

21. Educational Expenses: Planning for College

A college education may be the most important gift you will ever give your child. While college is not a guarantee of financial success for your child, it certainly provides an important start. And the nonfinancial rewards of education, including personal and intellectual growth, are important as well.

But a college education, which historically has been affordable to middle-class Americans, is quickly becoming the province of the well-to-do. Annual inflation in college tuition over the past several years has often been in excess of increase in the consumer price index. Although future increases may not continue to outpace inflation, it's a sure bet that college costs are not going to go down.

Clearly, paying for these expenses calls for a significant financial commitment. It is unlikely that you will be able to fund them at the time from income alone. But you have the opportunity as a parent to make this commitment a little less painful by planning (and saving) in advance how you will pay for your child's education when the time comes. Fortunately, it takes about 18 years to "grow" a college student.

If Your Child Is Young

If your child is presently young, the best way to begin planning for his or her education is to start a college savings program. By putting away some amount on a regular basis (ideally monthly), you will begin building a fund that can be used to pay for college when the time comes. Even a small amount, \$25 or \$50 per month, put away regularly can accumulate to a helpful sum in the future. The key is to make sure that you save consistently and that you invest the savings so that the investment earnings will add a significant amount for college.

The benefits of a consistent savings and investment program for college are significant. If you save \$50 per month, and earn 5% after taxes on the investment, over 15 years you will have accumulated \$13,364. Save \$150 a month and you will have \$40,092.

Improving Investment Performance

If you can improve your investment performance, the results are even better. If you save \$50 per month at 7% after taxes for 15 years, you will accumulate \$15,848.

If you started young, say when your child was three, and had 15 years to save, you would have \$2,484 more accumulated at 7% than at 5%. That's roughly 75% of a year's tuition at many state schools.

Tax deferred investments can also increase earnings because current income is fully available for reinvestment. Examples of such investments are U.S. savings bonds and tax deferred annuities.

Many parents also choose to invest a portion of educational funds in mutual stock funds for greater principal growth and lower current income return, where there is at least 10 years or more before the child reaches college. Although lower participation limits have made these investments more practical, it should be remembered that stocks are by nature longer-term investments and are subject to fluctuation in value. They are, therefore, generally not appropriate for short term requirements.

Reducing the Tax Rate

The easiest way to improve your after-tax investment performance is to reduce the tax impact on the earnings. Consider taking advantage of the new Education IRAs. These allow you to save \$500 annually per child and the earnings grow tax-free to pay for qualified higher-education expenses.

Another method is to take advantage of your child's lower tax bracket. Here's how it works. As a result of the 1986 Tax Reform Act, unearned income for children under 14 is taxed at the parents' highest tax rate. However, there is an important exception. Each child may have up to \$1,300 of unearned income taxed at his or her own rate. Of this amount the first \$650 is completely free of tax; the second \$650 is taxed at 15%. On a combined basis the child's tax rate on this \$1,300 of earnings is a very low rate of only 7.5%.

This lower rate can really increase your after-tax investment results. An investment in a certificate of deposit earning 7% yields only 5.04% if it is taxed at your 28% bracket. But if it can be taxed at the child's rate of 7.5% the yield jumps to 5.95%.

To take advantage of this exception just be certain that all college savings are held in the child's name up to the point where the savings are yielding \$1,300 per year in unearned income. You will greatly increase your child's college fund without having to save an extra dime.

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If Your Child Is Older

For a child nearing college, a consistent savings program, while still important, may not be enough. Other avenues may need to be explored. Several alternatives should be considered.

Encourage your child to work and save his or her own money. Some parents insist that the child put at least 50% of earnings away for college. If you own your own business, you may be able to put the child to work for you and pay him or her a fully deductible salary.

Obtain a scholarship or other financial aid. For most middle or upper income families it is virtually impossible to qualify for such programs. Even student loans are very difficult to obtain. Don't count on them as part of your plan to fund college. However, it always makes sense to apply. You may get lucky. And if your child has a special talent or sports aptitude your chances are improved.

Find other financing sources. Some creative thinking may help you to find financing sources that are less expensive. If you have accumulated pension funds or life insurance cash values you may be able to borrow against those at an advantageous rate. If you use your home as collateral you may be able to deduct the interest on a home equity loan. If you have elderly relatives with cash investments you may be able to borrow from them and pay them a better return than they could hope to get at the bank, but still pay a substantially lower interest rate than on a loan from a commercial lender.

The crucial thing is to begin planning and considering alternatives as soon as possible. While it is never really too late to plan for college, the sooner you begin planning (and saving) the better

2001 Tax Act

The 2001 Tax Act expanded the tax-favored opportunities to save for you child's future education needs.

1 Education IRAs

- Annual contributions increased to \$2,000 per beneficiary. The contribution period is extended from December 31 to April 15 of the following year for individual taxpayers.
- For married couples filing jointly, the phase-out range has been increased to \$190,000-220,000.
- Contributions for special needs beneficiaries have been extended past age 18.
- The definition of qualified education expenses is expanded to include qualified elementary and high school expenses, tuition/fees, special needs services, and extended day programs.

2 Section 529 College Savings Plans

- Offer tax-favored method of saving for higher education. A wide range of options are available.
- All provisions that apply to state plans now apply to prepaid tuition programs established by public or private eligible educational institutions.
- All distributions from qualified 529 plans are excluded from gross income

to the extent they are used to pay for qualified higher expenses, even if the taxpayer claims a HOPE credit or lifetime learning credit in the same year after December 31, 2003.

- Definition of family members expanded for tax-free rollovers.
- Special gift tax provisions apply

3 Deduction for Education Expense

- The new law allows qualified taxpayers to deduct some higher education expenses during a taxable year.

The above options offer favorable tax benefits in planning for college, but are complex, and tax advisors should be consulted.