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3 WAYS TO SAVE FOR YOUR CHILD'S COLLEGE EDUCATION

by Michael Evans on March 16, 2012 with 5 comments

If you plan to one day send your child to college, it is best to have a good investment strategy and start saving early. According to the National Center for Education Statistics, the average annual cost of a college education at a public institution rose from $5,881 in 1980, to more than $12,000 during the 2009 to 2010 school year. A private education comes with a more dramatic sticker price, averaging nearly $32,000 during the 2009 to 2010 academic year.

Only a limited number of investment vehicles offer savings options specifically for education costs. 529 plans enable you to pre-purchase tuition at today's rates or invest funds for tax-free use when your child goes off to college. However, 529 plans vary from state to state and pre-purchase tuition plans are only available in a few states. You can get a Coverdell Student Investment Account in all states, but there are strict limits on how much you can contribute.

You may also consider saving for college by opening a custodial account or Roth IRA, or by creating your own individualized investment strategy. Roth IRAs allow you to make tax-free withdrawals, as long as you use funds for qualified college expenses, without early-distribution penalties. You can use a custodial account to assign assets to children or grandchildren, while allowing them to choose how they use your contributions. If you have experience as an investor, you may want to gain full control of your money by opening an investment account dedicated solely to your child's future college costs.

> CERTAIN PLANS MAY REDUCE YOUR STUDENT'S ABILITY TO QUALIFY FOR FINANCIAL AID.

Choosing a college savings strategy ultimately comes down to your own needs and goals. While certain plans have no effect on your child's ability to qualify for student financial aid, others may cause a reduction in awards from need-based programs such as the Pell Grant. Taxation issues can vary widely, depending on the type of plan you choose. Certain plans offer tax-free distributions, but others tax withdrawals at regular income rates.

Before choosing a college savings plan, it is best to do your research. Determine what options are available in your state, or through a particular educational institution. If you do not have investing experience, a financial professional can help you decide what type of college savings plan is the right fit.

1) 529 QUALIFIED TUITION PLANS

States, colleges and universities sponsor 529 plans. Also referred to as "qualified tuition plans", 529 plans are offered in all states. Students can use 529 plans at any accredited United States college, vocational school or university, as well as certain universities outside of the United States. In addition to offering a structured financial vehicle to help save for college, 529 plans also feature tax advantages.

The 529 program offers two types of plans, called college savings plans and pre-paid tuition plans. As of January 2012, you can enroll in a pre-paid tuition plan in only 12 states. Educational institutions, public and private, and state governments sponsor prepaid tuition plans. With a pre-paid tuition plan a parent or grandparent can buy future class credits or units at today's tuition rates. However, the plan beneficiary must attend a participating college or university. Once the student begins school, the program pays his tuition at the pre-paid rate. Pre-paid plans typically allow the account owner to purchase future tuition in a lump-sum payment or by making installment payments. State governments often guarantee pre-paid tuition plan investments, but residency requirements may apply.

529 savings plans, administered only by states, enable an account owner to save money for a beneficiary's future college expenses, while earning a return on the invested funds. All states and the District of Columbia sponsor 529 savings plans, which typically limit total contributions to between $100,000 and $305,000. 529 savings plans vary from state to state and offer differing investment options, including plans based on stock and bond funds and plans with guaranteed minimum rates of return.
Earnings from 529 plans are usually tax-exempt, if you use the money to pay for certain qualified college expenses. Qualified expenses include basic college expenses, such as room and board, textbooks, tuition and school fees. During the 2010 tax year, the IRS also allowed 529 savings to be used tax-free for computer equipment purchases and Internet connection fees, as long as the student incurred the expenses while enrolled in an eligible school. The IRS does not allow you to take a deduction for contributions to 529 plans.

State tax laws regarding 529 plans vary and are subject to change yearly. For instance, Arkansas enables taxpayers to take a tax deduction for contributions made to its Gift College Investing Plan, and Arizona allows tax deductions for those contributing to its InvestEd 529 program. However, California does not offer tax deductions for participants of its ScholarShare College Savings Plan.

2) COVERDELL EDUCATION SAVINGS ACCOUNTS

Coverdell Education Savings Accounts are not tied to a specific educational institution or state. You can open a Coverdell ESA at a bank, or with a stockbroker or mutual fund company, but only for children under 18 years of age or a person with qualified special needs.

Coverdell ESAs enable account owners to choose how funds are invested, which can include cash equivalents, mutual funds, stocks or bonds. Once established, you can transfer a Coverdell ESA to a different mutual fund or brokerage, but you may incur penalties and fees.

> HE COVERDELL PROGRAM ONLY ALLOWS CONTRIBUTIONS UP TO A MAXIMUM OF $2,000 PER YEAR.

Coverdell ESAs limit the amount of money you can save. The Coverdell program only allows contributions up to a maximum of $2,000 per year per beneficiary. While parents and grandparents can open separate Coverdell ESAs for a single beneficiary, maximum contributions to all accounts cannot exceed $2,000. Anyone can open a Coverdell ESA for a beneficiary, even non-family members, and more than one person can make contributions to an account.

While 529 plans only allow you to save for college or university expenses, the Coverdell program allows a beneficiary to use funds to pay education costs for primary or secondary school, at public or private institutions. When applying for federal financial aid, Coverdell ESAs are not considered an asset of the beneficiary, as long as another person owns the account, which can enable a student to qualify for higher federal financial aid awards. However, if parents own a Coverdell ESA for their child, the account does count as a parental asset.

The IRS does not offer a tax deduction for Coverdell ESA contributions, but invested funds can grow tax-free. Beneficiaries can use distributions tax-free for qualified education expenses, including tuition, room and board, school fees and supplies. This applies to students attending elementary or secondary school, a college or university, a vocational school or a special needs institution. However, if distributions exceed actual qualified education costs, a portion of the distribution becomes taxable at a rate of 10 percent.

A beneficiary can only receive tax-free distributions until the age of 30. After a beneficiary reaches 30 years of age, all remaining funds must be distributed and become taxable at rate of 10 percent. Beneficiaries can often avoid this tax by rolling over remaining funds into another Coverdell ESA for a different beneficiary.

3) ROTH IRAS

Students, parents and grandparents can save for college expenses with a Roth IRA. You can use funds from your own Roth IRA to pay for your child's college expenses, or open a Roth for your child in her own name after she starts earning her own income. Sold by private financial institutions, Roth IRAs have annual contribution limits, based on the account owner's tax filing status and income level, typically ranging from $5,000 to $6,000. Investments contained in a Roth IRA can include mutual funds, stocks and bonds, certificates of deposit, or even real estate, depending on the rules of the Roth IRA provider.

To qualify for a Roth IRA, you must have a taxable income less than $179,000 if you are married and file taxes with your spouse. If you are single, the head of your household or married but file your taxes separately, the limit is $122,000. Married people who live with a spouse, but are not head of the household, must earn less than $10,000 per year to open a Roth IRA.

> YOU CAN TAKE OUT ANY OR ALL OF THE MONEY YOU PUT INTO A ROTH IRA AT ANYTIME WITHOUT A PENALTY.

Typically, you must wait until you reach age fifty-nine and one-half before withdrawing funds from a Roth IRA. Otherwise you face a 10 percent early-distribution penalty. However, you can take penalty-free withdrawals from your Roth contributions at any time. This means that you can take out any or all of the money you put into a Roth IRA at anytime without a penalty. Additionally, the IRS allows early, penalty-free Roth withdrawals (including withdraw of any interest earned) to pay for qualified education expenses, such as tuition, school fees, room and board and textbooks. You can only utilize this exemption to pay your own education expenses, or those of a spouse, child or grandchild.

Note that if you roll over a traditional IRA into a Roth, you will have to wait 5 years to make withdrawals and you must pay income taxes on the rollover funds.

Using a Roth IRA as a college savings account has advantages and disadvantages. If you already own a Roth for retirement, you can use the same account to save for your child's education. Roth IRAs do not interfere with receiving need-based financial aid because student aid administrators do not consider Roth accounts in their needs analysis. However, funds received from a Roth IRA are considered income, which can affect need-based student aid renewals in subsequent years. Also, you can only use penalty-free Roth distributions during the year expenses are incurred. For instance, you cannot withdraw funds in September to pay for upcoming tuition expenses the following January.

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comments

BRANDON45 *March 19, 2012 at 12:13 pm*

You can take money out of a roth ira without a penalty? I've been hesitant to maximize my contributions, but if that's the case, I guess you should always maximize contributions.

OASIX *March 19, 2012 at 12:39 pm*

Great info, thanks! Brandon, I just talked to somebody from Northwestern Mutual last week who said that you could withdraw principle from a Roth anytime, so it is indeed the case.

CLARABELLE *April 13, 2012 at 11:17 am*

529 tuition plans seem like a great idea. On top of earmarking the money for your kids' tuition, you can also get tax savings too.

ZENINVESTING *April 16, 2012 at 6:42 pm*

Had looked at Coverdell ESA and I wasn't really impressed by it. Unless you start really early, $2,000 a year won't really be enough!

NURSINGGRADUATE *April 29, 2012 at 3:45 pm*

Which one would you recommend? Or would you recommend having all three or a combination of these?

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