

College or Bust – Part 1

By Laif Meidell – American Retirement Planners

www.FinancialHealth.com

Published July of 2004 in the Sparks Tribune, Sparks, NV

Summer is officially here, and while some families are getting ready to ship their kids off to college, the rest of us are recognizing and possibly agonizing, that that fateful day is one year closer. Due to the complexity of most jobs from computer engineer to auto mechanic, most people would agree that farther education after high school is practically a necessity for a stable career. Whether your child decides to pursue the standard college education or a technical education, the big question for most parents is how to financially plan for it.

This week we will focus on the features of 529 plans and identify the two different types of plans, but spend most of your time discussing the College Savings Plan. Next week we will cover the other types of 529 plans, namely the Prepaid Tuition Plan, along with other remaining options such as the Coverdell Education Savings account, savings bonds, and the Uniform Trust to Minors Act. or UTMA, accounts.

According to The College Board, in 2003 the average cost for a year of education including tuition and fees, room and board (TFRB) at a public college was \$10,636, up 9.8% from the year prior. For a private college, the average cost for TFRB in the same year was \$26,854, up 5.7% from 2002. With costs increasing at these rates, it means that parents either have to save more or target investment returns that will meet, if not exceed, your expectations of college costs.

According to Michael S. Lee a shareholder in the Chicago, IL law firm Schuyler, Roche and Zwirner. Section 529 of the Internal Revenue Code has made qualified tuition programs possible since 1998. As you probably know, Section 529 permits two types of plans; College Savings Plans and Prepaid Tuition Plans.

In a College Savings Account, the owner contributes money to the plan, which is then invested in some kind of savings vehicle, typically mutual funds, which are managed by a manager or a group of managers. You will find that today, many of the major fund families have partnered up with at least one state to offer a 529 College Savings Plan. Further, since most College Savings Plans allow you to invest across state lines, if you don't like the plan in your home state, you are allowed to look elsewhere and possibly work with the fund family that you trust. Therefore, the account owner can select from a variety of different plans from different states, with different investment styles and options to choose from. Any earnings on the account grow tax free, but in some states may be subject to state income tax. If the money is used for qualified higher education expenses, there is no income tax paid on the distributions. As we will discuss later, beginning in 2002, a 10% penalty will be imposed on earnings of non-qualified distributions.

Under the definition provided by the Internal Revenue Code, a qualified higher education expense includes those expenses paid for tuition, books, supplies, equipment, as well as, room and board. Mr. Tee states that to be eligible for room and board the student must be at least half time (as opposed to being a full time student) and the actual expenses must not exceed the allowance described in the Higher Education Act of 1965 or the actual amount paid to the school. If you want to have a part in how your contribution to the 529 Plan account is invested, then the College Savings Account could probably be an attractive option.

In the past couple of years 529 plans have grown in popularity as an investment vehicle for education savings. Some of the reasons for their broad appeal are that anyone who is a U.S. civilian or a legal U.S. resident can open one for a designated beneficiary and there are no restrictions on who can be the beneficiary or account owner. Basically they are open to anyone of any age. The owner of the plan can change the beneficiary of (he dollars, so if one child decides not to attend college but a sibling does, the money can be redirected to the next child. One of the most attractive features of the 529 plans is the lock-in of today's prices in the case of a prepaid tuition plan,¹ or the potential tax-free growth combined with tax-

free qualified distribution of dollars in the 529-plan savings account.

Finally, contributions to the a 529 plan are treated as completed gifts, despite the account owner retaining rights that would in any other instance not constitute a completed gift or otherwise create an estate tax problem. With each parent giving the maximum exclusion allowance of \$1,000 per year to a given child, they could deposit in the account \$22,000 annually. Alternatively, each parent can accelerate up to five years' worth of annual exclusions by contributing up to \$55,000 (\$110,000 for married couples) in one calendar year. If you choose to accelerate your option, you must remember that additional contributions or other gifts to the same beneficiary during that calendar year and the next four calendar years will exceed the annual gift tax exclusion. Furthermore, under this option if the contributor dies before the proper numbers of years have passed, a portion of the gift comes back in the contributor's estate.

With all the advantages of 529 plans here are some of the drawbacks you need to consider. As stated by Mr. Lee, one of such drawbacks is that there are two types of penalties that can be imposed. Penalties imposed by the Internal Revenue Code and penalties imposed by the Plan itself. For those imposed by the Code, if the distribution is used by the beneficiary for other than a qualified education expense, the income portion is taxed at the beneficiary's bracket as ordinary income. Additionally, a 10% penalty is assessed on the income portion of any distribution in excess of the qualified higher education expense.

For example, let's suppose that you are the account owner, the account is worth \$40,000 and you have contributed to the account \$30,000 over the years. If you take \$10,000 out of the account to pay for something that does not qualify for higher education expenses, like a car for your daughter, then one fourth of the \$10,000 distribution (\$2,500) could be subject to a 10% penalty (\$250). Your daughter may also be taxed on the \$2,500 of income on her income taxes since it wasn't used for qualified higher education expenses. Remember, plans can also assess a penalty or charge a fee. According to Mr. Lee, the

¹ Under prepaid-tuition plans you can pay now, at today's tuition rates, to cover tuition costs further down the line. Under this arrangement, you may have a restricted choice of schools to choose from

State of Florida imposes a penalty of 100% of the income, so that only the initial contribution into the plan is refundable (you lose all of your investment gains).

The penalty is not assessed if you terminate the account because of the beneficiary has died or is disabled, or if you withdraw funds not needed for college because the beneficiary has received a scholarship. If you find that the funds are not needed for the intended beneficiary, you are allowed to change the beneficiary to another qualifying member. To qualify as a "Member of (the Family)" the new beneficiary must be a member of the prior beneficiaries' immediate family. Each plan may have different rules, so please consult with your financial advisor and refer to the Plan's prospectus for detailed information.

You should be aware that saving for college might impact financial aid. In fact, any investments or savings can affect federal financial aid eligibility. The impact on financial aid varies depending on whether the savings belong to the parent or the child. Now, savings in a parent's name can reduce federal financial aid eligibility by at most 6%. But assets saved in the child's name can reduce aid eligibility by 35%. Pre-paid tuition plans like those we are about to discuss next week may have even a greater impact on federal financial aid. Every dollar saved in a pre-paid tuition plan can reduce a family's federal financial aid need by a dollar. So, if you save \$10,000 in a pre-paid tuition plan, you will be considered as needing \$10,000 less in financial aid. States and private colleges may have their own rules for financial aid, and some states give more favorable treatment to pre-paid tuition plans than other college savings options.

As we continue next week, you will see that each option has its weaknesses and strengths. The trick will be deciding which one is best for you and the child you are trying to help. In reaching your goal, sometimes the best solution is a combination of the various options. With some research and possibly the help of an advisor, you can put together a plan that is best for you.

Investors should carefully consider the investment objectives, risks, charges and expenses of the 529 College Savings Plan that is being considered. This and other important information are contained in the prospectuses and/or brochures that contain product descriptions, which can be obtained from your financial adviser and should be read carefully before investing. Further, please consult with your tax advisor/accountant to obtain detailed information regarding the tax ramifications of this product.