Money matters

College Savings Plans

As you make your financial plan for retirement, you'll have to make some tough decisions on priorities. For many parents, the most difficult decision is how to save for both the children's college fund and their own retirement fund.

While saving for your child's college education is important, it should not come at the expense of saving for your own retirement. Children whose parents cannot afford to pay all their college expenses can apply for financial aid. But the only financial aid for retirement is the money that you carefully put aside, month after month, during your working years. So before you put money into a college fund, be sure to make full contributions to your 401(k)s and IRAs.

The Cost of College

College is expensive, and it will cost more in the future. Tuition rates are rising faster than the general rate of inflation. A college that costs $25,000 a year today could cost nearly $250,000 for a four-year education 18 years from now.

Of course, you want your child to attend the college of his or her choice, which hopefully is the one that you also think is the best match. However, there are vast differences in the cost of attending public and private colleges, and even among the same types of colleges. The College Board estimates that tuition and fees at public colleges cost about one-fourth of those at private institutions. Public colleges also usually cost less for state residents than for out-of-state students.

Paying for College

There are many ways to pay for college. Some students will qualify for scholarships. Each scholarship has different eligibility requirements. For example, the Pell grants from the federal government are awarded based on the family's financial need. Other scholarships, offered by government or by colleges or other private sources, may be awarded based on academic achievement. Examples of these are federal Academic Competitiveness Grants awarded to first- and second-year students; and the National Science and Mathematics Access to Retain Talent (SMART) grants for third- and fourth-year students. To qualify for these two programs, the student must meet the financial criteria for receiving a Pell grant.

College students may also qualify for education loans. Former military personnel, they may qualify for the GI Bill to pursue their higher education. Federal college loans have lower interest rates than a regular personal loan. Working part time, enrolling in a work-study program and taking a job that offers tuition reimbursement are other ways to help pay higher education expenses.

Savings Options

To help your children with future education expenses, you could simply save through regular savings accounts or through mutual funds. However, a better approach is to use federal and state programs that offer tax breaks for college savings. Some of these options are specifically intended for college savings. Others, such as U.S. Savings Bonds, may be used for any purpose you choose but can be useful for education savings. Here are some useful tools for saving for college:

- **Coverdell Education Savings Accounts (ESA):** This account is similar to an IRA for retirement. If your income is less than $110,000 adjusted gross income for individuals and $220,000 for a couple filing taxes jointly, you may contribute up to $2,000 a year until your child's 18th birthday. The account may be set up at a bank, credit union, brokerage firm or other financial institution. You choose investments such as stocks or bonds, mutual funds or Certificates of Deposit.

AARP®

- You will not receive an income tax deduction for the contribution. However, when your child withdraws the money to pay education expenses, he or she will not have to pay taxes on it.
- **529 Savings Plans:** Each state offers a plan that you may set up through the state, a financial institution or an educational institution. The amount saved may be spent for higher education in the state where you have the account, or in another state. The amount you may contribute may reach up to about $300,000 over the years. You don't get a federal tax deduction for contributions, but the state may offer a tax deduction for them. There is no federal tax on the money when it's withdrawn to pay higher education expenses. Plans vary widely in the types of investments you may choose.
- **Custodial Accounts:** You can set up an account in which you direct all the investing, and receive a tax advantage on the earnings. These are the Uniform Gift to Minors Act (UGMA) and Uniform Transfer to Minors Act (UTMA) accounts. There are no contribution limits and the money may actually be used for expenses other than higher education. Income taxes are payable on account earnings. Some income will be reported in the child's tax return, usually at a lower rate. Other income will be reported on the adult's return.
- **U.S. Savings Bonds:** Bonds you buy from the U.S. Treasury are a very safe investment, may carry tax advantages, and can be cashed out to pay for college expenses. I Bonds and Treasury Inflation-Protected Securities (TIPS) help protect against inflation. They pay a fixed interest rate plus a variable interest rate. EE Bonds earn a fixed rate of interest.
- **IRAs:** In general, you should not use IRA savings for anything but your own retirement. In most cases, if you take money out before age 59 1/2, you must pay a penalty of 10 percent on the amount (as well as income tax, for a traditional IRA). However, the federal government allows you to avoid early-withdrawal penalties on both traditional and Roth IRAs if you use the money for certain higher education expenses.
- **Municipal Bonds:** Consider individual municipal bonds (not a fund) for college savings. You can target the maturity dates to the date when tuition payments are due. If the child does not go to college, the proceeds can be used for other purposes. Municipal bonds pay lower interest rates, but the interest is not subject to federal taxation and may not be subject to state income taxes.

Your To-Do List:

- [ ] **Contribute as much as possible into your own tax-advantaged retirement savings** before putting money into a child's college fund.
- [ ] **Use the college tuition calculator** at savingforcollege.com to estimate college costs based on your child's current age, and what your monthly savings should be to get there.
- [ ] **Search for a low-cost provider for Coverdell ESAs** and compare 529 plans at savingforcollege.com.
- [ ] **Research financial aid options at finaid.org.**
- [ ] **Purchase savings bonds** at most financial institutions or directly through the U.S. Treasury at treasurydirect.gov.
- [ ] **Check on the latest rates for series EE and I Savings Bonds** on treasurydirect.gov.
- [ ] **Analyze 529 plan expenses** at the Financial Industry Regulatory Authority (FINRA), www.finra.org/investors/index.htm.
- [ ] **Check out Tax Benefits for Education** IRS publication 970 at www.irs.gov.

Special thanks to The Actuarial Foundation for their expertise on this project.