed by saving for college and then saving for retirement. Every situation is unique, but in general, **saving for retirement should come before saving for college.**

This is because there may be other avenues for financing college education, like scholarships, financial aid and student loans. **But there are no scholarships or financial aid for retirement**—you're pretty much on your own.

** Source: "From the Age of Aquarius to the Age of Responsibility", The Pew Research Center, December 2005.*

age restrictions and large amounts (as much as $300,000) can be contributed over time on behalf of each child.

It's important to note that the money in a Section 529 plan **must be used for educational purposes**. Otherwise, upon withdrawal earnings (but not contributions) are subject to taxes and a 10 percent penalty. Funds can be transferred from one child to another, which provides some flexibility if a child should decide not to go to college.

Also, because you as the donor maintain control of the plan, assets in the plan do not affect your child's eligibility for financial aid, or his or her ability to claim the HOPE Scholarship or Lifetime Learning Credits.

Coverdell Education Savings Accounts (ESAs)

These were originally established as Education IRAs, with an annual contribution limit of just $500. But in 2002, they were renamed Coverdell ESAs and the limit was raised to $2,000, **making them a more viable education savings tool**. In addition to college savings, Coverdell ESAs can be used to save for private elementary and secondary school expenses

Any family member or friend can contribute to a Coverdell ESA on behalf of your child. Contributions (non-deductible) are made to a specially designated investment trust account where, like those to Section 529 plans, **they grow tax-deferred and can be withdrawn tax-free** if used for qualified education expenses. Unlike 529 plans, however, the money doesn't have to be used for qualified educational expenses—it will eventually be distributed (with some portion taxed) to your child if he or she doesn't attend college, or receives scholarships and/or financial aid and doesn't need the money for qualified education expenses.

Coverdell ESA funds can be transferred from one child to another, which gives these accounts an added degree of flexibility. Keep in mind, however, that if the account is not fully withdrawn by the time the beneficiary reaches age 30, it will be subject to taxes and penalties. Contributions can no longer be made to the account once the beneficiary reaches age 18.

Many families use Coverdell ESAs in conjunction with Section 529 plans, contributing the first $2,000 each year to a Coverdell. Also, funds can be transferred from Coverdell ESAs to 529 plans.

Custodial Accounts

Before education savings accounts like 529 plans and Coverdell ESAs were introduced, custodial accounts were a common college savings vehicle. Also known as UGMAs and UTMAs (these acronyms stand for Uniform Gifts to Minors Act and Uniform Transfers to Minors Act), these are special accounts set up by parents and grandparents for the exclusive benefit of their children and grandchildren.

While custodial accounts don't offer tax-free growth and distributions like 529s and Coverdell ESAs, they do offer another tax benefit: **Most of the earnings are taxed at the child's rate, which is usually lower than the parents' or grandparents'**. There are no annual contribution limits, although contributions above $13,000 a year (or $26,000 if married filing jointly) to a child's custodial account may be subject to federal gift taxes.

A potential drawback to custodial accounts is the fact that the child will assume complete control of the funds when he or she reaches age 18 or 21 (depending on the state), and the money doesn't have to

CALCULATING COLLEGE COSTS

Savingforcollege.com, one of the most popular sites on the Internet for information on education financing, has created what it calls the "World's Simplest College Cost Calculator." Give it a try here:

http://www.savingforcollege.com/college-savings-calculator

be used for college. However, this flexibility could be a benefit if you and your child together decide against going to college, or the child receives scholarships and/or financial aid and doesn't need the money for college.

Roth Individual Retirement Accounts (IRAs)

While Roth IRAs are usually thought of as retirement savings tools, many families use them as potential college savings vehicles as well. **Their flexibility makes them a great option for killing two birds—both retirement and college—with one investing stone.**

Here's why: Contributions to Roth IRAs can be withdrawn prior to age 59½ **for any purpose you choose *without* tax or penalty**. This includes paying for private school, college or any other form of higher education. With this strategy, you could withdraw some or all of your Roth IRA principal for college and leave the earnings in the account for retirement.

With a Roth IRA, you receive no deduction for contributions, but all earnings are tax-free upon withdrawal. **So you save money on an after-tax basis with tax-deferred accumulation of earnings and tax-free withdrawals**. In 2010, you and your spouse can each contribute up to $5,000 (or $6,000 if you're age 50 or over) to separate Roth IRAs for yourselves.

Why is it so important to take advantage of tax breaks when saving for college? Simple: Every dollar you save in taxes is another dollar that's available to meet education expenses. If you have two investment options that earn the same gross amount, you'll always net more from the one that's tax advantaged.

COLLEGE COST BUSTERS

The cost of a college education may seem overwhelming, but there are some things you can do to help make college more affordable:

Stay close to home. Many students are more comfortable and perform better in the smaller setting of a community college during their first year or two. The curriculum is often very similar to (or virtually the same as) that at four-year schools, with the added benefit of smaller class sizes.

To obtain a degree from a particular school, it is generally only necessary to spend the final two years there. So your child may be able to start off at a less-expensive community college and earn an associates degree, and then transfer to a bigger "name" university, thus saving tens of thousands of dollars. You'll also save room and board if your child lives at home during this time, and you'll benefit from less-expensive in-state tuition.

Shop around. Obviously, there are extremely wide fluctuations in the cost of various colleges. Each year, publications like the *Fiske Guide to Colleges* release lists of their "best buy" universities—study them carefully to look for options that are more affordable while still delivering a quality education.

Investigate *all* your financial aid options. Sixty-three percent of undergraduate college students receive some kind of financial aid, whether in the form of a grant, scholarship or loan. There are numerous financial aid options that many parents aren't even aware of, or that they don't bother applying for because they don't think they'll qualify.

Don't leave any potential financial aid stone unturned. Complete a Free Application for Federal Student Aid (FAFSA), which you can find online at www.fafsa.ed.gov. Also look into Federal Pell Grants, the Leveraging Educational Assistance Partnership (LEAP) program, and the Federal Supplemental Educational Opportunity Grant (FSEOG).

Beat the scholarship bushes—hard. There's more scholarship money out there than most people realize, and not just for straight-A students. Check with social organizations like the Kiwanis and Rotary Clubs, as well as with your employer, union, and religious group. Scholarships sponsored by organizations like these are often poorly advertised, so there's less competition. Two good places to start are www.fastweb.com and www.collegequest.com.

Start early. It doesn't hurt to start researching scholarship and financial aid opportunities as early as your child's freshman year of high school. And keep looking even after your child has entered college—there are many scholarships available to students who are already in school.

Put your child on the "three-year plan." There's no rule stating that it has to take four years to earn a bachelor's degree. By taking summer classes and adding an extra course or two each semester, many students graduate college in three years, or even less. You and your child should be prepared, however, for the heavy workload and year-round education schedule this will entail

Comparing Your Options

Here's a handy side-by-side comparison of three of the main options available to help you save for your children's college educations:

YEAR 2010 RULES	529 Plan	Coverdell Education Savings Accounts	UGMA/UTMA
Federal Income Tax	Non-deductible contributions; withdrawn earnings excluded from income to extent of qualified higher education expenses	Non-deductible contributions; withdrawn earnings excluded from income to extent of qualified higher education expenses and qualified K-12 expenses before 2011 also excluded	Earnings and gains taxed to minor; first $950 of unearned income is tax exempt; unearned income over $1,900 for certain children through age 23 is taxed at parents rate
Federal Gift Tax Treatment	Contributions treated as completed gifts; apply $13,000 annual exclusion, or up to $65,000 with 5-year election	Contributions treated as completed gifts; apply $13,000 annual exclusion	Transfers treated as completed gift; apply $13,000 annual gift exclusion
Federal Estate Tax Treatment	Value removed from donor's gross estate; partial inclusion for death during a 5-year election period	Value removed from donor's gross estate	Value removed from donor's gross estate unless donor remains as custodian
Maximum Investment	Established by the program; many in excess of $300,000 per beneficiary	$2,000 per beneficiary per year combined from all sources	No limit
Qualified Expenses	Tuition, fees, books, supplies, equipment, computer technology and special needs; room and board for minimum half-time students	Tuition, fees, books, supplies, equipment, computer technology and special needs; room and board for minimum half-time students; additional categories of K-12 expenses	No restrictions
Able to Change Beneficiary	Yes, to another member of the beneficiary's family	Yes, to another member of the beneficiary's family	No; represents an irrevocable gift to the child
Time/Age Restrictions	None unless imposed by the program	Contributions before beneficiary reaches age 18; use of account by age 30	Custodianship terminates when minor reaches age established under state law (generally 18 or 21)
Income Restrictions	None	Ability to contribute phases out for incomes between $190,000 and $220,000 (joint filers) or $95,000 and $110,000 (single)	None
Federal Financial Aid	Counted as asset of parent if owner is parent or independent student	Counted as asset of parent if owner is parent or independent student	Counted as student's asset
Investments	Menu of investment strategies as developed by the program	Broad range of securities and certain other investments	As permitted under state laws
Use for Nonqualifying Expenses	Withdrawn earnings subject to federal tax and 10% penalty	Withdrawn earnings subject to federal tax and 10% penalty	Funds must be used for benefit of the minor

Source: www.savingforcollege.com

Financial Aid Basics

Since most undergraduate college students receive some kind of financial aid, it pays to know how colleges determine the amount of need-based aid students may receive. Most colleges base this on three criteria:

1. **The school's Cost of Attendance (or COA).** Federal guidelines dictate this calculation, which must be performed annually by every college.
2. **The Expected Family Contribution (or EFC).** The data you provide on your Free Application for Federal Student Aid (FAFSA) will be used by the federal government to determine how much money your family will be expected to contribute toward college education expenses. It considers both the student's and his or her parent's income and assets.
3. **Other student resources.** Examples include things like scholarships and tuition payments made directly to the school by grandparents or employers. These resources reduce the student's cost-of-attendance and, thus, the amount of need-based financial aid dollar-for-dollar.

The total amount of a student's EFC and other resources is subtracted from the annual COA to determine financial need. Consider the following example, and then you can plug your own numbers into the worksheet below to determine how much need-based financial aid your child might qualify for:

Annual Cost of Attendance (COA)		$12,000
Expected Family Contribution (EFC)		
From parents	$ 5,000	
From student	$ 2,000	
Total EFC		$ 7,000
Other Resources		$ 1,000
Student's Financial Need		**$ 4,000**

Your Child's Annual Cost of Attendance (COA)		$ _________
Your Expected Family Contribution (EFC)		
From your child	$ ________	
From you	$ ________	
Total EFC		$ _________
Other Resources		$ _________
Your Child's Financial Need		**$** _________

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